A GROWTH STUDY OF THE CANADIAN MUTUAL FUND INDUSTRY

by

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ABSTRACT

The Canadian mutual fund industry has been well recognized as being the fastest growing financial intermediary in Canada. An examination of this industry as a financial intermediary and the reasons behind its rapid growth represents the fundamental purpose of this theses.

This examination encompasses a brief study of the Canadian capital market and of the financial intermediaries operating in this market. It also confirms the growth position of the Canadian mutual fund industry relative to other major financial institutions. The Canadian mutual fund industry is then more fully discussed to provide the reader with a basic understanding of what mutual funds are, how they are organized, their growth, how they differ from other financial institutions, what relationships they have to other financial institutions, what benefits or financial services they provide and finally, how they are sold. This background information provides insight into the attractiveness of the mutual fund package and the effective means by which it has been sold. Once this insight is attained, it is possible to analyze the factors that have created public interest in the mutual fund package.

A projection of the future growth of the industry is then attempted based on social and technological changes expected to favour the mutual fund form of investment and specific industry innovations geared to creating new demands for an expanding range of financial services.

Many interesting conclusions are reached as a result of this growth study of the Canadian mutual fund industry. Firstly, it is concluded that the pooling of savings in a single diversified portfolio combined with professional management, marketability, accumulation plans, administrative features, dollar-cost averaging, variety of mutual funds and withdrawal rights, when combined, form a very attractive investment package offered by mutual funds to potential investors. At the same time, the industry has been remarkably successful in developing channels of distribution through which the mutual fund package has been sold to the Canadian public on a national basis.

Secondly, it is concluded that certain environmental factors have stimulated tremendous public interest in mutual funds; hence causing the industry's rapid asset growth from 1957 to 1968. These environmental factors are the growth in personal net savings, a development of financial sophistication by Canadian savers and a marked public preference to save through specific financial institutions. An analysis of each one of these factors reveals developments which have enabled the Canadian mutual fund industry to expand its assets.

The growth in personal net savings, for instance has been accompanied by a desire for higher rates of return as a means of inflation protection. The traditional approach for such protection has been to invest in equities of growth corporations. Mutual funds have represented an attractive vehicle for equity participation by investors who also desire professional investment management. A development of financial sophistication by Canadian savers has been revealed by their demand for investments in which risks are large but where potential rewards are great. In addition, they have demanded a broader range of financial services. Mutual funds and other financial institutions which have altered their package offering to include an increased amount of investment counselling and investment management have benefited in terms of growth. The growing tendency toward indirect investment through financial institutions is somewhat difficult to understand, especially when increasing financial sophistication assumes that individuals progress from indirect to direct investment. The explanation for this inconsistent trend is based upon three problems in the Canadian financial community. First, the class structure has had a limiting effect on the amount of common stock available to middle class investors as large holdings become consolidated in the hands of the wealthy.

Second, there is a shortage in the supply of equities becoming available in relation to an expanding demand for equities. Third, brokerage firms in Canada and the United States have begun to show a reluctance to service small investment accounts. As a result of these three problems, the small investor has gradually altered his investment strategy by participating in the equities markets indirectly through mutual funds and other financial institutions offering similiar opportunities.

The third and final conclusion reached in this study is that the Canadian mutual fund industry will continue to maintain its relative growth position in the immediate future. An examination of expected social and technological changes reveals that the mutual fund concept of investing will gain wider public acceptance. In terms of innovations, this industry has made tremendous strides which should enhance its future expansion. The formation of mutual fund complexes, financial complexes and venture funds represent three such innovations. All three will enable the industry to provide potential investors with an integrated line of financial services and to spread operating costs over a wider range of activities.

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CHAPTER I

INTRODUCTION

This is a paper about the Canadian mutual fund industry as one of the many financial intermediaries operating in the Canadian capital market. The primary purpose herein will be to examine this industry as a financial intermediary and attempt to isolate the reasons for its rapid growth since 1957. In addition, a prediction will be made about the future growth of the industry based upon trends developing in the financial community through social and technological changes and financial innovations.

I. IMPORTANCE OF THE STUDY

It is the writer's hope that this study will inspire students of finance to examine other Canadian financial intermediaries from the same viewpoint. Because of the contribution financial intermediaries have made toward the economic development of Canada, a clear understanding of the role played by these intermediaries in the capital market should be sought by all members of the business community. The importance of this understanding becomes clear when we think in terms of the economic development that has taken place in Canada and the outlook for continuing development in the future.

It is often expressed that Canada is a land of opportunity. This is so because of the seemingly endless quantity of natural resources, the intelligence of the Canadian people in recognizing the uses for these resources, the technology available for developing useful products from natural resources and the capital to finance the exploration and exploitation of these resources. Obviously, this list could be expanded upon, but will suffice to indicate some of the reasons for Canadian economic development in the past and the potential for continued development in the future.

Economic development would not, however, have taken place without an expanded use of money and credit. In very primitive societies economic development is held back because of the limited methods one group can utilize in paying for goods and services they desire from another group. In some cases credit may be extended which involves claims entitling the holder to receive payment from the issuer according to specified terms. In a primitive society these claims may pass directly from one group requiring funds to another group with surplus funds. As a nation begins to develop past the primitive stage, economic growth is accompanied by the development of a capital market. In simple terms, the capital market itself is a market where intermediate and long-term funds are gathered and made available to the users of capital, and where instruments that are already outstanding are transferred.

The process of gathering, altering and transferring of funds and instruments are performed by institutions commonly referred to as financial intermediaries. The financing of any large undertaking is facilitated by a capital market and the institutional machinery to back it up. It has been the existence of the capital market and the financial intermediaries operating in this market that have assisted in making economic development possible in Canada.

II. METHODOLOGY

The above digression from the purpose of this paper was necessary to assist the reader in appreciating the importance of a study of financial intermediaries. An extensive study of all financial intermediaries would be an undertaking of significant importance; however, a somewhat ambitious task for one individual to accomplish with any degree of success. For this reason the writer decided to limit this study to one financial intermediary. Nevertheless, a study of one intermediary requires that the reader have some background information on what the capital market is, what financial intermediaries are, the role they play in the capital market and how they have fared in terms of growth and development. Because of the necessity for such information, this study will begin with a simple discussion of the growth and development of Canadian financial intermediaries which will serve the dual purpose of explaining the function of financial intermediaries, and where the Canadian mutual fund industry stands in relation to other major financial intermediaries. Then in the balance of the study we will be concentrating on the Canadian mutual fund industry.

There are three reasons why the writer decided to write about the past and future growth of the Canadian mutual fund industry. Firstly, this intermediary has grown more rapidly since 1957 than any other major financial intermediary. Secondly, it is the writer's prediction that this industry will continue to maintain its growth relative to other financial intermediaries for several years. Thirdly, the writer has developed an appreciation of many of the operational aspects of this industry by serving as the research co-ordinator on The Canadian Committee on Mutual Funds and Investment Contracts.[1]

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1 Appendix A., contains a description of the formation and responsibilities of The Canadian Committee on Mutual Funds and Investment Contracts. The reader is encouraged to read this description before proceeding into the text of the study.

III. ORGANIZATION OF CHAPTERS

The study has been organized to provide a logical sequence of relationships necessary to accomplish the purpose of the thesis. Following this chapter, there are four chapters containing the body of the thesis plus a final chapter representing the summary and conclusions.

Chapter II begins by providing a brief review of the growth and development of Canadian financial intermediaries. Initially it will provide a definition of the term "capital market", and then proceed into a discussion of the role played by financial intermediaries in the capital market. Once this task has been accomplished, it will be possible to discuss the development of financial intermediaries in terms of their date of appearance and growth in assets from 1957 to 1968. A glimpse at the growth in assets of the nine major Canadian financial intermediaries should confirm the growth leadership of the Canadian mutual fund industry.

The Canadian mutual fund industry as a financial intermediary is the topic under consideration in Chapter III. Primarily the chapter is included to provide the reader with a basic understanding of what mutual funds are, how they are organized, how the industry has grown in size, how mutual funds differ from other financial institutions, what relationships they have to other financial institutions, what benefits or financial services they provide and finally how they are sold to the public. In short, the main function of the chapter is to show the attractiveness of the mutual fund product, and the ability of the industry to distribute its product to the public. An attractive product and efficient distribution facilities would certainly represent two reasons for the impressive growth of this industry. A third reason, and possibly the most important, is the acceptance of this product by the public.

Chapter IV will be devoted to an analysis of the factors that have created public preference for the instruments and services offered by the mutual fund industry over those offered by other financial intermediaries. Three factors will be mentioned as having had a major influence upon the public's attitude towards mutual funds as a form of equity investment. The first factor discussed will be the growth of personal net savings combined with a growing concern by savers to be protected against the harmful effects of inflation. It will be shown that historically investors have found some measure of protection by investing in corporate equities. The ability of the mutual fund industry to offer indirect participation in the equities markets may give some clue to its rapid growth.

The development of financial sophistication by Canadian savers will be cited as a second factor. It will be shown that Canadians are very aggressive investors in terms of seeking higher rates of return and the assumption of risk associated with higher returns. It will also be shown that Canadian investors have been moving up the scale of financial sophistication for some time. The implications this might have for the mutual fund industry is that as financial sophistication develops, investors seek out intermediaries that can offer a greater amount of investment counselling and investment management; mutual funds are renown for such services.

The third factor to be suggested as creating public interest in mutual funds is the trend in Canada towards indirect equity investment through financial intermediaries. This trend is the result of three major problems in the financial community which have discouraged direct participation by investors in the equities markets. The class structure of investors in the stock market, the supply of and demand for Canadian equities and the attitude of the financial community toward the small investor are the three problems which merit discussion.

In Chapter V, the mutual fund industry is considered in light of its prospects for future growth and development. This will be attempted by citing some of the factors that will continue to enhance the growth of the industry.

These factors will be of a social and technological nature, and will favour the mutual fund industry because of parallel developments taking place within the industry. Growth within the industry itself will favour some organizations more than others. A prediction is made that the innovators within the industry will benefit most through the rewards they will receive for creating new demands. Three recent innovations to be mentioned are the formation of financial complexes, improved financial counselling and the development of venture funds. Basically, the overall theme of the chapter is to look at the potential of the mutual fund industry in light of new demands which will develop for financial services, and the innovations that may create new demands.

Chapter VI, is the final chapter and contains a summary and major conclusions of the study.

IV. LIMITATIONS OF THE STUDY

It was emphasized earlier in this chapter that this is primarily a study about the growth of the Canadian mutual fund industry. Thus, this paper should in no way be considered as an exhaustive study of mutual funds. Although specific information is provided about the industry in Chapter III, this material has mainly been included for the purpose of providing the reader with background information relevant to the analysis of growth discussed in later chapters. It is important for the reader to appreciate that the main purpose of this study is to isolate the reasons which have enabled the Canadian mutual fund industry to increase its assets at a rapid pace since 1957. Further, to examine the factors which will assist the mutual fund industry to maintain its relative growth position in the future.

A comprehensive study of the mutual fund industry would be a monumental task. Fortunately, individuals interested in the many facets of this industry will have an opportunity to examine its operations in detail when the report of The Canadian Committee on Mutual Funds and Investment Contracts is published in December 1969. A considerable portion of the statistical information included in this Committee's report was prepared by the writer and could have been included in this paper. To a very limited extent some of this statistical information has been incorporated; however, it was the feeling of the writer that duplication of information would serve no worthwhile purpose. It is, therefore, the hope of the writer that a small contribution to the body of knowledge of the mutual fund industry will be provided by this thesis in as much as the topic of growth is not covered in detail in the report of the Committee.

A second limitation of this study is that it only touches lightly upon the importance of the capital market and the role of financial intermediaries in this market. Nothing will be said as to the size, features or efficiency of the Canadian capital market or the extent of financing in the Canadian economy. The role played by Canadian financial intermediaries in the capital market will be expressed purely in terms of their claims - converting function. With the exception of the mutual fund industry, it is not intended to explain the roles played by individual financial intermediaries in the capital market. Nor is it intended to define other financial intermediaries, explain what they do, how they operate or the reasons for their growth. In other words, the main concern of this paper is to focus on the Canadian mutual fund industry as a financial intermediary and not to be overly concerned with the characteristics of other Canadian financial intermediaries.

V. DEFINITIONS OF TERMS USED

The following list of definitions are applicable to the entire paper, unless the context otherwise implies:

Brokers. Where used with reference to the sale of mutual fund shares, refers to the sale of such shares by or through firms duly qualified in their jurisdictions of operation to engage in trading in securities and which sell mutual fund shares as one part of a more general securities business. Sales made by or through such firms are treated as made by brokers even if the particular salesman concerned is engaged on a full-time basis in the sale of mutual fund shares.

Direct Sales Force. Where used with reference to the sale of mutual fund shares, refers to the sale of such shares by or through persons or companies associated by contract or otherwise with the Fund, the Distribution Company or the Management Company, but does not include sales through brokers or an independent sales force.

Distribution Company. Means the person principally responsible for effecting the distribution to the public of mutual fund shares, subject to the board of directors of the Fund or to other relevant authority, whether such responsibility arises under a contract with the Fund or with the Management Company. If there is no separate person with such responsibility, the words "Distribution Company" may refer to the Management Company.

Fund or Mutual Fund. Except where the context indicates that the reference is to mutual funds generally, means any Canadian open-ended investment company or trust.

Independent Sales Force. Means all salesmen who sell mutual fund shares, and who: (a) are not brokers or employed by brokers, as defined; (b) also sell shares or units issued by mutual funds other than funds associated with the Management Company; and, (c) are not employed by or independent contractors of the Management Company, the Distribution Company or companies related to them.

Management Company. Means the person principally responsible for advising the Fund concerning the selection and supervision of portfolio securities. The "Distribution Company" refers to the same company as the Management Company if the two functions are not separated with reference to the Fund.

VI. STATISTICAL DATA

Included in this paper are a few statistical tables extracted from the final draft chapters of the report of The Canadian Committee on Mutual Funds and Investment Contracts.

As explained previously, these tables were prepared by the writer from information collected from the mutual fund industry by the staff of this Committee. If the source of information is not stated on a particular table it can be assumed that a similiar table will appear in the published report of this Committee.

There are other statistical figures included in text which have not been footnoted as to source of information. In such cases, the statistics were prepared from replies submitted to The Canadian Committee on Mutual Fund and Investment Contracts in response to preliminary and final questionnaires circulated to the mutual fund industry. For this reason, it was impossible to specify all the documents used to generate the statistical figures referred to in this paper.

In Chapter IV, there are three sections relying partly on statistical data to show the supply of, and the demand for Canadian equities. Statistical information in these particular sections has only been provided up until the end of 1966. The writer seriously considered updating this material to the end of 1968, but decided against doing so because of frequent reference in these sections to the "York Study" which also relied upon statistical information for the end of 1966.[2]

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2 G. R. Conway, The Supply of, and Demand for Canadian Equities, (Toronto: The Toronto Stock Exchange, September 1968), "Conspectus".

Adhering to comparable statistical information has added to the clarity of these sections.

CHAPTER II

CANADIAN FINANCIAL INTERMEDIARIES AND THE CAPITAL MARKET

In this chapter we will be concerned with the importance of a capital market and the role of financial intermediaries. As a direct consequence we will observe the growth and development of Canadian financial intermediaries. Some intermediaries have grown faster than others. On this topic we will be interested in confirming the leadership position held by the Canadian mutual fund industry.

As a start, we will see the value of the capital market and financial intermediaries in the process of economic development. The term "capital market" will be defined, followed by an explanation of the functions of the financial intermediaries in terms of their role in the capital market. Secondly, there will be a review of the institutional development process which will encompass the history, growth and concentration of resources among Canadian financial intermediaries. Finally, there will be a concise discussion concerning the growth attained by the Canadian mutual fund industry in relation to other major Canadian financial intermediaries.

I. THE CAPITAL MARKET AND ROLE OF FINANCIAL INTERMEDIARIES

Canada has experienced a tremendous change in the last century due to economic growth, technological advances, new educational processes, greater mobility, automation and computerization. Without the existence of a capital market and institutional machinery to streamline this market it would have been impossible for this country to develop at such a remarkable pace. It has been the existence of the capital market and the financial intermediaries operating in this market that have largely made possible the process of capital formation.

On the subject of capital markets and financial intermediaries, Herbert E. Dougall, states that in a primitive society the savers and users of capital were largely the same, although, through barter some exchange of capital goods for consumer goods occurred. But there was no financing problem. He also states that in a modern capitalistic economy instruments representing money and claims to money are essential for the specialization and the division of labour and for the transfer of savings to those who invest in capital goods. Capital formation, he suggests, would be virtually impossible without money and a market.

Furthermore, extensive institutional machinery is necessary to channel the money value of savings generated by some units in the economy to those who have use for these savings. He concludes that it is the existence of these markets that largely makes possible the process of capital formation.[3]

Dougall also attempts to clarify what should be considered as a reasonable definition of the "capital markets". To quote him,

> "There is no such thing as a market for capital, that is, the economic capital goods themselves. But there is a market, or rather a group of markets, for the dollar instruments that represent either title to, or claims to, capital, and to the other resources owned by government, business, and individuals."[4]

Therefore, the "capital markets" should be taken to mean the markets where intermediate and long-term funds are gathered and made available to businesses, governments and individuals, and where instruments that are already outstanding are transferred.

The role played by the financial institutions in the transfer process is that of middlemen between the savers in our society and those who wish to borrow the funds provided by these savers. In its role as

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[3] Herbert E. Dougall, Capital Markets and Institutions, Prentice-Hall, Englewood Cliffs, New Jersey, 1965, p.3.

[4] *Ibid.*, p.4.

intermediary the financial institution channels funds from savers to borrowers by providing the financial assets savers want and the funds borrowers require. They accomplish this transformation by issuing their own instruments such as deposits, shares, or certificates for the lenders to buy, and use the funds received to purchase instruments such as corporate stock, corporate bonds, mortgages and so forth issued by ultimate borrowers. By offering financial assets that differ in liquidity, in maturity, in yield and in risk, the institutions can attract funds from a wide variety of lenders. At the same time they can offer considerable flexibility with respect to terms of borrowing that will satisfy almost all types of borrowers.

It should be clarified, however, that not every financial intermediary stands as a direct middleman between borrowers and savers. Some financial groups, such as the sales finance companies, link ultimate borrowers and other intermediaries. In addition, the stock exchanges, and investment dealers provide the necessary facilities for marketing and trading the debt and equity instruments of borrowers.

II. THE DEVELOPMENT OF CANADIAN FINANCIAL INTERMEDIARIES

Now that the role financial intermediaries play in the capital market has been stated, it is possible to provide a brief analysis of the history, growth, and development of financial intermediaries in Canada from 1957 to 1968.

History of Canadian Financial Intermediaries

The numerous Canadian financial intermediaries are essentially a creation of the nineteenth century, although a great number of different types did not make their appearance until the present century. In fact, some of our major financial institutions, such as the investment companies, trusteed pension funds, credit unions, sales finance and consumer loan companies were still unknown at the turn of the century or without practical importance.

The appearance of the different types of financial intermediaries may be observed in Figure 1, which indicates the decades in which the different types of Canadian financial intermediaries first came into existence. It is shown on this figure that of the nineteen types of financial intermediaries or financial groups distinguished, only seven originated in the nineteenth century. The remaining twelve intermediaries made their first appearance in the twentieth century.

FIGURE 1

APPEARANCE OF SELECTED FINANCIAL INSTITUTIONS

IN CANADA, BY DECADES

	1810 -19	1820 -29	1830 -39	1840 -49	1850 -59	1860 -69	1870 -79	1880 -89	1890 -99	1900 -09	1910 -19	1920 -29	1930 -39	1940 -49	1950 -59	1960
Banks and Deposit Institutions:																
Bank of Canada													X			
Chartered Banks		X														
Quebec Savings Banks							X									
Credit Unions										X						
Trust Companies								X								
Mortgage Loan Companies				X												
Life Insurance and Pensions:																
Life Insurance				X												
Trusteed Pension Funds												X				
Fire & Casualty Companies	X															
Other Financial Institutions:																
Sales Finance											X					
Consumer Loan												X				
Mutual Funds													X			
Closed-End Funds										X						
Investment Dealers								X								
CMHC														X		
Farm Loan Board												X				
Industrial Development Bank														X		
Industrial Estates															X	
Alberta Municipal Financial Corporation															X	

Growth of Financial Intermediaries in Canada

In order to observe how Canadian financial intermediaries have performed in relation to one another we can look at the trends in the essential quantitative features of the major financial institutions since 1957. Table I, shows the aggregate growth in assets of the nine major Canadian financial intermediaries from 1957 to 1968.

The figures presented in this table clearly show impressive rates of growth for these nine financial institutions during the eleven year period. One indication as to how outstanding this growth has been is to compare the growth of these institutions with that of the economy as a whole. Compared on this basis the assets of these intermediaries were $26.4 billion or 83% of G.N.P. at the end of 1957. By the end of 1968, their assets had expanded to $73.7 billion or 109%.

Growth rates for the nine major financial institutions, measured by the value of their assets during the 1957 - 1968 period, have for the most part been uneven. While all these organizations increased in size during the eleven year period, differences in the rates of expansion were significant and can be seen by looking again at Table I. It is apparent that the most outstanding growth in assets has been achieved by Canadian mutual funds followed by trust companies and credit unions respectively. By way of comparison the two largest Canadian financial

TABLE I

GROWTH IN TOTAL ASSETS OF MAJOR CANADIAN FINANCIAL INTERMEDIARIES,(1) 1957 to 1968

($ millions)

	ASSETS		PER CENT GROWTH	PER CENT OF TOTAL ASSETS		INCREASE (DECREASE)
	1957	1968	1957 - 68	1957	1968	
Canadian Mutual Funds	220	2,743	1,146 (2)	.8	3.7	2.9
Chartered Banks	12,417	29,321	136	47.0	39.8	(7.2)
Credit Unions and Caisses Populaires	852	4,278	402	3.3	5.8	2.5
Closed-End Investment Companies	240	656	173	.9	.9	-
Life Insurance Companies (Canadian only)	7,104	14,850 (3)	109	26.8	20.2	(6.6)
Mortgage Loan Companies	690	2,977	331	2.6	4.0	1.4
Sales Finance and Consumer Loan Companies	1,684	4,927	192	6.4	6.7	.3
Trust Companies	774	4,972	542	2.9	6.7	3.8
Trusteed Pension Funds	2,460	8,960 (4)	264	9.3	12.2	2.9
Total	26,441	73,684		100.0%	100.0%	
G.N.P. (Market Prices)	31,909	67,368				
Total as percent of G.N.P.	83%	109%				

(1) Assets are at book values.
(2) Percentage growth at market values (1957 - $305 million, 1968 - $3,410 million) - 1018%.
(3) 1968 figure estimated on basis of 15% growth 1966 to 1967 and 1967 to 1968.
(4) 1968 figure estimated on basis of 11% growth 1966 to 1967.

SOURCE: -Dominion Bureau of Statistics, Business Financial Statistics Balance Sheets, Selected Financial Institutions, Various Issues 1967 and 1968, Ottawa: Queen's Printer, Catalogue No. 61-006.
-Dominion Bureau of Statistics, Trusteed Pension Plans Financial Statistics, 1967, Ottawa: Queen's Printer, Catalogue No. 74-201, November 1968.
-Report of the Superintendent of Insurance of Canada, various yearly issues.

institutions, the chartered banks and life insurance companies, recorded the smallest growth in assets.

If individual enlargement is observed on the basis of percentage gains made in relation to the total assets of this selected group of institutions, the results become even more interesting. A glimpse at the last two columns of Table I, shows that the chartered banks share of aggregate assets fell from 47.0% in 1957 to 39.8% in 1968. Among the non-monetary financial intermediaries, the Canadian life insurance companies lost a 6.6% share of aggregate assets during the same period. The biggest re-distribution favoured the trust companies, mutual funds and trusteed pension funds.

III. SUMMARY

This completes a very limited study of the capital market and the growth and development of Canadian financial intermediaries. Although the review was quite short it did serve the purpose of showing the history, growth and concentration of resources among Canadian financial intermediaries as well as clearly describing the role of these intermediaries in the capital market. In addition, we now know which of the nine major financial institutions have grown more rapidly than others from 1957 to 1968.

On a basis of growth and re-distribution of assets the mutual funds, trust companies, and trusteed pension funds showed remarkable gains while Canada's two largest financial institutions, the chartered banks and life insurance companies, suffered considerably.

Of particular interest is the tremendous asset expansion attained by Canadian mutual funds, especially when we recognize that this industry is a relatively recent addition to the vast array of financial intermediaries. A closer examination of this particular financial institution should give some insight into its role in the capital market, reasons for its rapid growth and growth potential in the near future.

CHAPTER III

CANADIAN MUTUAL FUNDS AS FINANCIAL INTERMEDIARIES

We now realize where the Canadian mutual fund industry stands in terms of growth relative to other major financial institutions. What we do not know is what mutual funds are, how they are organized, how they have grown in size, how they differ from other financial institutions, what relationships they have to other financial institutions, what benefits or services they provide and how they are sold to the public. Providing concise information on these topics represents the purpose of this chapter.

After the reader has gained a fair understanding of mutual funds and their role as financial intermediaries, it will be possible to examine some of the predominant factors that have assisted the growth of the mutual fund industry. Later in the chapter we will review two of these factors. The first is the attractive product the industry has for sale. The second is the means by which the mutual fund product is marketed. In Chapter IV, we will go one step further by examining some of the factors which created public interest in the investment package sold by mutual funds.

I. MUTUAL FUNDS AS INVESTMENT COMPANIES

In short, mutual funds are a form of investment company. An investment company is a financial organization that sells its own shares or units to the public and invests the proceeds. Unlike other financial institutions, the activity of investing in securities is their principal function and reason for existance.

The justification for an investment company in our financial community is that it enables investors, through a pooling of savings, to obtain a professionally managed portfolio of securities. Serving as a media through which individual investors acquire an indirect stake in bonds and stocks, these companies have had a great influence upon investor behaviour and on the securities markets in general. Their role has been to funnel savings into outstanding securities in the secondary markets rather than to finance new capital investment. The two types of investment companies are known as mutual funds and closed-end (leveraged and non-leveraged) investment companies.

Mutual funds and the non-leveraged closed-end companies are in the unique position among financial institutions of having no significant amount of liabilities. Their only debts are current liabilities incident to regular business operations and they constitute a relatively small percentage of total assets.

Thus, there is a very large margin of equity capital; almost the entire right-hand side of the balance sheet is represented by outstanding capital stock. So far as the use of assets to support liabilities is concerned, these companies have very little need for stability of principle in their investment portfolios.

It is possible to generalize that operating expenses impose no significant limitation on their ability to tolerate fluctuations in investment income. It is, therefore, obvious that such organizations are able to assume considerable financial risk. For this reason, investment companies have considerable latitude in the types of investments they select for their portfolios. The only selection limitations are those written into the prospectus of a mutual fund or in the corporate charter and by-laws of a closed-end company. One normally finds, however, that open-end funds restrict their investments to the more popular issues listed on the organized exchanges which are considered to be highly marketable. The reason for this tendency evolves from the fact that unsophisticated investors prefer corporate names they recognize and have confidence in; naturally this also adds sales appeal.

It has been the trend for conventional investment companies to select stock issues with good dividend records and to stay almost fully invested with little regard to the prevailing level of stock prices.

Such companies also tend to avoid major changes in the composition of their portfolios because of the adverse effects that may result if their judgement is wrong.

The main area of concentration in this thesis is with the investment company known as a mutual fund. As some confusion may arise as to the difference between mutual funds and other investment companies it is worthwhile making the distinction. The main distinction among investment companies, as was already mentioned, is between "closed-end" and "open-end" companies. These terms refer to the manner in which the organizations sell their securities to obtain money for investing. Another distinguishing feature is that closed-end companies are usually managed by their directors and officers without management service from another firm, a practice that is in contrast to the management arrangement used by most of the open-end companies and will be discussed in more detail in a later section. Directors of closed-end companies are often officers or partners of brokerage firms, investment banking houses, or commercial banks.

Although both types of investment companies have their own separate features, the amount of portfolio assets per share is an important consideration in both types when estimating the value of their shares or units issued. Portfolio assets per share is calculated by taking the market value of the investments and other assets of the investment company, less the liabilities, and dividing the resultant figure by the number of shares outstanding. For example, if an investment company's net assets on a certain date are worth $10 million and there are one million shares outstanding, the net asset value per share that day is $10. Naturally, the net asset value varies as the value of the securities in the portfolio change. If stock prices drop, for example, the net asset value per share may also drop. If stock prices rise, the net asset value per share normally rises. As a general rule, the movement of investment companies net asset values coincide fairly closely with changes in stock market prices because investment companies and the stock market indicies contain a representative cross-section of shares available to investors.

Open-End Investment Companies (Mutual Funds)

Mutual funds are organizations that have the right to sell continuously new shares or units to the public and to re-purchase or redeem these shares or units at any time and in any amount at the shareholder's option. A precise definition of a mutual fund will be proposed by The Canadian Committee on Mutual Funds and Investment Contracts in it's report on the Canadian mutual fund industry expected to be published in December, 1969.

The proposed definition is herein reproduced with the suggestion that interested readers refer to the mutual fund report for a detailed presentation of how the definition was developed and to follow-up on the exceptions referred to in the definition.

> "We recommend: that the term 'mutual fund' should be defined, subject to the exceptions recommended in the next section, to include any organization which issues, offers for issuance, or has outstanding instruments (whether called shares, units, or by any other term) that entitle the holder to receive on demand or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the assets of the issuing organization. If the redemption price is computed by reference to the value of a proportionate interest in a specified portfolio of assets such as a separate fund or trust account, that portfolio is treated under this definition as the issuing organization and therefore as an entity which is (again subject to the exceptions in the next section) a mutual fund".[5]

Further to this definition, it is important to keep in mind that an investor who holds shares or units of a mutual fund acquires them from the mutual fund or from other distributing organizations. There is no open-market trading as mutual fund shares are not listed on any Canadian stock exchange. The market for their sale is the issuing company, through the privilege of redemption.

All shares are sold at net asset value per share plus a certain percentage of asset value.

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5 The definition of a mutual fund has been extracted from a draft copy of Chapter V of the unpublished report of The Canadian Committee on Mutual Funds and Investment Contracts.

The premium above net asset value is called the "load" -- basically representing a sales commission for the salesman plus a small margin of profit for the distribution company. In a majority of cases this acquisition charge falls in the range of 8% to 9% of the offering price with the percentage falling as the amount of money invested increases. Most prices for mutual fund shares or units are published in newspapers with a "bid" and "ask" quotation. The "ask" price is approximately the sum of the "bid" price plus the acquisition charge. If the investor wants to sell his shares, he will receive the "bid" price. If he wishes to buy mutual fund shares he must pay the "ask" price. Computation of the public offering price of mutual fund securities is complicated by the funds' practice of relating the acquisition charge to the offering price rather than the net asset value of the shares. For example, suppose a company's net asset value per share is $10 and the acquisition charge of 8% is levied on the offering price. The offering price (X) is made up of the net asset value of $10 plus the acquisition charge of 8% of X, or .0800X.

Calculation:

$$X-.0800X = 10.00$$
$$.9200X = 10.00$$
$$X = 10.87$$

Net Asset Value:	$10.00
Plus 8% of public offering:	.87
Public offering:	$10.87

Thus the charge is 8.7% of net asset value.

The standard practice for redeeming shares is for the mutual fund to repurchase its shares at net asset value per share, although in a few cases a small discount (usually not more than 1%) is charged for the privilege of redemption. Because redemption is one of the features offered by a mutual fund it is essential for the distribution company to engage in a continuous sales programme to prevent redemptions from shrinking the asset value of the mutual fund. Put simply, the asset growth of an individual fund depends upon:

(1) the excess of shares issued over shares redeemed, sold to existing and new shareholders;

(2) any increase in the market value of the portfolio.

In Canada, a study of 11 mutual funds was performed by the Royal Commission on Banking and Finance, and showed that 65% of the increase in net asset values in the decade ending in 1961 resulted from an inflow of new funds and 35% from capital appreciation.[6] From 1961 to 1967, new sales of mutual fund shares contributed about 69% to the growth in total net assets.[7]

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[6] Report of the Royal Commission on Banking and Finance, Ottawa: Queen's Printer and controller of Stationary, 1964, p.255.

[7] Percentage based on statistical information collected by The Canadian Committee on Mutual Funds and Investment Contracts.

Closed-End Investment Companies

Prior to the depression of the 1930's closed-end investment companies were quite popular in Canada and the United States.[8] This type of investment company sells all its common stock in one offering. It has, therefore, a fixed number of shares outstanding equal to the number offered at the time of formation of the company. There may be additional stock offerings, but not on a continual basis. Shares may be purchased only from existing shareholders offering their stock for sale on the stock exchanges or on the "over-the-counter" market; therefore share price is set by supply and demand conditions. Unlike mutual fund shares the net asset value has no direct bearing on the price at which the closed-end shares may trade at in the market. For this reason, closed-end shares may be purchased or sold at a "discount" below net asset value per share or at a "premium" above asset value per share depending on the market conditions at the transaction time.

Normally, the discounts from net asset value tend to widen during a declining stock market and to narrow during a rising market; thus making closed-end shares slightly more volatile than the stock market in general.

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8 For an account of the history and development of the investment company industry, see Bullock, Hugh, The Story of Investment Companies, Columbia University Press, New York, 1960.

The volatility associated with the shares of closed-end companies, however, usually comes as a result of their policy of issuing senior debt in order to obtain "leverage". This factor should be considered by investors interested in purchasing shares of closed-end companies in as much as leverage can cause the market value of such shares to fluctuate more than stock prices in general. Many closed-end investment companies, particularly prior to 1930, issued senior classes of securities in significant amounts, for purposes of leverage. This factor accentuated the losses suffered by their investors in the depression, losses which were so large that closed-end investment companies have been comparatively unimportant in the United States ever since.

The effect of the economic depression for holders of Canadian closed-end investment company securities were not, generally speaking, as disasterous as was true in the United States. This may in part give substance to the fact that, proportionate to the mutual fund industry, closed-end investment companies are now considerably larger in Canada than in the United States. In Canada, aggregate assets of closed-end investment companies at the end of 1967 were roughly $768 million; an amount equal to about 28.8%[9] of the total net assets of Canadian organized mutual funds being sold to Canadians at that date.

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9 Dominion Bureau of Statistics, Business Financial Statistics Balance Sheets, Selected Financial Institutions, Fourth Quarter 1967, Ottawa: Queen's Printer, May 1968, Table 5A, p.10. Assets are given at market value.

The corresponding figure in the United States at the end of September 1968 was 7.8%.[10]

Now that the distinction has been made between mutual funds and closed-end investment companies, it is possible to discuss some of the characteristics of the Canadian mutual fund industry without risking the danger of confusion. To provide the reader with an appreciation of the scope of the Canadian mutual fund industry we will review those items which best describe the operations of the industry. Specifically, the following sections will describe the organization, growth, classification and service aspect of Canadian mutual funds. In addition, there will be sections covering the relationship between mutual funds and other financial institutions and mutual fund channels of distribution.

II. ORGANIZATION OF CANADIAN MUTUAL FUNDS

The differences among mutual funds extend to their legal form of organization. In Canada, funds may be incorporated or unincorporated.

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10 Percentage figure provided by The Investment Company Institute, New York, N.Y., 10006, in a letter addressed to The Canadian Committee on Mutual Funds and Investment Contracts.

Incorporated funds, both provincial and federal, establish a legal identity in their chosen jurisdiction by applying for and receiving letters patent. Unincorporated funds take two main forms; the independent funds established under trust indentures, and the trust company funds which are divisional operations of parent trust companies. In spite of this distinction, the general characteristics, together with the fact that the operation of a mutual fund is a business enterprise, has resulted in some important organizational and operational similiarities that are true of almost all mutual funds; trusteed or incorporated. This is so because of the necessity to provide a means whereby the promoters may receive their rewards while profits and losses on the funds portfolio is passed through to mutual fund shareholders or unitholders.

In other financial institutions, portfolio profits or losses are not passed through to public shareholders. Most institutions, which include the chartered banks, insurance companies and trust companies, raise money mainly through the issuance of financial instruments that promise fixed rates of return. Their promoters obtain organizational returns primarily through ownership of equity securities issued by the financial institution. Such securities receive the benefit of earnings on the assets of the institution in excess of what is required to provide the fixed return to the holders of debt instruments and to pay other expenses. This procedure is not possible in the context of mutual funds because of the necessity to pass profits or losses through to mutual fund shareholders.

It is traditional for mutual fund organizers to obtain their benefits from two sources: compensation for administration and investment management, and profits on the issuance of shares or units of the mutual fund. In order that such benefits may take the form of organizational profits rather than of salary, the organizers cause the administration and investment management of the mutual fund, and the distribution of its shares or units, to be carried on by separate firms in which the organizers or their successors hold the equity ownership. The organization that performs the administration and investment management is referred to as the "management company" and the organization that distributes shares or units is called the "distribution company"; it is important to realize that these two companies are often the same.

The method of organization just described is universal in the Canadian mutual fund industry, and has another advantage in addition to the fact that it facilitates the receipt of a promotional reward. In several cases, a mutual fund is organized not as an independent commercial enterprise but to be carried on in conjunction with other organizations.

In such cases, the responsible persons do not devote their full-time to the operations of the mutual fund, and it would be troublesome for them to be compensated by means of a salary. Even where these persons are engaged on a full-time basis in mutual fund operations they may be responsible for several mutual funds with different investment objectives organized to appeal to a wide variety of investors. Any other arrangement than allocation of the adminstration, management and distribution functions would cause considerable difficulty and inconvenience in this and other situations. It is for these reasons that delegation of these functions (externalization of management) is universal in the Canadian mutual fund industry, although presumably a mutual fund could be organized in which the functions are internalized and performed by employees of the mutual fund.[11] A few mutual funds in the United States have been organized in this manner. A good example of such an arrangement in the United States is Massachusetts Investors Trust ("MIT").[12]

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11 For the definition of an internally managed fund see: A Study of Mutual Funds, prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce, Union Calendar No.955, August 28, 1962. Chapter II, p.37.

12 The largest internally managed mutual fund in the United States, Massachussetts Investors Trust, had assets of approximately $2.4 billion at the end of 1968. For a discussion of the organization of this mutual fund, see the Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, House Report 2337, 89th Cong. 2nd sess., 1966, pp. 49 and 105.

If considered in the context of their relationship with other financial intermediaries, significant differences exist among mutual funds. Some funds are created as minor sections of the operations of financial intermediaries principally engaged in other financial activities. Others from parts of financial complexes which will be discussed in Chapter V. There are yet others started by organizations engaged exclusively or principally in the operation of mutual funds. An appreciation of these different arrangements is essential to an understanding of the Canadian mutual fund industry. They are considered in the next section.

III. MUTUAL FUND RELATIONSHIPS TO OTHER FINANCIAL INSTITUTIONS

There are many mutual funds created to be operated in conjunction with other organizations. Several brokerage firms have found it a rewarding way to meet the needs of smaller clients who wish their savings to be managed on a discretionary basis. Administration and other expenses make such investment management costly unless the funds invested are substantial. Through an inhouse mutual fund, savings from a number of clients can be combined for investment in a single portfolio. One such inhouse mutual fund, First Harfund Limited, was created by Harris and Partners Ltd. to provide for the portion of its clients' managed accounts invested in securities of United States corporations.

In all cases, the brokerage firm acts both as the management company and distribution company. The mutual fund facility often forms a comparatively small part of the business operations carried on by the brokerage firm, which considers it merely as an attractive service for its smaller clients, although investors in the mutual fund may include individuals who are not actual clients of the investment firm.

Applications similar or identical to those followed by brokerage firms have stimulated other financial institutions to create or to participate in the creation of mutual funds. At the end of 1968, three Canadian chartered banks were able to arrange investments by their customers in mutual funds that are associated with the banks. At the same date, 20 Canadian trust companies were also distributing investment funds for public participation. Banks and trust companies regard the mutual fund as an additional service to existing clients.

The trend towards the establishment of Canadian financial complexes has become well recognized in recent years. Such complexes differ in approach from a brokerage firm, bank or trust company that organizes a mutual fund to offer an attractive service to clients. Basically, they consist of a number of financial organizations, each concentrating on a different type of financial service.

Invariably, they include at least one mutual fund, which may be separate from the other financial organizations that form part of the financial complex but is more usually operated in conjunction with one or more of them. A detailed discussion of these arrangements has been deferred until Chapter V.

IV. CANADIAN MUTUAL FUND GROWTH STATISTICS

It was made apparent in an earlier discussion, that the impressive growth of Canadian mutual funds has occurred within a reasonably short period of time. The oldest Canadian mutual fund, Canadian Investment Fund Ltd., was incorporated in 1932; the first United States fund came into being in the 1920's. By 1940 the two major funds in Canada were the one mentioned above and Commonwealth International Corporations Limited, having combined total assets in that year of approximately $7.5 million.

The Canadian mutual fund industry did not, however, swing into its period of accelerated growth until the mid-1950's. Detailed figures for the entire period are not available, but at the end of 1950 total net assets of mutual funds qualified for sale in Canada aggregated approximately $46 million. The corresponding figure at the end of 1961, inclusive of trust company investment funds, was $795 million.

From that time, assets have generally continued to expand at a rapid rate as public demand for equities has developed and as the number of newcomers to the mutual fund industry has increased. By the end of 1967, aggregate total net assets of investment funds offered for public investment by Canadian trust companies was approximately $158 million; the value of shares held by Canadians in United States mutual funds qualified for sale in Canada was approximately $104 million; and the total net assets of Canadian mutual funds qualified for sale in Canada was approximately $2,508 million, for a grand total of $2,770 million.[13]

The number of mutual funds shows a correspondingly rapid increase. At the end of 1967, there were 118 organizations qualified as mutual funds for sale in one or more provinces of Canada; an approximate subdivision of this figure was 19 investment funds offered by trust companies, 12 United States mutual funds and 87 Canadian mutual funds. By the end of 1968, the number qualified had increased to 136, subdivided into 20, 19 and 97 in the three categories respectively.

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[13] It should be noted that these figures do not agree with published figures circulated by other information services. These figures have been prepared by the staff of The Canadian Committee on Mutual Funds and Investment Contracts on the basis of submitted statistical material and according to the terms of the recommended definition of a mutual fund.

V. BENEFITS ATTACHED TO MUTUAL FUND OWNERSHIP

There are several well-publicized non-monetary benefits associated with the purchase of shares or units of a mutual fund. Although the principal reason for making an investment is to obtain present or future income or capital gains, there are certainly other considerations that influence the investor in selecting a suitable investment. The investment must be consistent with the degree of risk he is willing to assume, the level of liquidity he desires, the manner by which he is able to invest and the time he can devote to managing his investments. In light of these problems, the non-monetary benefits offered by mutual funds are often cited as working in favour of the mutual fund investor. The principal items offered by the distributors and managers of funds are professionally managed, diversified investment portfolios that can be purchased in either large or small quantities.

Professional Management

Mutual fund portfolios are supervised on a continual basis by people with experience in investing, backed by competent research and the use of technical aids to market analysis. Some funds have their own security analysts but are normally backed up by a separate management company.

As well as acting as security analysts the managers are also trained field investigators able to obtain pertinent operating information through direct communication with corporate officials. This enables the fund to have a continuous and intimate study of corporate management, its problems, and the caliber of the individuals involved.

Diversification

A non-specialized mutual fund normally invests in a carefully diversified group of securities made up of short and long-term bonds of governments and corporations, preferred shares and common stock. These investments encompass several industries and several companies within an industry. The investor, with only a small amount of capital to invest could only purchase a few stocks, and his success rests solely on what happens to these stocks. However, by investing a similiar amount of capital in a mutual fund he obtains an interest in many stocks; thereby, cushioning the effects of a sharp price fluctuation of an individual security. This reduction of risk is an obvious advantage to the investor if the mutual fund is properly diversified.

Liquidity and Marketability

Unlike most stocks and other forms of investment, the value of mutual fund shares or units are not influenced by the supply of and demand for them. This is the reason why an investor can sell his mutual fund shares at any time for their net asset value. Nevertheless, the net asset value is indirectly affected by equity market supply and demand factors because the securities the mutual fund holds are subject to such factors.

Regularity of Investing

Mutual fund shares may be bought on a lump-sum basis, or on an accumulation basis. Mutual fund distribution companies make it possible to invest relatively small amounts monthly or quarterly. Dividends may also be re-invested automatically at net asset value without a sales charge. Basically, the mutual funds offer two types of plans:

> Voluntary accumulation plan. This differs from the regular lump-sum purchase of mutual fund shares or units in that it enables the investor to buy fractional shares from his agreed-upon periodic payment, and can automatically provide for re-investment of all dividends. The sales commission is charged in the same manner as it would be under a regular lump-sum purchase. These level-charge, voluntary accumulation plans have no specific time duration and the investor may discontinue the plan at any time without penalty.

Prepaid or Contractual Plan. This type of plan has a fixed duration and the investor is penalized if he does not meet his commitment. The investor signs a contract stating that he will invest a pre-determined amount of money on a regular basis for a specified number of installments. Penalty for non-completion arises from the manner in which the sales commission for the entire investment is taken from the early payments made by the contractual planholder. For example, if he agrees to invest $25 per month for five years the sales commission is calculated as a percentage of the entire $1,500 investment. The largest portion of commission (normally 50%) is levied against the first twelve installments. If the planholder does not complete the contract, the sales commission paid cannot be recovered. The argument stressed by the mutual fund industry in favour of this type of arrangement is that it forces individuals to save. An individual may think twice before deciding to cancel his contractual plan especially when he realizes the amount he would lose on previously paid-in amounts.

Convenience

Normally an investor who purchases mutual fund shares or units makes only one investment choice in his lifetime. He receives dividends and regular financial statements from the mutual fund rather than a statement from every company in which the fund invests. It is relatively easy to buy and sell mutual fund shares and relieves him of continuous administrative responsibilities. These are real advantages to the investor providing that the mutual fund he invests in is well managed.

Dollar-Cost Averaging

If an investor buys the same shares at varying prices, and invests the same dollar amount each time, the average cost per share will be less than the average of the prices. This is so because his money will buy more shares when prices are low than when prices are high. If stock prices continue to move upward over the longterm it also improves the chances that his investment performance will be profitable. Mutual funds make use of this technique through their accumulation plans which enable the investor to purchase a constant dollar amount of shares on a regular basis and to purchase fractional shares.

Variety of Mutual Funds

Some management companies organize and manage a "mutual fund complex". This term is specifically defined as a number of mutual funds having different investment policies but only one investment manager.

As explained in the Public Policy Report of the S.E.C.[14] mutual fund complexes enable a mutual fund adviser to reach a broader cross-section of potential investors and to offer each investor the opportunity to apportion his aggregate mutual fund investment among several funds with different objectives. Most shareholders of a mutual fund belonging to such a complex have the option of switching to other funds within the complex at a reduced sales load, no sales load, or upon payment of a minimal exchange charge. This policy applies in Canada and the United States.

In Canada, the largest mutual fund complex is managed by The Investors Group. There are, however, several other organizations which fit the "mutual fund complex" definition. To give some indication of the size of these complexes refer to Table II. This table identifies the constituent companies and gives the assets (as of December 31, 1967) of the five largest Canadian mutual fund complexes. The 17 funds listed in these five complexes held roughly 78% of all Canadian mutual fund assets as at December 31, 1967.

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[14] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, Union Calendar No. 1046, December 2, 1966. p. 47.

TABLE II

CANADA'S FIVE LARGEST MUTUAL FUND COMPLEXES

AS AT DECEMBER 31, 1967

Management Company and names of funds in the mutual fund complex	Aggregate Net Assets of complex ($ millions)
1. The Investors Group	915.5
(a) Investors Growth Fund of Canada Ltd.	
(b) Investors Mutual of Canada Ltd.	
(c) Investors International Mutual Fund Ltd.	
(d) Provident Mutual Fund Ltd.	
2. United Funds Management Ltd.	399.8
(a) United Accumulative Fund Ltd.	
(b) United American Fund Ltd.	
(c) United Venture Fund Ltd.	
(d) United Funds Canada International Ltd.	
3. A.G.F. Management Ltd.	257.8
(a) American Growth Fund Ltd.	
(b) Canadian Trusteed Income Fund	
(c) European Growth Fund Ltd.	
(d) Growth Equity Fund Ltd.	
4. Canadian Channing Corporation Ltd.	123.0
(a) Commonwealth International Corporation Ltd.	
(b) Commonwealth International Leverage Fund Ltd.	
5. Capital Management Ltd.	121.7
(a) All-Canadian Compound Fund	
(b) All-Canadian Dividend Fund	
(c) All-Canadian Venture Fund	
TOTAL ASSETS AT MARKET VALUE	$1,817.8

SOURCE: The files of the Canadian Committee on Mutual Funds and Investment Contracts

Temporary Withrawal

There are several mutual funds that offer the shareholder or unitholder the right to withdraw all or a portion of his investment with the opportunity of reinvesting it at a later date without a sales charge. The terms under such an option differ from fund to fund with some being more restrictive than others. Regardless of the case, this right does provide the mutual fund investor with a secondary source of liquidity that can be readily converted into cash at little or no cost.

This list of benefits obtained by investing in mutual fund shares or units by no means represents all the inducements offered by the industry to encourage investors to allocate their long-term savings to the mutual fund vehicle. There is no question, however, that these services have helped the mutual fund industry to grow at a rapid rate in the last decade.

From the list reviewed, one is left with the impression that the mutual fund industry is concerned with time itself, rather than timing, or guessing market action, as the secret of investment success. "What to buy? When? What to do then?" These are the questions which every investor must answer in the contemplation and prosecution of any investment action.

The mutual fund industry is based upon the premise of reducing investment risks, through diversification rather than attempting to find "the get rich quick stock". It presumes, in fact demands, that a reasonable period of time is necessary for the successful conclusion of an investment experience.[15]

VI. MUTUAL FUND CHANNELS OF DISTRIBUTION

The growth rate of mutual funds owes much to the effective distribution techniques developed by mutual fund distribution companies. An analysis of the channels of distribution for mutual fund shares or units will enable the reader to see how successful the industry has been in showing the instruments and services it has to offer to the public. The Canadian Committee on Mutual Funds and Investment Contracts has made the following statement in its report which sums up the importance of looking at the marketing side of the mutual fund industry.[16]

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[15] Hugh A. Johnson, Johnson's Investment Company Charts, nineteenth annual edition, Buffalo, New York, 1967, p. XVIII.

[16] Quotation taken from the final draft of Chapter II, paragraph 2.02, of the unpublished Report of The Canadian Committee on Mutual Funds and Investment Contracts.

"An oft-quoted aphorism of the mutual fund industry is that shares or units of mutual funds 'are not bought, they're sold. Like many aphorisms, this represents an over-simplification of a complicated situation but contains a significant element of truth. Traditionally, the market for mutual fund shares or units has been regarded as a market in which potential purchasers must be convinced that the suggested investment is desirable and appropriate for them."

Up until the time of writing, the mutual fund industry has used three main channels of distribution in the sale of mutual fund shares or units to the public: direct sale forces, brokers, and independent sales forces. It should be made clear that not all distribution companies use all three channels. Some mutual funds managed by brokerage firms are available only through that firm. The distribution companies geared to a larger market usually place emphasis either on sales through a direct sales force or on brokers and independent sellers. The methods vary and depend to a large extent upon policy and tradition.

Reviewed historically, sales through brokers who handle mutual fund shares or units as part of a general securities business form the oldest channel for their distribution in Canada. Two examples of funds using this technique are Canadian Investment Fund, Ltd. and Commonwealth International Corporation Limited. Both funds were established in 1932 and sold through brokers. Sales through brokers continued to be the primary sales outlet until the mid-1950's.

Direct sales forces began to grow rapidly in the late fifties and now surpass brokers in importance as a channel of distribution, even though a large volume of mutual fund shares still continue to be sold through brokerage firms. In statistical terms, in 1967, 66% of total sales of mutual fund shares or units (not including trust company investment funds) were made through direct sales forces, 30% through brokers, and the balance of 4% through independent sales forces and other direct channels.[17]

The reader can see from the statistics in the preceeding paragraph, that the most important channel of distribution for mutual funds in Canada is the direct sales forces. The first of these were established in the late 1930's and early 1940's. One of the early direct forces was established by the Commonwealth International Corporation Limited, which was mentioned above as an early user of brokers for the sale of its shares. It's distribution company and those of a few other mutual funds established forces of salesmen who sold shares or units of one or more mutual funds under common management. Despite their late introduction, the direct sales forces grew in importance with the greatest increase in number of salesmen occurring during the 1950's.

[17] Statistics compiled by the staff of The Canadian Committee on Mutual Funds and Investment Contracts.

Two large mutual fund organizations which developed their sales forces during this period were Investors Mutual of Canada Ltd. and United Accumulative Fund Ltd. In 1950, Investors Syndicate formed the former company and began selling shares to the public. In 1957, United Accumualtive Fund Ltd. was established and distributed to the public by United Investment Services Ltd. and United Investment Services (Quebec) Ltd.

The Mutual Fund Committee, collected detailed statistics on Canadian direct sales forces that offered shares or units of a mutual fund or of associated mutual funds qualified for sale in Canada at December 31, 1967, and having aggregate total net assets at that date over $5 million. In this category there were 2,725 full or part-time salesmen at the end of 1962, and the corresponding figure at the end of 1967 was 5,682. Throughout this period, the percentage of part-time salesmen remained reasonably stable at about 15% of the total. In addition to these figures, there were 140 salesmen at the end of 1967 associated with direct sales forces selling mutual funds with total net assets less than $5 million.

Table III, lists the seven largest distribution companies in Canada as well as providing other interesting information.

CANADIAN MUTUAL FUND DISTRIBUTION COMPANIES WITH
OVER 200 SALESMEN AS AT JUNE 30, 1967

	Name of Distribution Company	No. of Full & Part-time Salesmen	Mutual Funds Distributed	Principal Investment Objectives of the Mutual Funds*
1.	United Investment Services Ltd.	2,236	United Accumulative Fund Ltd.	- growth - maximum capital gain - income
			United American Fund Ltd.......	- growth - maximum capital gain
2.	Investors Syndicate Limited	804	Investors Growth Fund of Canada Ltd..............................	- growth
			Investors International Mutual Fund Ltd..........................	- growth
			Investors Mutual of Canada Ltd.	- stability
3.	Federated Investments Ltd.	434	Federated Financial Fund Ltd....	- growth with stability
			Federated Growth Fund Ltd......	- growth
4.	I.O.S. of Canada Ltd.	410	Regent Fund Ltd.................	- growth - maximum capital gain
5.	A.G.F. Management Limited	399	American Growth Fund Limited....	- growth - maximum capital gain
			Canadian Trusteed Income Fund...	- income - security - stability
			European Growth Fund Limited....	- growth - maximum capital gain
			Growth Equity Fund Limited......	- maximum capital gain - growth
6.	All-Canadian Group Distributors Limited	306	All-Canadian Compound Fund......	- growth
			All-Canadian Dividend Fund......	- maximum capital gain
			All-Canadian Venture Fund Ltd...	- maximum capital gain - growth
7.	Canadian Channing Corporation Ltd.	239	Commonwealth International Corporation Limited..............	- balanced fund
			Commonwealth International Leverage Fund Ltd...............	- growth

* The information in the last column was supplied by the organizations themselves.

All except one of the direct sales forces included in this table distribute more than one mutual fund, and that exception was changed recently when I.O.S. of Canada Ltd. began distributing the shares of I.O.S. Venture Fund Ltd. The development of mutual funds under common management was discussed in an earlier section and is in large part a result of the use of direct sales forces. The reader will recall from the discussion in that section that from the management companies point of view it was desirable to have available a choice of mutual funds with different investment objectives.

One additional aspect of direct sales forces should be mentioned, and this is that they are expensive to create. For this reason only organizations prepared to make a substantial investment are able to develop an effective direct sales force. This is possibly one reason why the United and Investors organizations were both started by large organizations from the United States. Because of the expense involved, the direct sales force aspect of the industry is dominated by a comparatively small number of organizations. This domination extends right across Canada as is made clear by Table IV .

TABLE IV

CONCENTRATION OF DIRECT SALES FORCE
SALESMEN BY REGION AT JUNE 30, 1967

Region	No. of salesmen active	% of salesmen in each geographical area associated with the indicated number of the largest distribution companies				
		Largest	2 larg.	3 larg.	4 larg.	5 larg.
Atlantic Provinces	357	21.6	36.4	47.6	58.5	67.8
Quebec	1,536	51.0	64.7	71.9	79.0	85.1
Ontario	1,528	46.3	63.8	73.6	81.2	87.3
Manitoba	224	56.3	74.6	86.2	93.8	98.7
Saskatchewan	399	25.3	44.9	60.7	75.4	82.5
Alberta	660	34.4	55.0	67.7	75.8	83.5
British Columbia	897	47.9	62.3	75.9	82.1	87.4
	5,601					
Canada	5,718	39.1	53.2	60.8	67.9	74.9

Note: This table indicates the percentage of the direct sales force salesmen in each of the geographical regions who were associated with the largest, and the two, three, four and five largest distribution companies. One distribution company, with the seventh largest direct sales force in Canada, could not provide a breakdown of its Western Canada salesmen among the four Western provinces. It is therefore not reflected in the percentages for Manitoba, Saskatchewan, Alberta and British Columbia; its total number of salesmen in the four provinces at June 30, 1967 was 117.

The second channel of distribution mentioned above is through brokers. Several brokerage firms have recently started separate mutual fund departments staffed by individuals engaged exclusively in the sale of mutual funds. Many of these salesmen actively solicit orders, following procedures similiar to those used by direct sales forces. Because these salesmen have signed sales agreements with a number of distribution companies they are able to provide their clients with a choice among several mutual funds.

The third channel of distribution is the independent sales forces specializing exclusively in the sale of mutual fund shares or units. These organizations represent a recent development in the Canadian mutual fund industry. They are mainly managed by persons who were formerly salesmen on direct sales forces. Like brokerage houses, each independent sales force has an arrangement with the distributing companies of a number of mutual funds which enable it to make available a variety of mutual funds to its potential customers. In most cases the salesmen on independent sales forces receive a higher proportion of the acquisition charge than would be available to them as members of direct sales forces, since the latter must allocate a significant portion of this charge to the managers above them.

Although the growth of the independent sales forces has been rapid, they are still small by comparison with other channels of distribution. As at June 30, 1967, it is estimated that there were about 35 such organizations in existance in Canada. The Canadian Committee on Mutual Funds and Investment Contracts was able to collect detailed information on 17 such organizations and found them to have a total of 341 full or part-time salesmen.

VII. SUMMARY

We have seen that mutual funds are financial intermediaries which sell their financial instruments to the public and invest the proceeds in stocks, bonds, and in the money market. They enable small investors, through the pooling of savings, to obtain a professionally managed diversified portfolio of securities. They are, basically, investment companies but have certain distinguishing features which set them apart from other investment companies. These distinguishing features were covered in a definition of a mutual fund which briefly stated that a mutual fund is an organization that stands prepared to redeem its issued securities on demand by the holder at net asset value per share or unit. Closed-end organizations, also classified as investment companies, do not offer this feature.

Mutual funds are usually organized in one of three ways; they are incorporated provincially or federally, unincorporated under a trust indenture, or an unincorporated trusteed mutual fund of a trust company. Regardless of their legal form of organization a mutual fund group is usually structured so that there are two or more organizations involved. These would be the mutual fund, the management company and sometimes a distribution company if it is not part of the management company. This structure allows portfolio profits or losses to be passed directly on to the participants in the mutual fund. The management company is compensated by some form of remuneration, usually referred to as a management fee and the distribution company is compensated through the commissions received on the sale of mutual fund shares or units. This type of structure also allows the management company and sales company to act on the behalf of more than one mutual fund. It is these features that distinguish a mutual fund from other financial institutions. On the other hand, it was also shown that relationships can exist between mutual funds and other institutions. Many brokerage firms, banks and trust companies have become associated with or offer mutual funds to their clients.

The topic of mutual fund growth was discussed although it had been briefly touched upon in Chapter II.

In this chapter, however, the growth figures used were based on the findings of The Canadian Committee on Mutual Funds and Investment Contracts, who only included mutual funds that fitted its suggested definition.

Later in the chapter we observed the non-monetary benefits or services provided to investors who purchase mutual fund shares or units. These benefits in essence represent the package or product the mutual fund industry offers. The list of benefits included professional management, portfolio diversification, liquidity, regularity of investing, conveniences, dollar-cost averaging, variety of mutual funds and temporary withdrawal. It was implied that the product the industry has to offer is attractive to the investor who wishes to allocate his long-term savings to an institution that will invest his savings in the equities markets, continue to manage these savings on a professional basis and handle the administrative features associated with such investments.

The last section of the chapter provided a rundown of the various channels of distribution through which mutual fund shares or units are sold. In recent years the direct sales forces have played the predominant role in the marketing of shares followed by brokers and independent sales forces.

The purpose of this chapter has been accomplished in that the reader now knows what mutual funds are, how they are organized, how the industry has grown in size, how funds differ from other financial institutions, what relationships they have to other financial institutions and what benefits they provide. Much more than this, he knows what the mutual fund product is and how it is distributed.

In one respect the mutual fund industry is no different from many other firms that have products for sale. If such a firm is to grow it must be able to sell its product, which in turn calls for an acceptance of the product on the part of the potential purchaser, and an aggressive sales force to go out and sell the product.

In this chapter, among other things, we have looked at the product the mutual fund industry has to offer. We have also looked at the means by which the product is distributed. Both the attractiveness of the product and the ability of the industry to sell its product has greatly assisted the industry to grow at a rapid pace. These two factors alone, however, cannot be attributed with all the credit for the rapid growth of the mutual fund industry since 1957 in as much as they both depend upon public demand for the instruments and services the industry has to offer. The creation of public interest in the mutual fund product is the subject of the next chapter.

CHAPTER IV

PUBLIC ACCEPTANCE OF MUTUAL FUNDS

In Chapter II, we saw that during the period since 1957, the growth rate of mutual funds exceeded that of other major financial institutions. This situation owes much to the package the mutual fund industry offers and the effective distribution techniques developed by mutual fund distribution companies, but could not have occurred without increasing public interest in equity instruments, and the acceptance of mutual funds as the principal financial institution for such investment. What has generated public interest in the mutual fund product? There have obviously been some predominant factors which have altered the preferences by savers for the services and obligations offered by the mutual fund industry over those offered by other financial intermediaries.

Basically, there are two ways in which preferences for the services provided by financial institutions are created. The first is created by a shift in the level of economic development, a changing attitude of individual savers and in the wants and needs of borrowers at a particular period in time. Institutions that benefit from this type of preference are those that can respond to the changing needs of a developing economy by providing the desired financial instruments and services. The second type of preference is created through innovations by financial institutions which alternatively create new demands. This second type of preference will be the topic of discussion in the next chapter.

In this chapter we will examine the former type of preference. In doing so it will be necessary to isolate the predominant factors that have aided the Canadian mutual fund industry in expanding its assets. The term, aided, is stressed here, because the Canadian mutual fund industry was quick to recognize changing preferences and reacted by providing the wide range of financial instruments and services demanded by savers. Some of these instruments and services were explained in the previous chapter and need not be repeated here. What is worth repeating is that Chapter III, provided a basic definition of a mutual fund, its role as a financial intermediary and what it has to offer to savers as a financial institution. It is now possible to show the factors that have created the demand for the financial instruments and services offered by Canadian mutual funds.

What then are the major factors that have shifted this particular institution into the growth limelight? There are three major factors that appear to be most influential - an increase in personal net savings, the development of financial sophistication by savers, and a marked preference for saving through certain financial institutions. Before proceeding with the analysis of these factors it should be mentioned that they have also aided the growth of a few other financial institutions. For this reason, this chapter will not be devoted exclusively to a discussion of the impact these factors have had upon the growth of the mutual fund industry. If other financial institutions have benefited in terms of growth, they too will be mentioned. By doing so, the reader will have some appreciation of the competition facing the mutual fund industry in the future.

I. PERSONAL NET SAVINGS

Broadly speaking, all financial intermediaries have benefited from the rise in personal net savings as well as by a developing social consciousness that stresses the responsibilities of both government and private organizations to provide continuous income payments during periods of high unemployment as well as during old age. In response to this trend the financial institutions have developed numerous programmes to facilitate the savings process and attract funds from the expanding middle income class.[18]

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18 Sidney Roblins, The Securities Markets Operations and Issues, The Free Press, New York, 1966, p. 215.

Nevertheless, there are some financial institutions that have benefited more than others as savers have allocated their funds to those institutions who could best fulfil their desired savings objectives. Let us examine the growth in personal net savings in an attempt to see why the mutual fund industry in particular has benefited from the changing desires of savers.

In Canada there has been a strong tendency since 1961 for personal net savings to surpass the growth in personal disposable income.[19] This tendency can be observed by referring to Figure 2, and Table V.

As individuals increase the amount of income they allocate to savings combined with a greater concern over the returns obtained on their savings, the greater will be the growth of financial institutions expanding their fields of activities in the areas demanded by savers.

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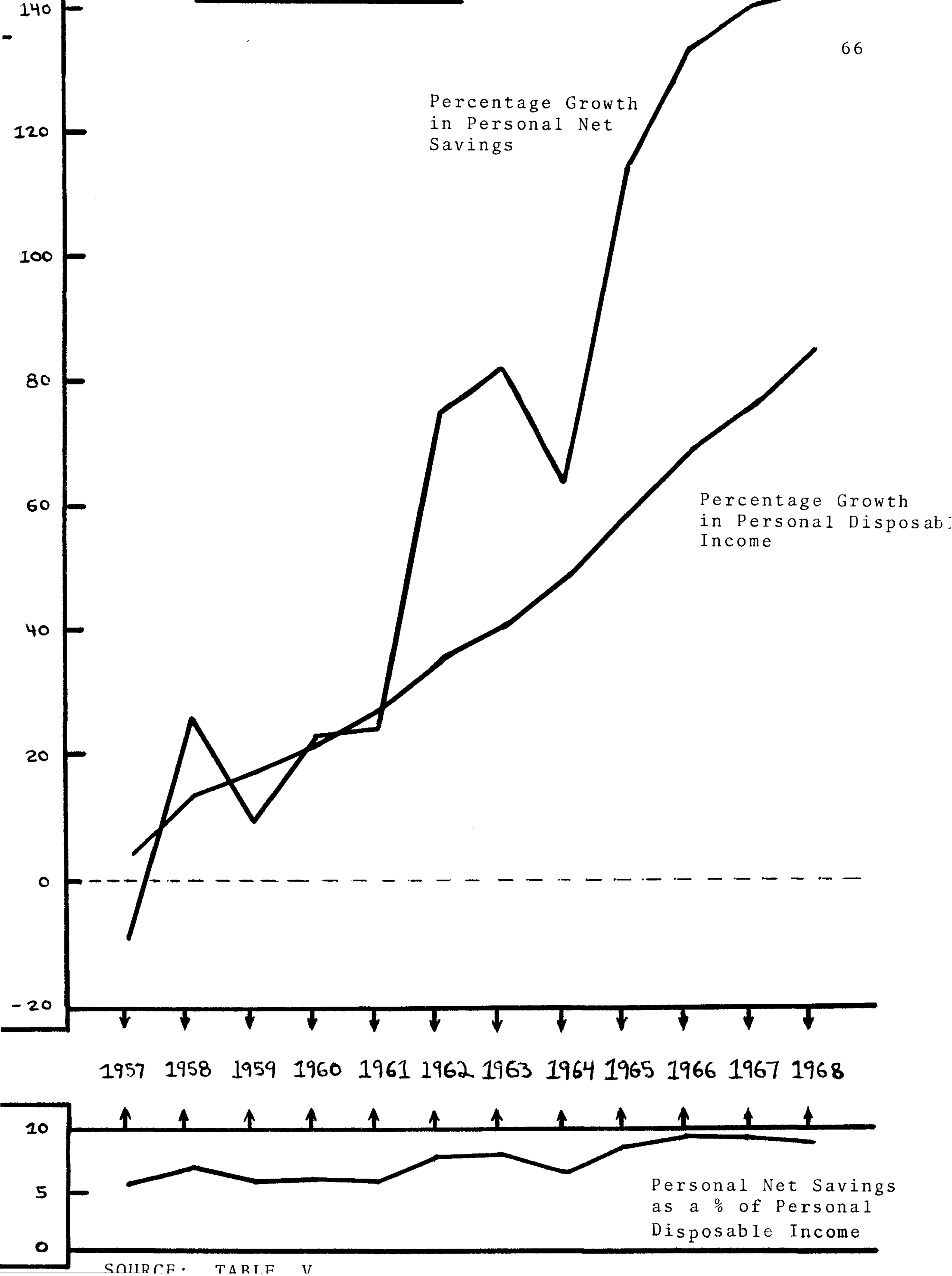
[19]Since 1966 the personal net saving rate has tended to level off. The possible explanation for this might be based on a combination of demographic changes and rapidly rising prices. Younger consumers who are not considered to be high savers, are becoming a larger proportion of the total population. Moreover, in the face of rapid price increases, higher tax rates, and more compulsory welfare payments, there appears to be merit to an argument that consumers are willing to decrease their saving rate and to borrow heavily in order to maintain growth in their real standard of living.

FIGURE 2



SOURCE: TABLE V

TABLE V

PERSONAL INCOME, EXPENDITURES, AND SAVINGS IN CANADA - 1957 - 1968

FISCAL YEAR	PERSONAL DISPOSABLE INCOME	PERSONAL EXPENDITURES	PERSONAL NET SAVING	PERSONAL NET SAVING AS A % OF PER. DIS.IN.	PERCENTAGE GROWTH IN PER. DIS. INCOME	PERCENTAGE GROWTH IN PERSONAL NET SAVINGS
	MIL.$	MIL.$	MIL.$	%	%	%
1957	21,274	-20,072	1,202	5.7	5.6	-8.9
1958	22,880	-21,245	1,635	7.1	7.5	36.0
1959	23,948	-22,591	1,357	5.7	4.7	-17.0
1960	25,075	-23,540	1,535	6.1	4.7	13.1
1961	26,011	-24,466	1,545	5.9	3.7	.7
1962	28,243	-25,926	2,317	8.2	8.6	50.0
1963	30,018	-27,487	2,531	8.4	6.3	9.3
1964	31,725	-29,666	2,059	6.5	5.7	-18.6
1965	35,145	-32,061	3,088	8.8	10.8	49.9
1966	38,579	-34,848	3,731	9.7	9.8	20.8
1967	41,709	-37,714	3,995	9.6	8.1	7.1
1968	44,964	-40,916	4,048	9.0	7.8	1.3

SOURCE: Bank of Canada Statistical Summary, Supplement 1965.
Also the June Monthly Statistical Summary, 1969.

If history repeats itself, it is unlikely that inflation consciousness will be erased from the minds of savers. There is hardly a day that passes when Canadians do not hear about the disadvantages of inflation.

One approach open to the public for inflation protection is to invest in equities of corporations. Over the years, many investors have earned substantial rewards by putting their savings to work in corporations. Proof of this lies in an extensive study undertaken by Lawrence Fisher and James H. Lorie at the centre for Research in Security Prices at the University of Chicago.[20] Their study shows how an investor would have faired in terms of average annual rates of return compounded annually, assuming equal investments in the common stocks of each corporation listed on the New York Stock Exchange.

There are a number of tables presented in this article. The most significant table, however, is the first one which shows how an investor faired with reinvestment of dividends but without payment of taxes on dividends or capital gains and without commissions on liquidation. In other words, the data are those that would apply to the portfolio of a tax-exempt investor.

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20 Lawrence Fisher and James H. Lorie, "Rate of Return on Investments in Common Stock the Year-by-Year Record 1926 - 1965," The Journal of Business, July,1968, pp.291-316.

Because of this the rates of return for common stocks shown in the table can be compared most directly to the compound interest rates paid by chartered banks on savings in the various periods, (1926 to 1965) and with the published yields on most other investment media, which are also published as pre-tax figures.

The study showed, among other things, that the average annual rate of return compounded annually, assuming tax exemption and reinvestment of dividends for the period ending December 1957 to December 1965 was 17.7%, and from December 1962 to December 1965 the rate was 22.6%.

The authors admit that no one actually makes investments on the basis assumed in their study and that it would be impossible to make a definitive statement about the relationship between the rates in the table and the rates resulting from a policy of random selection. They state, however, that it is possible to say something about the relationship between the ratios of terminal wealth to the initial investment which are implied by the rates of the table and the corresponding ratios of terminal wealth to initial investment that would result from simple random selection.[21]

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[21]Lorie and Fisher define "simple random selection" as any scheme which produces equal expectations of the amount of initial investment in each stock - a scheme, for example such as equal probabilities of selection with equal investment in selected stocks.

They say that these ratios would be the same on average. That is, an investor who selected stocks at random would, on average, have ended up with the same wealth as the investor who earned the rates in the table.

Despite the favourable rates of return generated out of the Lorie and Fisher study there is, of course an element of risk in security ownership - the risk that any one person at a given time may lose money in a particular security. This means, therefore, an alert investor must constantly re-examine his equity holdings to assure that they continue to meet his investment objectives. Both stock prices and the prospects of companies and industries are constantly changing variables which must be weighed in portfolio policy and investment selection.

To aid the investor in his continual search for securities offering exceptional value, the investment dealers and brokers provide the services of their research departments as well as their own specialized experience.

The brokerage community, however, is only one financial group that has benefited from the desire for investment advice. It is quite apparent that investing in mutual funds is growing at an impressive rate in Canada. Thus, part of the reason for the growth recorded by mutual funds is that they provide a combination of investment services that appear attractive to investors.

Many of these services were explained in the previous chapter; others will be discussed in the next chapter.

The desire by individuals for investment outlets capable of offering higher returns per savings dollar is only one factor which assisted selected institutions to expand their assets over the years. Another factor worth considering is that stock prices have climbed considerably over the years and those institutions that held a substantial portion of their assets in equities have benefited from the rewards of capital appreciation.

The four distinct groups that were in a position to take advantage of the upsurge in stock prices are listed in Table VI. A glimpse at the portion of their assets represented by common stock in relation to their yearly percentage growth rate, clearly indicates the influence this particular factor has had upon the growth recorded by these groups.

TABLE VI

COMPARISON OF GROWTH AND STOCK HOLDINGS OF SELECTED FINANCIAL GROUPS

	Percentage Change in Assets	Average Annual Growth Rate	Percent of Stocks Held to Total Assets
1. Estate, Trust & Agency Accounts 1961-1966	605.5%	47-48%	60.8%
2. Open-End Mutual Funds 1957-1966	211.7	13-14	82.7
3. Closed-End Investment Companies 1957-1966	130.8	9-10	90.9
4. Trusteed Pension Funds 1956-1966	262.5	12-13	16.8

Source: Financial Intermediaries, a Reference Survey, Published by the Economic Analysis Branch, Office of the Chief Economist, Department of Economics and Development, September, 1967.

Although the estate, trust and agency accounts are not classified as financial intermediaries, they were included because of the growth implications for the trust companies. A trust company being a hybird functioning both as an administrator managing a great many separate estate, trust and agency accounts and also as a financial institution. The estate, trust and agency activities of the trust companies consist of managing individual asset holdings for a percentage or fixed fee.

It is difficult to determine from the discussion in this section how savers decide where they should channel their savings. Certain obvious questions come to mind. Why are some savings outlets preferred over others? Are savers becoming more sophisticated in their savings approach? Where will their savings be allocated in the future? Which financial institutions will benefit most? An attempt will be made in subsequent sections to shed some light on these unanswered questions.

II. DEVELOPMENT OF FINANCIAL SOPHISTICATION

For reasons indicated above, the desire of savers for higher returns on their savings will continue to run a consistent path in the future. This trend will have tremendous implications for the future growth of certain financial institutions. It will quite probably mean that tremendous competitive pressures will be emerging among all financial institutions which will prompt a broadening of the range of services offered to the public and efforts to spread costs over a wider range of financial activities.

Such pressures may well stimulate innovations.

Leon Kendall presents a very worthwhile argument to this effect.[22] In discussing trends in savings, he suggests that the increase in participation in the stock market, the increased number of investment articles found in magazines, and the ability of investors to suffer losses in the market without altering their consumer spending, indicates that the U.S. population in general is moving up a scale of financial sophistication.

Figure 3, lists the options Kendall sees available to savers in the form of investment alternatives. It lists the choices open to investors, ranking them from the mattress and cashbox, to direct business investment. At the bottom of the figure one finds greater security, but a lesser reward; the management decisions are few. At the top, risks are large, but the potential rewards are great; management decisions falling upon the individual are many.

Generally speaking, the further toward the top one moves, the greater the portion of equities to be found in an investment portfolio. The scheme assumes that normally, individuals progress from indirect

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[22] Leon T. Kendall, "The New Environment Facing Financial Intermediaries in the Next Decade", Readings in Financial Institutions, Houghton Miffin Company, Boston, 1965, pp. 284-304.

FIGURE 3

ZONES OF FINANCIAL SOPHISTICATION

Pull toward
Greater Reward
and Growth

The Continuum of Money Movement

NE OF HIGH SOPHISTICATION

mand for Management Decisions by Individual	Business investments Real Estate Speculative stocks Speculative mutual funds Blue-chip stocks Corporate stocks	Minimum Security Maximum reward Minimum availability Speculative

NE OF MODERATE SOPHISTICATION

mand for Decision in principle (at least initially)	Balanced diversified mutual funds Credit unions Savings and loan Associations	Medium security Medium reward Medium availability Considered slightly speculative

NE OF LITTLE OR NO SOPHISTICATION

Demand for Management Decisions (or very minimal)	Mutual savings banks Commerical Banks Government savings bonds Cash box Mattress/drawer/socks	Maximum security Minimum reward Maximum availability Not speculative

Pull toward
Greater Security

to direct investment, and to fuller participation in equity ownership. The ranking does not in any way indicate the size of asset holdings in various categories.

If Kendall's thesis is valid in the Canadian setting, it would mean the financial intermediaries must alter their package offering to include a greater amount of investment counselling and investment management. Certainly, the traditional sources of saving will fall by the wayside unless these intermediaries respond by offering liabilities with the desired mix of attributes.

What then is the situation in Canada with respect to Kendall's thesis? This question must be answered if valid conclusions are to be drawn as to the future growth of Canadian financial intermediaries and the mutual fund industry in particular. In attempting to substantiate Kendall's thesis in Canada we must analyze the Canadian saver in relation to the zones of financial sophistication.

Canadians have historically been classified as "conservative investors," meaning that they were more inclined to invest in debt securities rather than equities. This myth has recently been challenged by the York Study, commissioned by the Toronto Stock Exchange under the direction of Professor G. R. Conway.[23] He writes in this regard,

> "Canadians are not more conservative investors than Americans. In fact, in many income groups, relatively more Canadians invest in stocks and they invest a larger proportion of their assets in equities than do their United States counterparts."[24]

Some of the interesting statistics developed by the York Study are listed as follows:[25]

1. There were an estimated 300,000 adult equity holders in Canada in 1955, and by 1965 an estimated 700,000 Canadian equity holders.

2. Canadian individuals at the end of 1966 owned approximately 40% of total market value of all listed Canadian equities.

3. Through institutions, Canadians owned an additional 9% of the total market value of all listed Canadian equities at the end of 1966.

4. Foreign holdings by Canadian individuals and financial institutions at the end of 1966 totalled $3 billion or 15% of total domestic and foreign holdings.

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[23] G. R. Conway, <u>The Supply of, and Demand for, Canadian Equities</u>, (Toronto: The Toronto Stock Exchange, September, 1968), "Conspectus", pp. 8-12.

[24] <u>Ibid</u>, p.10.

[25] <u>Ibid</u>, pp. 8-12.

5. The number of taxpayers reporting interest as compared to the number reporting dividends is relatively higher in the United States than in Canada.

6. Fixed income securities generally form a larger proportion of the total investment assets of individuals in the United States than in Canada.

These points would lead one to believe that Canadians are definitely moving up the scale of financial sophistication based on the presumption made by Kendall that the further toward the top an investor moves, the greater the portion of equities to be found in his investment portfolio.

The level of financial sophistication is partly substantiated by the fact that the new issues of equities brought to the stock market in 1968 and early 1969 were readily absorbed. By the same token, of the 53 new companies listed on the Toronto Stock Exchange last year, thirty became public companies since 1965. The distributions were limited to Canadians and the issues fully subscribed. This willingness on the part of Canadian investors to purchase new unseasoned issues is a clear indication that Canadians are moving toward greater participation in investments requiring greater decision making; thus moving up the scale of financial sophistication.

III. INVESTING THROUGH FINANCIAL INSTITUTIONS

We have observed that Canadians are aggressive investors and probably have been moving up the scale of financial sophistication for some time. This being the case, it is somewhat difficult to understand why indirect investing through financial institutions such as mutual funds, is becoming more and more popular. A close look at the class structure, the supply of, and the demand for, Canadian equities, and the attitude of the financial community toward the small investor may provide some clues as to why many investors have preferred the mutual fund form of equity participation.

Class Structure in the Canadian Equities Markets

A strong argument is expressed by John Porter that the class structure in Canada has had a limiting effect on the amount of common stock available to middle class investors.[26] He suggests that centralized ownership has proceeded to the point where there are frequent complaints that there is very little good stock available to purchase; and as large holdings become consolidated in the hands of the wealthy, the amount of common stock traded on the Canadian Exchange,

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[26] John Porter, The Vertical Mosaic - An Analysis of Social Class on Power in Canada, University of Toronto Press, 1965, p.249.

diminishes. His belief is that all patterns of consolidation have a social consequence of great importance quite apart from any economic effects on markets. This social effect, he suggests is the reduction of the amount of equity capital available for extending social participation in ownership of Canadian industry. Because of this, he concludes that the growth of the middle level income investor class is limited.[27] This belief is summed up in the following quotation:

> "Both income and estate statistics give some indication of the heavy concentration of equity capital, and therefore of the control of the productive resources of the society. It would seem that Canada does not have a large middle level investing class. It is clear that a good measure of control rests with a small group of very rich or in some cases with their representatives."[28]

Selected statistics published elsewhere would certainly tend to confirm that a major portion of the equity holdings of Canadian individuals, in both Canadian and foreign equities, is held by income groups earning over $10,000.[29] In addition, the average holdings per family are more than four times greater for the $10,000 and over income class than for the income class in the $7,000 to $10,000 range.

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27 Ibid., p. 244.

28 Ibid., p. 118.

29 At the end of 1966, 64% of Canadian and foreign equity holdings of Canadian individuals were held by income groups earning over $10,000. Conway, op. cit., p.10.

The basis for this statement comes from the numbers in Table VII. Taken together, the percentage of holdings of equities by income groups earning over $10,000 and the percentage of families owning stocks and average holdings per family, tend to strengthen the argument of "degree of concentration" professed by John Porter.

TABLE VII

WHO'S IN THE STOCK MARKET

Income Class	Percentage of families owning stocks	Average Holdings
Under $1,000	2.7%	$ 3,137
$1,000-2,000	3.1%	$ 5,919
$2,000-3,000	3.1%	$ 6,243
$3,000-4,000	4.0%	$ 6,716
$4,000-5,000	4.3%	$ 5,335
$5,000-6,000	5.9%	$ 4,768
$6,000-7,000	7.8%	$ 5,733
$7,000-10,000	12.7%	$ 4,110
Over $10,000	26.3%	$18,835

Data: Dominion Bureau of Statistics, publicly traded stocks, 1966.

The validity of Porter's arguments has definite growth implications for mutual funds in that the mutual fund concept is based upon providing the small investor with a portfolio offering the same benefits he might accrue if he were capable of entering the stock market on a scale equivalent to that of the wealthy investor.

Professor Conway has also suggested that financial institutions will play a major role in channeling the savings of the lower income groups into the equities markets in the future. His belief is summed up in the following quotation;

> "Presumably, a large proportion of the monies being assembled by the major Canadian financial institutions represent the savings of the $10,000 or less income group, and it is, therefore, quite probable that within a few years closer to 40% of all holdings of Canadian equities by Canadians will be held by this income group."[30]

Canadian Equities - Supply and Demand Factors

The implications the class structure has for the small investor is that there may be a limited amount of desirable common stock available for him to invest in. His method of defense, therefore, in the battle against the harmful effects of inflation may be to invest in the equities markets through a financial institution. However, investing through a financial institution may in itself worsen the individual's direct investment opportunities in the future.

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30 Conway, op cit., p. 45.

The reason is that the rapid growth of equity purchases by pension funds, mutual funds, and insurance companies has reduced further the possibility of extending investment opportunities to the low and middle income classes. Some proof of this can be found through an examination of the supply of, and demand for, Canadian equities.

The Supply of Canadian Equities. The new supply of Canadian equity issues coming to the Canadian stock market has been small from 1962 to 1966.[32] This limited growth has resulted in part from the increasing importance of mortgage financing and from the positioning of the installment finance companies as an important source of long-term financing for some businesses. Still another development that has taken place in recent years has been the leasing of buildings and equipment, particularly cars and trucks. Also under "leaseback arrangements", widely used in shopping centre and building financing, the tenant agrees to pay the owner a specified rental for an agreed period, and often has the subsequent option to purchase.

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31 The net new equity financing over four years 1962 to 1966 was $1.9 billion or about 8% of the market value of all listed Canadian companies at the beginning of the period. Conway op. cit. p.33.

In effect, long-term debt has been incurred, although no securities have been issued and no liability appears on the borrower's balance sheet.[32] The result of these trends combined with other factors, (wide nonresident ownership of stock, the small size of many Canadian companies, and the government ownership of many utilities) have tended to restrict the supply of equities available to the Canadian public.[33]

Omitted above, but likely the most influential factor causing the squeeze on the supply of Canadian equities is that the major share of financing needs of Canadian businesses comes from retained earnings, depreciation and depletion allowances.

During the period 1957 to 1965, retained earnings plus capital consumption allowances fluctuated between 90% and 110% of total business fixed capital formation. In 1966, internal financing dropped to 78% of total business spending. A vivid picture of the role that internal funds played in financing business spending in each of the years 1957 to 1966, is provided in Figure 4. This representation is expanded in Figure 5, to show the percentage breakdown of financing of total domestic capital formation instead

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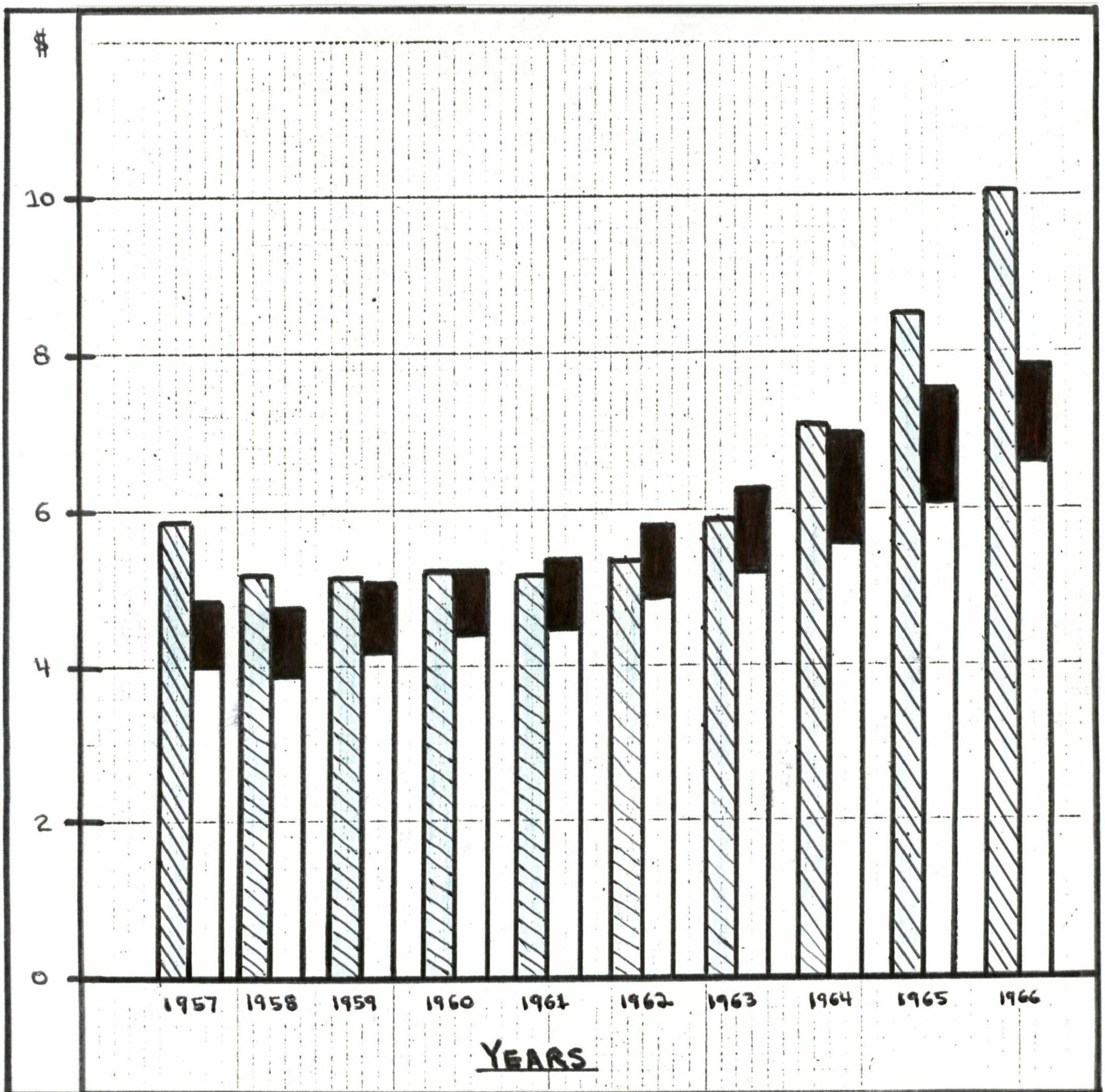
32 Report of the Royal Commission on Banking and Finance, Queen's Printer and Controller of Stationery, Ottawa, 1966, Chapter 3.

33 Ibid., p. 41.

FIGURE 4

INTERNAL CORPORATE FINANCING



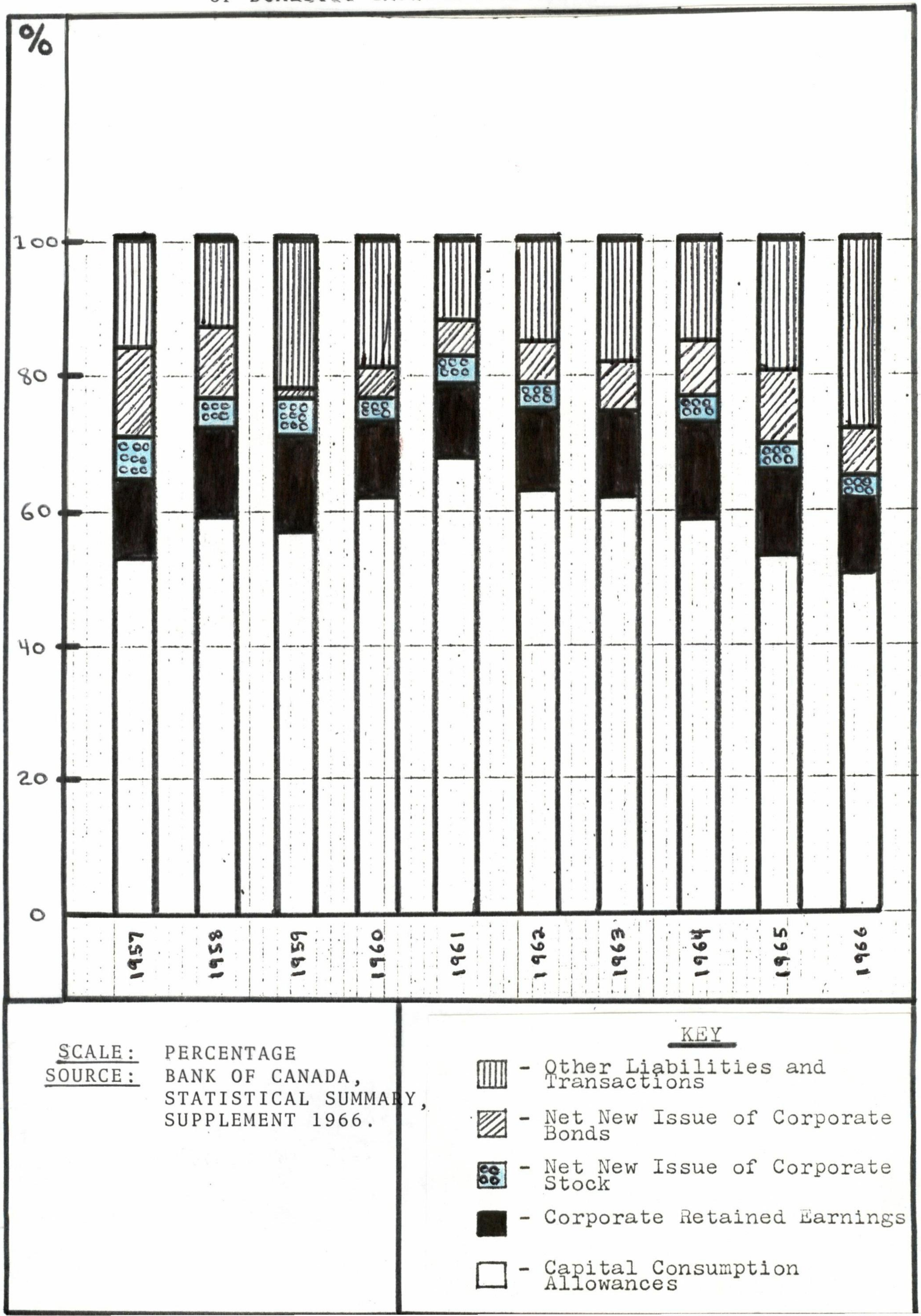
SCALE: BILLIONS OF DOLLARS
SOURCE: BANK OF CANADA, STATISTICAL SUMMARY, SUPPLEMENT 1966.

KEY

- Total Business Spending (Bus. Fixed Capital Formation)
- Corporate Retained Earnings
- Capital Consumption Allowances

FIGURE 5

PERCENTAGE BREAKDOWN OF THE FINANCING OF DOMESTIC CAPITAL FORMATION



SCALE: PERCENTAGE
SOURCE: BANK OF CANADA, STATISTICAL SUMMARY, SUPPLEMENT 1966.

of just the financing of new machinery and non-residential construction. It is obvious that slightly greater than two-thirds of total available sources for financing domestic capital formation in its broadest concept was represented by gross savings of businesses and slightly less than one-third was provided by external sources.

It is also interesting to observe that the internal financing portion, as drawn on Figure 5, increased from its 1957 position of 65% to a high of 79% in 1961 and then declined steadily to about 62% in 1966. Part of the explanation for this decline can be based on the various changes made in governmental public policy aimed at restraining increases in business fixed investment (17 to 20% range for the three years ending in 1966) to more sustainable rates. To curb expansion two measures were introduced in the March, 1966 Federal Budget, notably a reduction in depreciation allowances on a large variety of new plant and equipment obtained between the date of the Budget and October, 1967, and secondly the introduction of a 5 percent refundable tax on corporate cash flow (broadly, after-tax profits plus depreciation) in excess of $30,000.[34]

34 <u>1966 Bank of Canada Annual Report of the Governor to The Minister of Finance, and Statement of Accounts</u>, Bank of Canada, Ottawa, February, 1967, p.26.

The result these policy measures had on businesses was that cash flow available from retained earnings and depreciation allowance was only slightly larger than in 1965 and the external financing by businesses increased from about $1 billion in 1965 to $2.75 billion in 1966.

The effect internal financing has upon the issuance of new corporate stock is obvious - the amount of new money raised by this means tended to decrease. Unfortunately, the problem with this trend is that it runs completely counter to a growing appetite for equities by pension funds, mutual funds and other institutional investors.

Some interesting figures on the equity shortage in Canada were given by R. M. MacIntosh and K. E. Bissell, and are worth considering.[35]

They list four factors which caused the shortage of supply of Canadian equities.

1. The high rates of depreciation which are allowed for corporate tax purposes.

2. The tendency of corporate management to retain a generous share of net profits, since this is the most convenient and perhaps cheapest way to raise new funds.

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35 R. M. MacIntosh and K. E. Bissell, The Bank of Nova Scotia, "Some Factors in the Supply of and Demand for Canadian Equities", _The Canadian Chartered Accountant_, Volume 89, Number 5, November, 1966. p. 373.

3. The fact that corporate borrowing from outside sources are deductible for tax purposes whereas corporate dividends are not.

4. The increasing depth of the short-term money market.

Their article suggested that unless the existing corporate tax structure was changed so that equity financing became relatively cheaper, there would be little prospect of significant growth in the annual new supply of Canadian equities.

For corporations, there is an incentive to issue debt as long as the cost of doing so is less than the return which will accrue from the extra assets because the shareholder benefits from the additional "leverage" on the equity. Of course, the views of corporate management about assuming an unduly heavy debt burden and maintaining a sound financial position puts limits on this process, as do the views of banks and institutional and other investors. Given these basic conditions, however, the fact that interest charges are deductible as an expense before computing taxable profits, and dividends must be paid from income after taxes, means that pre-tax operating earnings must be twice as high to pay out the same amount of dividends as in interest charges.[36]

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[36] Assuming a 50% corporate tax rate, if $50 of additional interest is paid, operating earnings need rise only $50 for existing shareholders to be unaffected. If extra shares paying a dividend of $50 are sold, operating earnings must rise $100; this will be fully absorbed by extra tax liabilities of $50, and the dividends to new shareholders of an equivalent amount.

This is one reason why, preferred shares with their fixed dividends have become less important and now account for only about one-third of all stock issues. Another reason is that preferred shares have generally lost their appeal with investors in the market place.[37]

The discussion above provides the reasons why the supply of Canadian equities has not been extensive, but gives very little indication of the actual supply of new Canadian equities. In statistical terms, net new issues of Canadian corporate stock during the 1957-1966 period amounted to slightly less than $3.3 billion of which $2.6 billion represented common shares. These figures include all publicly announced issues and some private placement issues not publicly announced.

A yearly breakdown of the accumulated increases in corporate debt and equities can be found in Table VIII. While reviewing this particular data, the reader should keep in mind that the roll played by external financing has expanded slightly since 1961. However, from 1957 to 1966, net new issues of corporate stock have only been running around 5% of total business spending. In relation to the distribution of total external financing, corporate stock issues only represent about 12% of the aggregate figure - again without substantial changes over the entire ten year period.

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[37] "Preferreds are not preferred", The Financial Post, July 13, 1968, pp. 1, 4.

TABLE VIII

NET NEW CORPORATE SECURITY ISSUES IN CANADA - 1957 - 1966

Fiscal Year End of	Corporate Bonds	Other Bonds and Debentures	Preferred Stock	Common Stock	Total Common and Preferred
		(FIGURES IN MILLIONS OF CANADIAN DOLLARS)			
1957	955	4	89	426	515
1958	661	4	25	287	312
1959	98	21	72	332	404
1960	305	27	36	184	220
1961	331	28	-64(3)	309(1)	245
1962	422	10	66	271	337
1963	582	30	49(2)	-98(2)	-49
1964	761	11	39	293(1)	332
1965	1,198	39	155	304(1)	459
1966	921	33	190	331	521
TOTAL	6,234	207	657	2,639	3,296

NOTES: (1) Includes distribution by B.C. Power Corp., to its shareholders of funds received from the Province of B.C. in payment for the common shares of B.C. Electric Co. Ltd., these distributions amounted to $87 million in 1961, and $115 million in 1964, and $2 million in 1965.

(2) Includes the retirement of $345 million common stock and $55 million preferred shares of the privately owned hydro-electric companies which were taken over by Quebec Hydro. $53 million of the preferred were exchanged for bonds guaranteed by the Province of Quebec. Also includes new issue of $44 million shares of Shawinigan Industries Ltd.

(3) Includes retirement of $104 million B.C. Electric preferred shares exchanged for bonds guaranteed by the Province of B.C.

SOURCE: Bank of Canada Statistical Summary, Supplement, 1966.

In addition to net new issues, there is another source of Canadian equities which must be added to the supply entering the market. Since 1962, Canadians have been net purchasers of Canadian stock from non-residents, mainly from the "Non-Resident Owned Mutual Funds" which have divested themselves of Canadian equities since 1959. From 1962 to 1966, the total net purchases of outstanding Canadian securities from all non-residents has amounted to about $794 million.[38]

To some extent, the same type of equity supply problem exists in the United States, and is summed up by Raymond W. Goldsmith.[39] To quote him:-

> "The market for common stocks in the postwar period had the outstanding feature that new common stock issues were relatively small compared to the issuance of other capital market instruments, to the volume of internal and external financing of corporations, to the value of common stock outstanding and to the total assets of most investor groups".

To give some indication as to what might be expected in the future in terms of the supply of Canadian equities, we can turn to the following estimate made by Professor Conway.

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38 Dominion Bureau of Statistics, The Canadian Balance of International Payments, 1963 - 1966, and International Investment Position, Catalogue No. 6 7-201, Annual, 1966.

39 Raymond W. Goldsmith, The Flow of Capital Funds in the Postwar Economy, Columbia University Press, New York and London, 1965, p.18.

He predicts a projected level of net new equity issues of about $700 million a year.[40]

The Demand for Canadian Equities. In Canada there has been a growth in the demand for equities by financial institutions, especially by the mutual funds and trusteed pension funds. MacIntosh and Bissell, state that the factors that have created this demand are:[41]

1. Rising personal incomes and the accumulation of assets out of personal savings.
2. The rapid growth of corporate pension funds reflecting the rise in real incomes and the elaboration of corporate fringe benefits.
3. The rapid growth of mutual funds due to successful selling methods, professional investment management, and acceptable performance from the point of view of the small investor. This latter factor is related to the growing disenchantment on the part of the individual with the results of his direct participation in the stock market.

The trend is obvious from the statistics provided in Table IX, which show the extent to which the largest Canadian institutional investors have invested in Canadian corporate stock.

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[40] Conway, op.cit. p.35.

[41] MacIntosh and Bissell, op.cit., p.374.

TABLE IX

INSTITUTIONAL INVESTMENTS IN CANADIAN CORPORATE STOCK - 1960 - 1965

YEAR	Mutual Funds 1.	Trusteed Pension Funds 2.	Closed End Funds 3.	Life Insurance Co.s 4.	Trust Companies 5.	Mortgage Loan Co.s 6.	TOTAL
	(FIGURES IN MILLIONS OF CANADIAN DOLLARS - BOOK VALUES)						
1960	313 E	259	251 E	176	42	31	1,072
1961	385 E	342	281 E	218	53	33	1,312
1962	473 E	423	315 E	220	63	38	1,532
1963	582	519	453	257	65	52	1,823
1964	709	647	404	338	67	56	2,221
1965	918	820	429	420	75	55	2,707
1966	992	982	454	520 E	84	58	3,090
Increase	679	723	203	344	42	27	2,018

NOTE: E - Estimates taken from a table provided by R. M. MacIntosh and K. E. Bissell, Canadian Chartered Accountant, November 1966, p.374.

SOURCE: 1, 3, 5 and 6. - Business Financial Statistics - Selected Financial Institutions, 1963 - 1966, Dominion Bureau of Statistics, Ottawa.

2.- Trusteed Pension Plans - Financial Statistics, 1960 - 1966. Dominion Bureau of Statistics.

3.- Bank of Canada Statistical Summary, Supplement, 1966.

From 1960 to 1966 these six major institutions absorbed $2,018 million worth of Canadian corporate stocks. During the same period the net new issues supplied to the capital market totalled $2,065 million.[42] Thus, these institutions <u>were capable</u> of digesting almost the whole of the net new supply of Canadian common and preferred stocks.

The reason why the term, were capable, was underlined is that these institutions probably did not absorb all or a large part of the new issues placed in the market. Normally, such institutions are only interested in well seasoned equity issues which meet the minimum quality standards set by the financial institutions themselves, or set for them by the Canadian and British Insurance Companies Act and listed in the "Eligible Book". The concept that major Canadian financial institutions are basically conservative investors has also been implied by Professor Conway.[43]

It should be pointed out that omitted from Table IX, are the segregated funds managed by the life insurance companies under Section 81 (5)

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42 Figures derived from Tables VIII and IX.

43 Conway, <u>op.cit.</u>, p.16.

of the Canadian and British Insurance Companies Act. Established in 1961, the segregated funds can be wholly invested in equities. In 1961 the total assets of the segregated funds were approximately $2 million at market value, and grew to a position of $197 million by the end of 1967.[44]

Another important group of equity holders omitted from Table IX, are the estate, trust and agency accounts managed by trust companies. They must be considered as a growing force behind the demand for Canadian equities. It was estimated in a survey conducted for the Royal Commission on Banking and Finance that the demand for equities generated by the E.T. & A. Accounts represents $300 million per year. This survey also indicated that 48% of the market value of all these accounts was invested in Canadian equities. It did not cover pension funds or deposit securities held for insurance companies, which in 1962 amounted to about 20% of total assets at book value.

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44 The Canadian Life Insurance Association, Submission to The Canadian Committee on Mutual Funds and Investment Contracts (Toronto: The Canadian Life Insurance Association, June, 1968), p.9.

The following table indicates the known book value of assets in all E.T. & A. Accounts to the end of 1965.

TABLE X

E.T. & A. Accounts

ESTIMATED INVESTMENT IN CANADIAN EQUITIES - BOOK VALUE

1961	$2,697 millions of dollars
1962	2,955
1963	3,218
1964	3,606
1965	3,919

The Result of Excess Demand for Canadian Equities.
Basically, what the overall analysis of the supply of, and demand for equities implies is that since stockholders other than financial institutions undoubtedly acquire a substantial portion of new issues of corporate stock, particularly of those offered under subscription rights; other stockholders must, for the 1960 to 1966 period have been net sellers to financial institutions of seasoned marketable corporate stock. Furthermore, it would seem probable that the combined net purchases of mutual funds, pension funds, and other financial groups will continue to absorb a substantial portion of the new common stock issues entering the Canadian equities markets as well as searching out the highest investment quality stocks presently outstanding.

Some indication of the extent of this demand for equities is provided in two reasonably recent publications.

The first is the Report of the Task Force on the Structure of Canadian Industry, which indicated that the increase in demand for stocks by mutual funds and the pension funds may be nearly $5 billion over the period 1967 to 1970. An attempt was also made to project the holdings of Canadian equities by mutual funds, pension funds and life insurance companies in 1975. It was suggested that over the next eight years these three major financial institutions will want to acquire more than $6 billion in Canadian stocks. Thus these institutions, whose holdings of Canadian stocks at the end of 1966 had an estimated market value of $3 billion and had increased by an annual average rate of about $300 million since 1960, would be acquiring an average of $800 million of Canadian stocks each year.[45]

The second publication, the York Study, predicted that the same three major financial institutions could be looking to invest over the next few years, on average, about $1 billion a year in equities. This figure includes possible demands for both Canadian and foreign equities. To this figure an additional $300 million per year is added representing an estimated demand for equities by other Canadian financial institutions, by Canadian corporations, and by Canadian individuals.[46]

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45 Foreign Ownership and the Structure of Canadian Industry, Ottawa: Queen's Printer, 1968, pp. 284-5.

46 Conway, op.cit., pp. 40-41.

Considering population growth, and social trends in Canada, a further expansion in the number of people covered by pension plans is probable. From the viewpoint of stock investing, efforts by the life insurance industry to enlarge its share of the pension market through variable annuities might represent a substantial new institutional demand for equity securities by this financial institution.

Eventually, the trends discussed above might lead to the same type of situation that has developed in the United States since 1957. In the U.S., individuals have been heavy sellers, even while the stock market averages were being shifted upward during periods of optimism; suggesting that something fundamental had changed in the stock market. Considering this trend, it no longer seems possible to regard the bearishness of individual investors on a transitory matter; it seems clear, they are becoming increasingly disenchanted with stocks. Meanwhile the U.S. pension funds and mutual funds have become more attracted to stock every year. Thus, the new market in America is made by individuals selling stocks to pension funds and mutual funds.[47]

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47 New York Stock Exchange, "Institutional Shareownership", 1964, p.37.

In Canada, a development similiar to this would mean a transfer of stock from individuals to Canadian pension funds and mutual funds. This is obvious from the data presented in Table IX, which shows that the net purchases of common stock by financial institutions were concentrated in two groups - the mutual funds and the trusteed pension funds accounting for 37% and 33% respectively.

This now completes a rather detailed analysis of the supply of, and demand for Canadian equities, which was necessary for two reasons. First, to show that the growth achieved by the Canadian mutual fund industry has been aided by the fact that in Canada over the last few years the demand for Canadian equities has exceeded the supply. This situation has brought about an interest by the small investor to invest in the stock market through mutual funds because of the limited amount of desirable common stock available for him to invest in; thereby increasing the assets of the mutual fund industry significantly.

The second reason why this analysis was necessary is that it has been predicted that the demand for Canadian equities will continue to exceed the foreseeable supply. The demand by Canadian financial institutions alone could easily grow to triple their 1966 holdings; thereby reducing the number of shares available to individual Canadian investors and non-resident investors.

The impact this trend may have on the Canadian investor is discussed in the following section.

The Financial Community and the Small Investor

It has been fairly well established that the small Canadian investor is faced with the problem of competing with wealthy individuals and financial institutions for a limited supply of Canadian equities. This does not mean to say that with the assistance of a stock broker he will not be able to select securities from the Canadian or U.S. securities markets that are best suited for his investment programme. The fact is, however, that the costs per dollar invested in equity securities can be substantial for the small investor. It is not impossible for odd-lot charges on small purchases to reduce the investor's net yield below the rate of return earned on the security. And even at the current level of brokerage commissions, it may well be that the small investor is not paying the full cost of his transactions. As a result of this, brokerage firms in Canada and the United States have begun to show a marked reluctance to service small accounts.

Current opinions about the small investor expressed by members of the financial community lend strength to the belief that the small investor will be forced into using financial institutions as a means of participating in the equities markets.

One strong proponent of the belief that some day the small Canadian investor will vanish, is Mr. Leslie Rowntree, Ontario Minister of Financial and Commerical Affairs. In an interview with the press in early 1968, he suggested that the lack of comprehensive and current research data on Canadian securities was an important cause of a growing investment in U.S. securities by Canadian institutions and individuals. By the same token, the lack of worthwhile research data may be a partial cause of disenchantment of small investors; thereby causing them to flee from the market.[48]

Another person who feels that the small investor may be eased out of the market is Mr. Alden S. White.[49] A discussion with the writer in May, 1969, Mr. White said that most of the research being carried out by Canadian brokerage firms is geared to the needs of the institutional investor, mainly because this group provides the brokerage community with its greatest source of income. He felt that there was certainly no shortage of small investors in the market at that time, but eventually certain individuals would be gently eased out of direct equity investing as brokerage firms continue to devote more of their time and efforts to their institutional accounts.

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48 "The Lack of Adequate Securities Research Data is Blamed for Swing to Investment in U.S.", Toronto Globe and Mail, January 27, 1968, p2.

49 Mr. White is the Assistant Research Manager with Wood Gundy Securities Limited, Toronto.

In terms of the actual cost of looking after small clients, J. R. Kimber, President of the Toronto Stock Exchange, has recently said that member firms lose money on transactions of $1000 or less.[50] At the present time, members do not refuse this business but some firms make it a point to advertise their specialization in institutional activity and ability to provide services for large scale clients.[51]

In the United States, a special report prepared by the New York Stock Exchange on Profits as a Percentage of Securities Commission Revenue, revealed that brokers' profits are closely related to the amount of institutional business they do. The study showed that relatively big profits can be reaped from handling the brokerage business of large financial institutions; whereas, executing so called retail orders by small investors has caused a squeeze on profits and in some cases the lack of profitability.[52]

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50 "Small deals called costly for broker," Toronto Globe and Mail, May 14, 1969, p.B1.

51 Ibid., p.B1.

52 "Study shows where brokers profit most", Toronto Globe and Mail, August 1, 1969, p.B10.

There seems to be very little doubt in the minds of executives working in the Canadian financial community that the small investors will rely on the mutual fund industry to provide them with a more economical and beneficial method of entering into and remaining in the equities markets.

IV. SUMMARY

Two major tasks were accomplished in this Chapter. Firstly, we observed that three predominant factors have directly or indirectly aided the growth of the Canadian mutual fund industry. These three factors were said to be an increase in personal net savings, a development of financial sophistication by savers and a marked preference for saving through financial institutions.

In more specific terms, it was shown that there has been a high and increasing rate of savings in Canada since 1957. Combined with this, there is a growing concern by individuals of the harmful effects of inflation which has shifted the flow of savings to those channels of saving that can compensate best.

It was suggested that equity investing has historically provided rates of return higher than those offered by banks and other deposit accepting institutions.

And the groups capable of taking advantage of the shift in the attitude of savers toward reaping the benefits of equity investing were the investment dealers, mutual funds, trusteed pension funds, closed-end investment companies, and trust companies through their estate, trust and agency accounts.

A second major task accomplished in this Chapter was that of determining how savers decided where to channel their saving in the past and why some financial institutions were preferred over others. This was accomplished by studying the Canadian investor and his degree of financial sophistication. It was concluded that Canadians are actually fairly aggressive investors and have been moving up a scale of financial sophistication for some time.

Once this was established it became necessary to determine the reasons why indirect investing through financial institutions has become increasingly popular in recent years, especially when Canadian investors appear to be quite sophisticated. An analysis of the class structure of the investing public, the supply of, and demand for Canadian equities, and the attitude of the financial community toward the small investor provided the answers.

Briefly, it was shown that there may be a limited amount of desirable common stock available for him to invest in because of concentrated holdings of stock in the hands of the wealthy, combined with a growing tendency of the demand for Canadian equities to exceed the new supply entering the market.

To further worsen the small investor's opportunity for purchasing securities best suited for his investment programme he must contend with higher brokerage charges and a growing tendency for investment dealers to devote more of their time to their large clients and institutional accounts.

As a result of these developments, the small investor has altered his investment approach by participating in the equities markets indirectly through financial institutions. The mutual fund industry has benefited from this alternative investment approach by providing the extremely attractive investment package described in the previous chapter. In addition, Canadian mutual funds have played an active role in developing an aggressive distribution network through which the mutual fund package has been marketed.

CHAPTER V

GROWTH POTENTIAL FOR CANADIAN MUTUAL FUNDS

The tasks accomplished in the previous chapter provided a coverage of some influential factors behind the increasing interest in Canadian mutual funds as principal financial institutions for investing in equity instruments. In addition, some insight was given as to what lies ahead of the mutual fund industry and other financial institutions that can meet the future demands of savers.

Although the mutual fund industry has greatly benefited from the changing demands by savers, so too have other previously mentioned financial intermediaries. As savers continue to move to higher levels of investment sophistication they will invariably seek out and invest their savings in financial intermediaries that can satisfy two important demands. The first demand is for a wider range of financial services, which should include a greater amount of investment counselling along with a broad range of financial services under one roof. Secondly, they will continue to demand higher rates of return to protect themselves from the harmful effects of inflation.

The point that has been reached in the financial market at present is one in which the major financial institutions are scrambling in order to provide a broad range of financial services. Assuming that this scrambling process continues in future years, it will inevitably mean that the successful financial institutions will be fairly evenly matched in terms of the services they can provide to their clients. However, it is equally apparent that those institutions that can provide a complete range of services along with higher rates of return will prove to be most successful in terms of expanding their assets.

Insuring future growth is not, however, limited to maintaining a position of merely satisfying changing preferences. Through innovation, new preferences may be created and the innovator will be rewarded accordingly. It was suggested in the introductory section of Chapter IV, that preferences for the instruments and services offered by a financial institution may come about through innovations which create new demands.

There are two assignments to be completed in this chapter. The first, will be to mention some of the factors which will favourably influence the growth of the mutual fund industry in the future. If all goes well, these factors should contribute significantly to the future growth of the industry because it is presently well prepared to meet the future demands of savers. The second is to discuss the changes taking place within the mutual fund industry as it prepares itself for the future. In other words, we will want to look at the steps the industry has taken and will be taking to insure its rapid growth and relative position as a financial intermediary.

A logical starting point in an analysis of the factors assisting future growth is to introduce the obvious social and technological changes likely to benefit the mutual fund industry. These social and technological changes will result from a further shift in the level of economic development, in the attitude of individual savers and the wants and needs of borrowers. It is suggested that the mutual fund industry will be in a strong position to maintain its growth relative to other financial intermediaries because many of the expected social and technological changes are orientated along the lines of the services many mutual funds presently have to offer. Once we have reviewed these changes, it would seem reasonable to attempt to show the extent to which the mutual fund industry is innovating in order to capitalize on the business that may unfold out of new demands in the economy.

I. CANADIAN MUTUAL FUNDS AND SOCIAL AND TECHNOLOGICAL CHANGES

The past is a matter of record. The mutual funds and their growth in the future is now the greatest matter of concern. In a world in which social and technological changes are constantly accelerating, the expected (along with the unexpected) usually arrives ahead of time. No one can say for sure what is in store in the future, even the future of a single industry. Yet, bearing this in mind it remains both fruitful and fascinating to peer ahead. Given a factual body of knowledge it is possible to make predictions of what might possibly happen in the future; however, as time passes newly introduced knowledge may have a tremendous influence upon the events that actually take place.

As far as the Canadian mutual fund industry is concerned, it is possible to outline numerous factors that may benefit the future growth of the industry vis-à-vis other financial institutions. This procedure still leaves much to be desired in that no industry operates in a vacuum. For example, a major event in store for the mutual fund industry in the near future is the reporting by the Federal-Provincial, Canadian Committee on Mutual Funds and Investment Contracts.

Obviously the legislative recommendations to be made by this governmental body could have tremendous implications for the future growth and development of the mutual fund industry in Canada.

Historically, the major proportion of funds' shareholders or unitholders has been and still is the small investor who lacks a large amount of capital to allocate to long-term savings. Most recent economic and social developments in Canada are aimed at increasing the lower earners' income while keeping those in the higher income groups at the same level. Such a policy will contribute to increase the income in the hands of the people most likely to buy mutual fund shares. Some of these people have never had the opportunity to save any money, let alone invest it. A portion of their additional income will eventually go into long-term savings, meaning that they could be potential mutual fund shareholders or unitholders.

As far as individuals in the middle income classes are concerned, it is also possible that they will join in greater force with mutual funds. The stockbrokers will be instrumental in developing this trend. The situation is now developing whereby brokerage firms are discouraging direct investment by small accounts (under $10,000), and directing these accounts toward either inhouse or external mutual funds.

The high administration costs of operating an investment account makes most small accounts unprofitable for brokerage firms.

The growing financial sophistication in the market place will convince a greater number of average and even fairly sophisticated investors to turn to mutual funds. The advantage of professional management vis-à-vis do-it-yourself investing will increase sharply. Mutual funds, as well as other financial institutions are making more and more intelligent use of the computer as a tool for portfolio analysis. Although the computer may never take the place of human judgement in an investment decision, there is little doubt that its careful and sophisticated use can be enormously helpful to the well trained investment manager. As a consequence, financial research methods will change. Information will be far more refined and quantified. Investment research will probably be more mathematically orientated. Probability theory will be used in the prediction of earnings, dividends, and growth of companies held in the funds portfolios.

As the character of Canadian and American industry changes as the result of the technological revolution, financial analysts will have to become far more scientifically and technically orientated in order to ask the right questions of the corporations they analyze.

It is quite conceivable to imagine that in addition to employing economists, statisticians and financial researchers, mutual funds will also hire operations research specialists, mathematicians, behavioural scientists, systems analysts, and other such specialists to back up the managers in their search for valuable data on portfolio companies.

In brief, mutual fund managers will have better and more precise data for making investment decisions, and this data will inevitably be superior to that available to the average individual who invests in the stock market on his own; so much so that the advantages of professional management will be further dramatized. As a direct result, many private investors will probably become convinced that the risk-reward odds against them are too high. A logical solution for them will be to allocate their savings to a mutual fund which satisfies their investment objectives.

Changes such as these will transform the methods used by mutual funds and the business environment within which they operate. There may be great social changes in the reasons why people invest. Individuals may buy mutual fund shares not merely to provide their children with a university education, as many Canadians do today, but to provide themselves with additional education later in life.

This change may in part stem from a combination of technological advancement and the demand by industry for highly educated people. So too, people may also invest in mutual funds not to provide a marginal living after retirement, but to make possible a far more comfortable standard of living and a wide range of educational and recreational facilities.

Despite all such conceivable developments, it is unlikely that the basic idea upon which mutual funds are based will change. The principal of pooling one's capital with others' and purchasing professional management and diversification will make even more sense in the years ahead. This optimistic belief is generally supported by a summary of the prospects for mutual fund growth prepared for the Commission on Money and Credit in the United States.

> "The trend in individual and institutional financing is still toward more equity investment," the C.M.C. declares. Moreover, the fund industry "is in a strong competitive position to offer most economically the basic investment advantages of diversification and professional management... The industry has developed many investment service features not readily available in other investment media."

Before proceeding it should be emphasized that mutual funds are by no means appropriate for everyone. They will not supplant other types of savings and they certainly do not represent a panacea for all investors.

Nor is there in the foreseeable future, despite a popular misconception to the contrary, any way mutual funds can completely eliminate the element of risk from investing in securities. Investing in stocks and bonds, either directly or indirectly through mutual funds, will remain only part of any well-planned financial program. It is in the area of developing the other aspects of a financial program, through an increasingly wide range of services, that the mutual fund industry is likely to benefit considerably.

The discussion in the next section will be concentrated on the scrambling process taking place within the mutual fund industry to provide investors with a broad range of financial services.

II. MUTUAL FUNDS AND THE INNOVATION PROCESS

Changes are constantly taking place within the Canadian mutual fund industry. Some changes result from the demands of investors. Certain investors need and want a conservative portfolio; others require an adventurous package of securities. Some need immediate income; others want only long-term appreciation and still others search out speculative investments.

In Canada, the mutual funds have met specific demands of investors by offering funds with different investment objectives.

As the number of funds multiplied, they have arranged themselves along what might be called a "risk-reward spectrum". At one end of the spectrum are the conservative mutual funds. At the other end are funds that are more venturesome.

Other changes taking place within the industry, or expected to take place in the near future, result from attempts to provide an integrated line of financial services. The advantage of being in a position to provide an individual investor with the financial assistance he needs is obvious. The more services an individual can obtain under one roof, the more of his savings he will leave with the organization providing such services. Although the developments in this area have been notable as far as Canadian mutual funds are concerned, the greatest developments in recent years have taken place in the United States.

To put things in perspective, I will attempt first of all to show the steps the Canadian mutual fund industry has taken to provide an integrated line of financial services. Secondly, I will indicate the challenge the Canadian mutual fund industry faces in becoming better qualified in the area of financial counselling. Thirdly, I will discuss the measures the industry is adopting to satisfy the demand by investors for higher rates of return on their capital.

Financial Complexes

It is certain that the expanding market for financial services will intensify competition among financial intermediaries. Mutual funds will not only have to compete with one another, but also against an increasing number of firms entering this area from without. Life insurance companies and trust companies, for example, are well aware of the opportunities opening up in the area of financial planning.

At the outset, it is apparent that management companies advising more than one mutual fund are in a more favourable position than those managing an individual fund as far as potential sales are concerned; the reason being that they are able to offer to potential investors mutual funds with different investment objectives. This type of arrangement was previously defined as a "mutual fund complex". By way of summary, a mutual fund complex enables a mutual fund adviser to reach a broader cross-section of potential investors and to offer each investor an opportunity to apportion his aggregate mutual fund investment among several funds with different objectives. Most shareholders of a mutual fund within a fund complex also have the option to switch to other funds within the complex at a reduced or no sales charge.

The obvious advantage of being able to offer all funds along the "risk-reward spectrum" is that the potential investor can find under one roof a fund or funds completely suited to his own particular investment needs. In Chapter III, five of the largest Canadian mutual fund complexes were cited as follows:

1. The Investors Group
2. United Funds Management Ltd.
3. A.G.F. Management Ltd.
4. Capital Management Ltd.
5. Canadian Channing Corporation Ltd.

Each of these five management companies offer two or more mutual funds with different investment objectives.

A clear indication of exactly what various management companies have to offer to the public in terms of financial planning can be observed by reading the following comments extracted from a standard newsletter circulated by Canadian Channing Corporation Ltd.

> "As with most Mutual Funds, the principal objectives of the three Canadian Channing Funds include the maintenance of stable income, the growth of capital invested and the safety of investments from serious decline in value. However, these objectives are to some extent mutually exclusive, that is, in order to give priority to one of the objectives, the emphasis on one or both of the other objectives must generally be decreased. Each of the three Channing Funds place differing degrees of emphasis on each of these objectives. Thus, certain classes of investors with particular objectives will prefer one type of fund to the others for an additional commitment. With the formation of the new Venture Fund, every potential investor can now find a Canadian Channing managed fund or funds completely suited to his own particular situation."

"The Commonwealth Fund is a "balanced" type of Mutual Fund, which, because of the character of its diversified investments acting in concert, provides a high degree of security and a stable rate of current income to its shareholders. At the same time unlike the situation with fixed dollar return, investments such as Canada Savings Bonds, shareholders participate in the growth of the economy through the capital appreciation of the fund's investment portfolio, although this growth potential is not necessarily as great as in the less conservative funds. The Commonwealth Fund is, therefore, designed for investors who desire equity investment and income to combat inflationary pressures, but who wish to be assured that their invested capital will not be seriously depleted even on a temporary basis."

"The Leverage Fund is commonly referred to as a "growth" fund, that is, its primary objective is long term capital growth. This fund should, therefore, be of interest to persons who are willing to accept a higher degree of volatility in their investment in order to achieve a higher growth potential, but at the same time, are not interested in a highly speculative investment."

"The Venture Fund is designed with a bolder and more aggressive investment policy than either of the other two funds. Its aim will be to attain above average appreciation of capital within reasonable limits by emphasizing investments in the higher growth segments of the economy and in companies with new ideas and technology, including smaller companies. The potential for capital growth will be the sole basis for selection of portfolio securities and in the variations in the liquidity of the Fund. The Venture Fund is consequently aimed at the investor who is willing to, and can afford to, take greater risk in order to seek higher appreciation of his invested capital."

The Canadian Channing example was chosen for no special reason other than the fact that their sales literature expressed the objectives of their funds in clear terms.

A review of the literature of the other mutual fund organizations would reveal a similar type of presentation.

Quite apart from the fact that several larger mutual fund complexes are able to offer a number of different types of funds geared to a broad range of desires of investors, they have also been successful in moving into other areas. These other areas would include many of the services presently being offered by the trust companies and insurance companies in the overall process of financial planning. This movement is generally termed as the process of "financial scrambling". When a mutual fund complex becomes associated with other financial institutions as a result of such scrambling we observe the development of a "financial complex."

The development of financial complexes has been evident in Canada for sometime and is well illustrated by reference to The Investors Group and its association with other financial intermediaries. This group is the successor of Investors Syndicate of Canada, Limited, which was incorporated in Manitoba in 1940 to handle the Canadian business of the U.S. parent company, Investors Diversified Services, Inc. of Minniapolis, Minnesota. The business at that time consisted only of the sale of investment contracts.

In 1950, Investors Syndicate of Canada, Limited organized a mutual fund called Investors Mutual of Canada Ltd., for which Investors Syndicate of Canada, Limited acted as the management and distribution company. At the end of 1968, the total net assets of Investors Mutual of Canada Ltd., were $584,818,616.

In 1956, Investors Diversified Services, Inc. divested itself of its Canadian subsidiary through the issuance of a stock dividend in shares of Investors Syndicate of Canada, Limited. The latter company was reorganized in 1964 and called The Investors Group. Control of this group is held in Canada, and it is operated separately from Investors Diversified Services, Inc.. The Investors Group is a public management company, and is listed on Canadian stock exchanges.

After the reorganization of Investors Syndicate of Canada, Limited as The Investors Group, a new company was established under the name Investors Syndicate Limited. The latter sells investment contracts and also acts as the distribution company for Investors Mutual of Canada Ltd., Investors Growth Fund of Canada Ltd., and Investors International Mutual Fund Ltd.. The Investors Group is the management company of all three mutual funds. The latter two mutual funds were created in 1957 and 1961 respectively to provide a broader range of investment objectives for potential shareholders; their aggregate total net assets at December 31, 1968 were $441,281,474.

The three mutual funds together make up the largest mutual fund complex in Canada. Salesmen of Investors Syndicate Limited sell its investment contracts and shares of the three mutual funds. In addition, they can offer their clients considerable information as to other services provided by The Investors Group and its subsidiary companies.

The Investors Group has several other financial interests. It also owns The Western Savings and Loan Association, an organization which issues investment contracts and acts as the distribution company for Provident Mutual Fund Ltd. and Provident Stock Fund Ltd. of which The Investors Group is the management company. These two mutual funds had aggregate total net assets at the end of 1968 of $42,996,574. The aggregate total net assets at December 31, 1968 of mutual funds managed by The Investors Group was $1,069,096,064. The Investors Group also carries on trust company operations through Investors Group Trust Co. Ltd., and has subsidiaries engaged in real estate development and other activities. In addition, The Investors Group has large interests in a number of Canadian public companies. The Investors Group and its associated companies can be observed in diagramatical form in Figure 6.

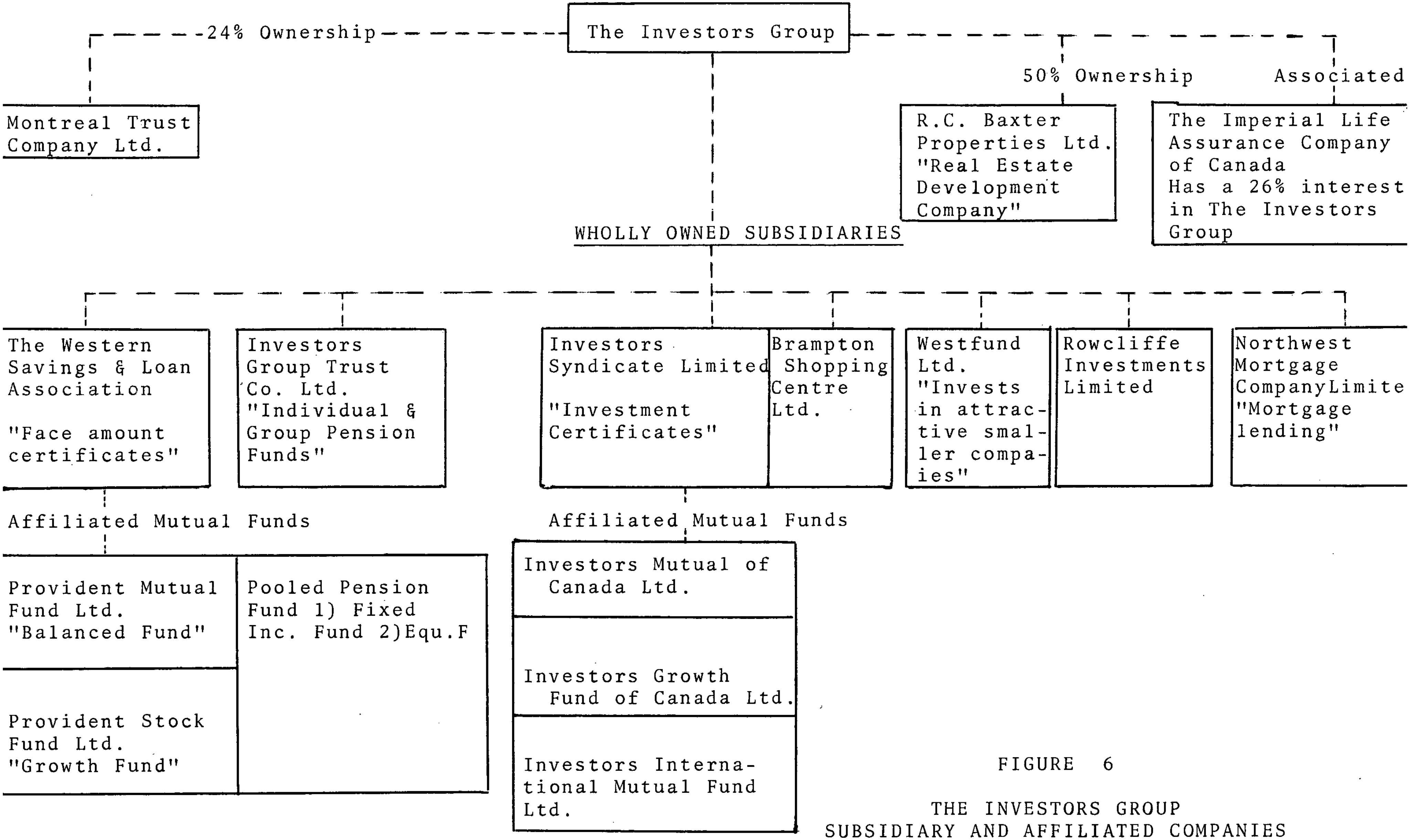


FIGURE 6

THE INVESTORS GROUP
SUBSIDIARY AND AFFILIATED COMPANIES

The development of Canadian financial complexes is further illustrated by the fact that The Investors Group has itself been absorbed by a large financial complex that covers a broad range of Canada's economic and financial community. Based on a closed-end investment company, Power Corporation of Canada, Limited, this complex controls or is associated with other mutual funds, life insurance companies, and a major trust company. The Great-West Life Assurance Company, of which The Investors Group recently acquired control and which has a substantial interest in The Investors Group, is active in the development of variable insurance contracts. Montreal Trust Company, in which both Power Corporation of Canada, Limited and The Investors Group have substantial interests, offers investment funds for public participation and had aggregate total net assets of $30,724,241 at the end of 1968. The Royal Bank of Canada, having interests in both Montreal Trust Company and The Investors Group, is associated with RoyFund Ltd., a mutual fund first sold to the public in 1967, with total net assets at the end of 1968 of $9,811,064. These are only a few of the organizations associated with the financial complex which offer mutual fund shares or units or competitive instruments, and almost every other type of financial service is provided by at least one company within the complex.

Other financial groups have also been active in the movement toward fully integrated services. Another interesting example is The Collective Group. This group professes to represent a complete one-stop financial center. Listed among the services they provide are savings and chequing accounts, savings certificates, mutual funds, pension plans, life, auto and fire insurance, trust services, realtors, mortgage loans, and property management. These services are provided by a number of different subsidiary companies which are named in the organizational structure illustrated in Figure 7.

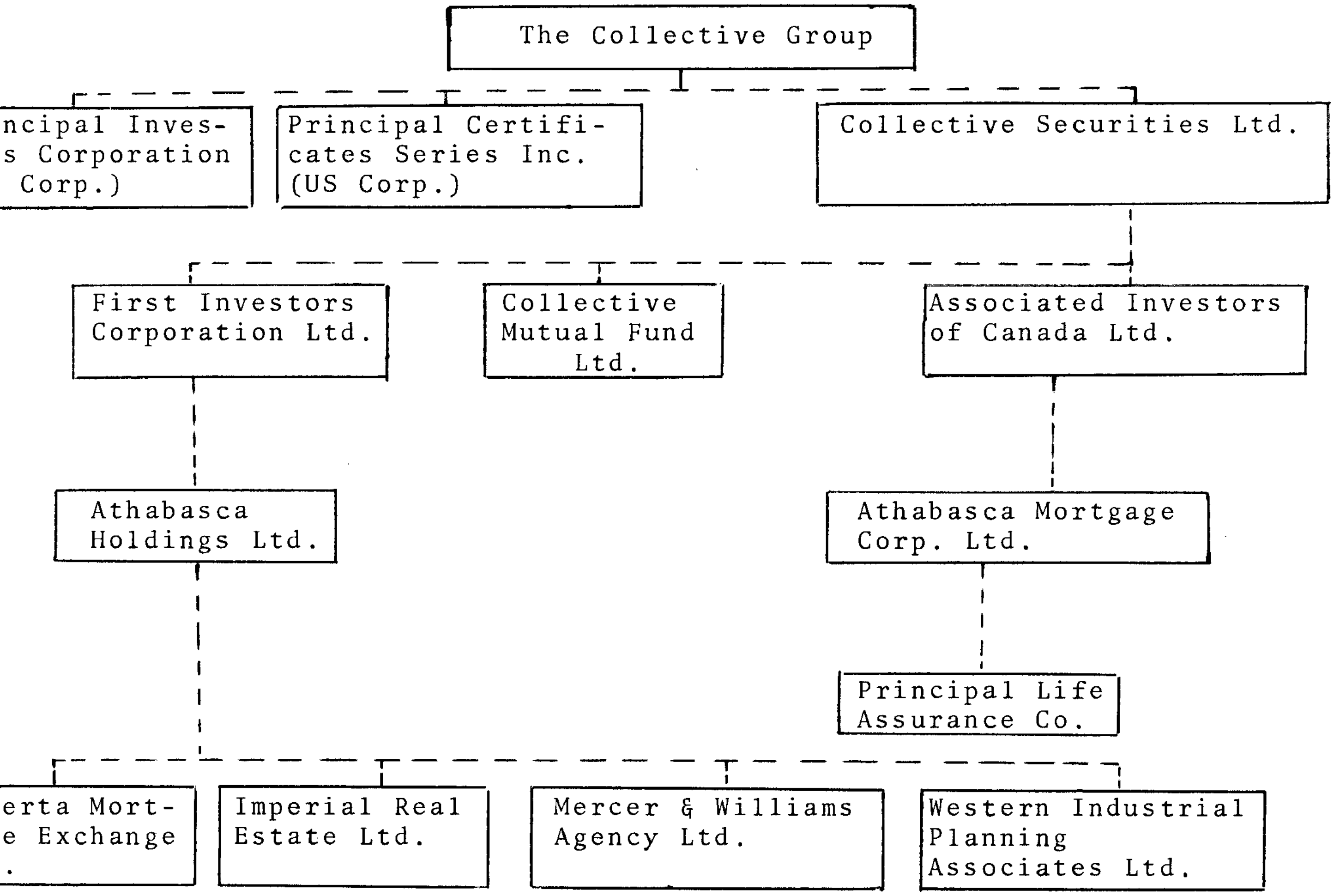
The two groups just described by no means represent the only financial complexes providing a complete range of financial services. They do, however, give a clear indication of the movement taking place within the industry to capture business that would normally flow to competitors. It would appear that the financial complexes are likely to attain tremendous asset growth over the next few years.

Financial Counselling

It is now worth considering some of the developments expected to take place within the industry as the battle for the investor's dollar becomes more fierce. One obvious development will be the improvement in the education of mutual fund salesmen.

FIGURE 7

THE COLLECTIVE GROUP
SUBSIDIARY AND AFFILIATED COMPANIES



RCE: Files of The Canadian Committee on Mutual Funds and Investment Contracts

Salesmen will have to do much more than just sell securities as the move toward personal financial planning is extended. Along with offering an integrated line of financial services, they will have to serve as financial counsellors to their clients, advising them on mutual fund matters, on insurance and other aspects of financial planning.

Many people believe, for instance, that as a result of financial scrambling by mutual funds, it will not be long before dual-licensing of insurance and mutual fund salesmen will be allowed. It is now allowed in most states of the United States but not officially as yet in Canada. This in itself will be one of the recommended changes to be suggested by The Canadian Committee on Mutual Funds and Investment Contracts.

In order to become a qualified financial counsellor the salesman will have to become more systematic and financially sophisticated. He will have to be well educated, not only in the fundamentals of the mutual fund business and the regulations governing the industry, but also in the complexities of personal financial planning. He will also have to be well trained in the newer selling and marketing techniques, for the next few years will probably be a marketing era.

Present mutual fund sales training techniques leave much to be desired, and have been criticized often although improvements are being introduced and will continue to be introduced by the more progressive organizations. In addition, The Mutual Fund Committee will be recommending more strictly controlled training procedures for all mutual fund salesmen, which, if implemented, should not only protect the investing public from abusive sales techniques but also force the industries' sales representative to become better qualified as financial advisers.

Venture Funds - Performance Aspect

A trend that has developed in Canada in recent years is the desire of investors for higher rates of return on their investments. This trend has, to a certain extent, induced salesmen to sell performance rather than the mutual fund concept. With an increasing emphasis being placed upon rates of return, it can be expected that investors will be looking more and more at the superior performers. The poor performers may find new capital hard to obtain. Because of the impact the demand by investors for performance will have on the future growth of the mutual fund industry, it is worthwhile reviewing one important aspect of performance - the performance funds.

The performance funds came into their own in 1966. Convinced that the "go-go performers" were not a flash in the dark and that they were in fact siphoning off considerable business, some of the major mutual fund organizations introduced their own performance funds. Since their introduction, a number of these mutual funds with investment objectives that contemplate the acceptance of risk in order to increase the rate of return (often referred to as "venture" funds) have had very considerable success.

Basically, the venture funds seek out stocks that appear to have a much greater opportunity for capital appreciation over the short-term. They also tend to follow a flexible management policy by frequently shifting to bonds or to stocks to take advantage of special conditions in the securities markets. In contrast, balanced funds try to hold enough senior securities (bond, debentures, preferred stocks) to offset sharp fluctuations in common stock prices. The managers of balanced and other conservatively managed funds also tend to emphasize long-term growth rather than trading frequently for short-term capital gains.

The venture funds, as mentioned above, have frequently good, and sometimes excellent, rates of return; in this they have been assisted by rising stock prices, but in some cases their performance has been considerably higher than those which would have been attained through investing in the equities that form recognized market indices or averages. It is difficult to specify with precision which Canadian mutual funds should be classified as venture funds, but for the purpose of this discussion one might accept as indicative of the success of these organizations the statistics contained in a brief submitted to The Canadian Committee on Mutual Funds and Investment Contracts by the Canadian Mutual Funds Association and based on a classification prepared by their consultants. The brief stated that for the period January 1, 1968 to June 30, 1968, net sales of the five venture funds then included in C.M.F.A. membership totalled $51.8 million, while net sales of all other member mutual funds were only $4.1 million.[53] These figures clearly show the extent to which venture funds have been accepted by the Canadian public. The five funds included in the C.M.F.A. membership are named in Table XI.

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[53] The Canadian Committee on Mutual Funds and Investment Contracts was subsequently advised that corresponding figures for the entire year 1968 were $105.2 and $102.3 million respectively. However, during the second half of 1968, AGF Special Fund Limited was organized and raised $60 million on the basis described in the report. It would be appropriate to treat this as a venture fund, which would change the latter figures to $165.2 and $42.3 million respectively.

TABLE XI

SPECULATIVE CANADIAN MUTUAL FUNDS

OFFERED TO THE PUBLIC

NAME OF FUND	MANAGER	DATE ORGANIZED
1. All-Canadian Venture Fund Ltd.	Capital Management Ltd.	Jan 16/67
2. Canadian Channing Venture Fund Ltd.	Canadian Channing Corporation Ltd.	April 2/68
3. Spec Fund	Les Placements Collectifs Inc.	April 25/67
4. United Venture Fund Ltd.	United Funds Management Ltd.	Dec. 31/66
5. Taurus Fund Limited	Planned Investment Management Ltd.	April 18/66

SOURCE: Recent Prospectuses

Although the aggregate total assets of all the venture funds represents only a small portion of total mutual fund assets, it is quite possible that these funds will grow rapidly in the years ahead. As Canadians move to higher zones of financial sophistication this type of investment alternative may become extremely popular. The almost overnight development of venture funds by their respective managers clearly indicates an anticipation of aggressive investors utilizing the services of a mutual fund for the first time.

Venture funds have a very important role to play by providing a valuable service to investors for whom they are appropriate. Although the concept of performance is relatively new and is catching on, it is still too early to predict what will happen in this area in the future. It is worth stressing, however, that management companies able to offer a venture fund have a new innovation available that may enhance their future growth position.

From the investor's viewpoint, it is very difficult to draw any strong conclusions on the topic of performance. Performance is a subjective concept, since to the investor the best performing mutual fund is the one that most nearly satisfies his personal investment objectives. The importance of rate of return to assessment of performance made by or for any investor is obvious. But for many investors a competing consideration is present - the desire to limit the degree of risk accepted in the pursuit of a high rate of return.

A considerable amount of academic work is being carried out at the present time on the subject of mutual fund performance, but little of this research is yet of practical use to the average investor. Until such time as research can be put to practical use, the investor will have to weigh the expected benefits against the risks involved in allocating his money to a specific investment vehicle.

It is impossible to state that all mutual funds will be able to meet the demands by investors for higher returns because of the nature of their operations. It is possible to say, however, that the developments taking place within the industry, combined with the changing financial environment, will put mutual funds in a favourable performance position.

III. SUMMARY

It has become inevitable that the remarkable success of the Canadian mutual fund industry, coupled with increasing public demand for equity investments, should attract other financial institutions into the market serviced by mutual funds. As investors become more sophisticated they will seek out financial institutions that are best able to meet their financial demands. The first demand will be for a wider range of financial services under one roof. This would include investment counselling and a broad range of financial services. The second demand is for higher rates of return on invested capital.

The mutual fund industry, as well as a few other financial intermediaries, have been successful in meeting these demands in the past and are continuing to provide new services in anticipation of the future demands of savers. It was suggested that new demands will develop through social and technological changes in our society.

It was also suggested that the mutual fund industry will be in a strong position to maintain its growth relative to other financial intermediaries because many of the expected social and technological changes are orientated along the lines of the services presently provided by some of the more progressive mutual funds.

On a social basis the income level of the lower income group will rise. For the first time people in this group may have an opportunity to save and will likely turn to the mutual fund form of investment as small scale direct investment continues to be discouraged.

From the technological side, the growing sophistication in the financial markets will convince a greater number of average and even fairly sophisticated investors to turn to mutual funds. Mutual funds are favoured because they offer professional management backed up by highly competent financial analysts following modern research techniques.

Although many of these factors will continue to favour the future growth of the Canadian mutual fund industry, it was also stressed that it is essential for the industry to innovate in order to avoid being outdone by other financial institutions who are also scrambling to capture new business.

The mutual fund industry is meeting this future challenge on three major fronts: the development of financial complexes, the movement toward improved financial counselling, and by offering a new type of mutual fund geared toward generating higher investment returns.

We saw that through association with other financial institutions, certain mutual funds have become part of financial complexes. Through the financial complex a mutual fund is capable of providing savers with a broad range of financial services either directly or indirectly.

In terms of financial counselling, the mutual fund industry is attempting to train its representives to serve as financial counsellors to their customers by advising them on all aspects of financial planning.

In the area of performance we observed the recent introduction of venture funds. Basically, they are funds with investment objectives that contemplate the acceptance of risk in order to increase the rate of return to the investor. It was suggested that as Canadians continue to move to higher zones of financial sophistication this type of investment vehicle will tend to become increasingly more attractive. Accordingly, those organizations that can offer a venture fund will benefit in terms of growth.

CHAPTER VI

SUMMARY AND CONCLUSIONS

The purpose of this paper has now been accomplished. The Canadian mutual fund industry has been examined as a financial intermediary operating in the Canadian capital market. Through this examination it was possible to isolate the reasons for its tremendous growth since 1957 and to observe some of the factors which should assist the industry to maintain its relative growth position in the future.

I. METHODOLOGY REVIEWED

The first undertaking necessary to accomplish the purpose outlined above was to give the reader a basic understanding of the importance of the capital market and the role of financial intermediaries. This was useful to provide necessary background information for a departure into an analysis of the growth and development of Canada's fastest growing financial institution - Canadian mutual funds. Accordingly, the reader was given information on the organization, growth and characteristics of the industry.

This information provided insight into the reasons for the rapid growth achieved by the Canadian mutual fund industry. Two of the reasons discussed were the attractiveness of the mutual fund product and the broad distribution network through which the product is distributed to the public. It was emphasized, however, that product sales depend upon public acceptance. An examination of the reasons behind public acceptance of the mutual fund product became the second major undertaking. The final undertaking was to examine the future outlook for the Canadian mutual fund industry to see if it would continue to maintain its relative growth position. The next section will highlight some of the more important findings and conclusions of this study.

II. SUMMARY AND CONCLUSIONS BY CHAPTERS

The main text of the thesis began in Chapter II, which provided the reader with a discussion of the term "capital market" and the role, growth and development of Canadian financial intermediaries. Economic growth, it was suggested, is accompanied by the formation of a capital market and financial intermediaries to streamline this market. It has been the existence of the capital market and financial intermediaries that have made possible the process of capital formation.

The capital market was defined as a market where intermediate and long-term funds are gathered and made available to businesses, governments and individuals, and where instruments that are already outstanding are transferred. Financial institutions act as middlemen between borrowers and savers. In their role as middlemen the financial institutions channel funds from savers to borrowers by providing financial assets savers want and the funds borrowers require. This transformation process is accomplished by a financial intermediary issuing its own instruments; such as deposits, shares, or certificates for lenders to buy, and in turn use the funds received to purchase other instruments such as corporate stock, corporate bonds, mortgages and so forth issued by borrowers.

The numerous financial intermediaries are essentially a creation of the nineteenth century; however, of the nineteen financial intermediares operating in Canada, only seven originated in the nineteenth century and twelve appeared in the twentieth century. Of the nineteen financial intermediaries, only nine are considered major and were the only intermediaries analyzed in terms of asset growth.

There has been an impressive rate of growth for the major financial institutions in Canada from 1957 to 1968.

Aggregate growth in assets compared with the growth in the economy shows that assets were 83% of G.N.P. at the end of 1957 and 109% for the corresponding period in 1968. While all nine major financial institutions increased in size during the eleven year period, growth rates were for the most part uneven. The most outstanding growth was achieved by the Canadian mutual funds industry. In terms of re-distribution of aggregate assets of the nine major financial institutions, the Canadian mutual fund industry ranked second. A glimpse at the statistics presented in Chapter II, will confirm the growth leadership of this industry for the period 1957 to 1968.

The success of the mutual fund industry in terms of growth launched a departure from the discussion of financial intermediaries on a global basis, to a specific analysis in Chapter III, of Canadian mutual funds as financial intermediaries. It was shown that a mutual fund differs from other institutions in that it sells its own shares or units to the public and invests the proceeds; therefore, the activity of investing in securities is its main function. It was stated that the justification for an investment company in the capital market is that it enables investors, through a pooling of savings, to obtain a professionally managed diversified portfolio of securities.

Mutual funds were distinguished from other investment companies by the fact that the instruments they issue entitle the holder to receive, on demand, or within a specified period of time after demand, an amount computed by reference to the value of a proportionate interest in the assets of the issuing organization. Shares of mutual funds are distributed to the public at net asset value plus, in most cases, an acquisition change of 8% to 9% of the offering price.

Closed-end funds represent another type of investment company. They were briefly discussed in Chapter III, for the purpose of distinguishing them from mutual funds which are often referred to as open-end investment companies.

We saw that Canadian mutual funds may be incorporated or unincorporated when organized. From an operational point-of-view the legal form matters little. This is true because of the necessity to provide a means whereby the organizers receive their rewards in that profits and losses on the portfolio are passed through to public participants. This is not the case with other financial institutions where the promoters obtain their organizational reward principally through ownership of equity securities issued by the financial intermediaries.

In the mutual fund context it is traditional for the organizers to obtain their rewards from management and administration fees and profits on the distribution of shares or units. Investment management and distribution is carried on by outside organizations in which the organizers hold the equity participation. These organizations are normally referred to as the "management company" and "distribution company" respectively. One advantage of the externalization of management and distribution is that it is possible for these two organizations to manage and distribute several mutual funds with different investment objectives organized to appeal to a wide variety of investors.

We also saw that mutual funds may be organized to operate in conjunction with other enterprises such as brokerage firms, banks and trust companies. In these cases a mutual fund may be created by one of these financial institutions to offer an additional service to their clients.

In terms of growth, the mutual fund industry embarked upon its period of rapid growth in the mid-1950's. By 1950 the total net assets of Canadian mutual funds qualified for sale in Canada aggregated approximately $46 million. The following table shows the net assets held by category of mutual funds in 1961 and 1967.

TABLE XII

NET ASSETS HELD BY CATEGORY OF MUTUAL FUNDS
1961 AND 1967

CATEGORY OF MUTUAL FUNDS	TOTAL NET ASSETS	
	($ MILLIONS)	
	Dec. 31,1961	Dec. 31.1967
Canadian Mutual Funds	787	2,508
Trust Company Investment Funds	8	158
United States Based Mutual Funds (holdings in Canada)	not known	104
TOTAL	795	2,770

In terms of the number of organizations qualified as mutual funds at the end of 1967 there were 118, and the number increased to 136 by the end of 1968.

Turning to the services provided by mutual funds to their shareholders or unitholders we observed an impressive list. Such services or benefits included professional management, diversified portfolios, liquidity and marketability, accumulation plans, administrative features, dollar-cost averaging, variety of mutual funds and rights of withdrawal. It was concluded that this list provided an attractive investment package available to a potential investor.

From a marketing point-of-view, it was shown that the mutual fund product is distributed through three principal channels: direct sales forces, brokers and independent sales forces.

The former has been the most important channel of distribution accounting for 66% of total sales of mutual fund shares or units in 1967. Sales through brokers represented 30% in the same period, followed by 4% through independent sales forces and other minor channels.

The conclusion reached in Chapter III, was that the attractiveness of the mutual fund product and the ability of mutual funds to sell their product, have greatly assisted the industry to grow at a rapid pace. At the same time it was suggested that these two factors depended upon public acceptance and demand for the mutual fund product.

In Chapter IV, we turned our attention to the factors which altered the preferences for the instruments and services offered by mutual funds over those offered by other financial intermediaries. The three factors cited as shifting mutual funds into a favourable position in terms of public acceptance were the growth in personal net savings, a development of financial sophistication by savers and a marked public preference to save through financial intermediaries.

It was suggested that although all financial intermediaries have benefited from the rise in personal net savings, there were some who benefited more than others.

The reason given for this was that savers are becoming more inflation conscious and are allocating their funds to those institutions providing rates of return adequate to protect the long-term purchasing power of their invested dollars. The traditional approach to this problem has been to invest in equities of corporations. Results of the Lorie and Fisher study were summarized to show the favourable rates of return obtained through equity investing.

Because of the risk in security ownership many investors have sought out professional management of their savings through brokerage firms, trust companies and mutual funds. Financial institutions having a substantial portion of their assets in equities have also benefited from the upward movement of stock prices. Among those included were the estate, trust and agency accounts of trust companies, mutual funds, closed-end investment companies and the trusteed pension funds.

The second factor mentioned as having some bearing upon public acceptance of the mutual fund product was the development of financial sophistication on the part of savers. As savers have become more sophisticated they have demanded investments where risks are large but where potential rewards are great.

In addition, they have demanded a broader range of financial services. Financial institutions that have altered their package offering to include a greater amount of investment counselling have benefited in terms of growth. It was proven by the results of the study conducted by Professor Conway that Canadians are in fact very aggressive investors and have probably been moving up the scale of financial sophistication for sometime.

A movement up the scale of financial sophistication assumes that the further toward the top one moves, the greater the portion of equities to be found in his investment portfolio. The scheme also assumes that normally, individuals progress from indirect to direct investment, and to fuller participation in equity ownership. We saw that this development has been curtailed in Canada because certain financial market problems have steered many investors toward indirect investing through financial institutions.

Three problems in the financial market were suggested as causing this curtailment: the class structure, the supply of, and demand for Canadian equities, and the attitude of the financial community toward the small investor. In brief, these three problems boil down to the simple fact that there is a limited supply of desirable common stock available in relation to the demand for these stocks.

In addition, brokerage houses in Canada and the United States have begun to show a marked reluctance to service small accounts. As a direct result of these developments, the small investor has altered his investment approach by participating in the equities markets on an indirect basis by investing in equity based instruments offered by financial institutions. The mutual funds represent one such institutional group which has benefited from this alternative investment approach by providing an attractive investment product, backed up by a nation wide distribution network through which the product was brought to the attention of the public.

In Chapter V, an assumption was made that savers will continue to seek out financial institutions that can satisfy their demands for higher rates of return on their savings and a wider range of financial services. It was suggested that financial intermediaries that can meet these demands will continue to expand at a rapid pace. By the same token, it was also implied that institutions that develop new instruments and services which become accepted by the public may grow more rapidly than others.

It was shown that many Canadian mutual funds are presently well prepared in terms of meeting the future demands of savers resulting from shifts in the level of economic development, in the attitude of savers and the wants and needs of borrowers.

This is so because many of the social and technological changes expected to take place in the future are orientated along the lines of the instruments and services certain mutual funds have to offer at present.

A few of the social changes mentioned which are expected to favour this industry are the forthcoming legislative recommendations of The Canadian Committee on Mutual Funds and Investment Contracts, increases in the wage level of the lower income groups making possible the opportunity for saving, and the lack of interest by brokerage firms in small investment accounts.

In terms of technological changes, the use of the computer as a tool for investment analysis, more refined and quantified research methods and highly qualified investment personnel will place certain financial institutions in a strong competitive position in the battle for public savings.

The mutual fund industry has already made great strides in these technological areas. Right now, many mutual fund managers have better and more precise data on which to formulate investment decisions, and this data is in most cases superior to that available to the average individual who invests in the market on his own; so much so that the advantage of professional management is becoming increasingly obvious.

As a result, many individual investors will be convinced that the odds against them are too high and will turn to the mutual fund industry for professional investment management.

It was suggested above that financial institutions that develop new instruments and services accepted by the public will grow more rapidly than others. These institutions will be the innovators who create new demands by savers. They are the financial institutions presently taking steps to insure their rapid growth and relative position as competition becomes more intensified. Here again, the mutual fund industry has taken a leading role.

The development of "financial complexes" has enabled the industry to provide an integrated line of financial services. Within the financial complex we observed "mutual fund complexes" which enable a mutual fund adviser to reach a broader section of potential investors and to offer them the opportunity to apportion their mutual fund investments among several funds with different investment objectives. Quite apart from this feature, the industry has also been successful in moving directly and indirectly into other areas. Other such areas included many of the services presently being offered by trust companies and insurance companies. This movement was broadly termed as the process of "financial scrambling". In the process of financial scrambling a mutual fund complex becomes associated with other financial institutions thus forming the financial complex. Two examples of financial complexes were described in Chapter V, to show the reader the number of additional financial services available to an investor who becomes involved with any one sector of the financial complex.

New developments are also taking place within the Canadian mutual fund industry by way of training its representatives to become qualified financial counsellors. The talent of financial planning will become a necessary requirement if the mutual fund industry intensifies its efforts to provide an integrated line of financial services.

In an attempt to meet anticipated investor demand for higher rates of return the industry has introduced mutual funds with investment objectives that contemplate the acceptance of risk in order to increase rates of return. These organizations are known as "venture funds" and have been well accepted by the public since their introduction in 1966.

What has now been said sums up the important findings and conclusions of this paper on the Canadian mutual fund industry. It is an extremely fascinating industry and has fulfilled a very worthwhile function in the Canadian economy. All in all, the next few years should prove to be a very interesting phase in the growth and development of Canadian mutual funds.

III. OPPORTUNITIES FOR OTHER STUDIES

A study such as the one undertaken in this paper always opens new doors for additional study on the same topic, or for research into areas lightly passed over. On the former, an immediate idea that comes to the writer's mind is the growth implications the recommendations of The Canadian Committee on Mutual Funds and Investment Contracts will have for the Canadian mutual fund industry. If certain recommendations are implemented, will the mutual fund industry have a competitive advantage over other financial intermediaries? What recommendations, if implemented, may slow down the growth of mutual fund industry? Within the industry, which mutual fund groups will benefit most from legislative recommendations; which groups will suffer? What changes might take place within the industry as recommendations are implemented?

Two areas of new research may become obvious as changes are introduced by government through tax and anti-combines legislation. What lies in store for the mutual fund industry as new tax laws are introduced? How will the anti-combines department react in future years toward the proliferation of financial complexes?

It is the belief of the writer that many worthwhile studies will develop out of government policy decisions presently on the legislative drawing boards.

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APPENDIX

APPENDIX A

THE CANADIAN COMMITTEE ON MUTUAL FUNDS AND INVESTMENT CONTRACTS

The Establishment of the Committee

During the Federal-Provincial Conferences on Securities Regulation held in 1966, consideration was given to the regulation of mutual funds and of investment contracts. It was decided that the available information on the operation of mutual funds and of investment contract companies in Canada was not sufficiently detailed, and that a committee should be appointed to consider this and related matters and to make recommendations as to legislation. In accordance with this decision, the Canadian Committee on Mutual Funds and Investment Contracts was established in March, 1967.

The members of the Committee, at the present time, are:

G. E. Grundy,
Superintendent of Insurance,
Province of Ontario.

K. P. Lawton, Q.C.
Administrator under the New Brunswick Securities Act

G. H. Rose, Q.C.
Chairman of the Alberta Securities Commission

W. S. Irwin,
Superintendent of Brokers,
British Columbia Securities Commission.

Louis de B. Gravel, Q.C.
Director, Companies Branch,
Province of Quebec.

Marc Lalonde, Q.C.
Principal Secretary to the Prime Minister

F. C. Tapley,
Registrar under the Manitoba Securities Act

The Overall Function of the Committee:

The Committee is presently in the process of conducting an extensive study of mutual funds and investment contracts in Canada. The purpose of the study is to obtain complete information concerning the open-end mutual funds (including funds sponsored by trust companies) and investment contracts upon the basis of which determination may be made as to whether legislation in addition to the existing legislation is required for the protection of the public interest. Apart from the structure of mutual funds and investment contract issuers, the scope of the study has been extended to such matters as the relationship of the issuers with management and selling companies and investment dealers, problems arising in the sale to the public of mutual fund shares and investment contracts, and variable contracts issued by life insurance companies.

At the outset of its work, the Committee distributed to mutual funds, investment contract companies, trust companies, life insurance organizations, brokers, stock exchanges and various other associations and organizations, a list of topics to be considered by it. Those who were interested were asked to submit briefs.

In addition, the Committee's staff and consultants have circulated detailed questionnaires and have had many meetings with representatives of mutual funds and investment contract industries. Because of the quality of information collected by the staff, and the high quality of formal and informal submissions received by it, it has been decided by the Committee not to hold public hearings.

The Staff of the Committee

The Committee has established a central office at Toronto, where it has a staff of approximately 20 persons headed by Messrs. J.C. Baillie and C. Bruneau. Mr. Baillie is associated with the law firm of Tory, Tory, DesLauriers and Binnington in Toronto and lectures in securities regulation at Osgoode Hall Law School. He previously worked on special studies for the Ontario Securities Commission, the Royal Commission on Windfall, and the Federal Task Force on Security Regulation and Corporate Disclosure. Mr. Bruneau, also a lawyer, has held the position of Special Assistant to the Minister of Justice, Ottawa, and worked on studies relating to federal regulation of securities and with the committee set up to study corporate and labour disclosure, which eventually led to the enactment of the Corporations and Labour Unions Return Act. He has also been associated with a firm of investment dealers, and before joining the Committee he was the Assistant Secretary of Steinberg's Limited in Montreal.

In addition to Messrs. Baillie and Bruneau the professional staff of the Committee also includes an economist, Mr. H.J. Cleland, formerly the Director of Surveillance with the Toronto Stock Exchange and a research co-ordinator, Mr. Paul H.C. Dyson, a business graduate student from the University of British Columbia.

The Report of the Committee

Since the creation of the Committee, it's staff has been actively engaged in the collection of information concerning these industries, and it is hoped that the Report will be completed in late 1969. Following the completion of the study, the Report will be submitted to the Prime Ministers and Premiers of the eleven jurisdictions concerned which will include recommendations as to whether additional legislation is required for the protection of the investor.