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The Czech Investment Fund Industry: Development and Behaviour

by Richard Podpiera

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Atlantic Financial Markets
Czech Republic
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Table of Contents

1. Executive Summary 2
2. Introduction 3
3. Industry overview 3
   3.1. Regulation 3
   3.2. Types of Funds 4
   3.3. Fund Industry Structure 5
4. Prices, Net Asset Values and Discounts 6
   4.1. Determinants of Price and Discount 6
   4.2. Prices, NAVs and Discounts Development 8
   4.3. Development of Discounts in the Future 10
5. Behaviour of Funds 11
   5.1. Structure of Portfolios 11
   5.2. Struggles Over Controlling Ownership 12
   5.3. Role of Funds in Corporate Governance 14
   5.4. Transformation into Holdings 15
   5.5. Impact on the Capital Market 16

1. Executive Summary

- The purpose of this study is to provide an overview of the Czech fund industry development and to describe, analyse and possibly predict behaviour of funds. The investment privatisation funds, which are our main focus, are the most important as measured by market capitalisation. They have existed for a longer time than some other fund categories and they exhibit unique behaviour features that cannot be observed in the case of unit funds.

- Fund industry regulation is insufficient. The same can be said, in fact, about the regulation of the Czech capital market as a whole. The main problem is the lack of minority shareholder rights protection. Amendments passed in late April 1996 attempt to solve some of the problems and should bring more transparency and safety into the Czech capital market. The effects will depend on actual implementation and enforcement of the law.

- The development of prices and discounts has revealed the crucial importance of international investors. Their trust in fund management is the single most important factor. In our opinion, the level of average discount at the end of April 1996 is caused by overreaction of international investors to the transformation activity in the investment fund subsector. The average discount should narrow as the market regains confidence in funds. Particularly in consideration of past discount developments, legislative changes and foreign interest in the Czech market, we expect average discounts to be 5-10 percentage points smaller at the end of 1996 than they are today.

- Large fund portfolio restructuring, which started after the Coupon Privatisation, continued during 1995. It will continue in 1996, but extremely low liquidity of small companies' shares is likely to be a major obstacle to the process.

- The overall effort to gain control over as many companies as possible has been one of the main characteristics of fund behaviour during 1995 and at beginning of 1996. We expect this effort to increase in the second quarter of 1996, but after July 1, 1996 this issue should no longer be the first priority on the agenda. The main reason for the change is that amendments to capital market laws will make a take-over of a company more difficult. That will be true if the amendments will be properly implemented and enforced.

- As basically all private investment funds have utilised a loophole and approved their transformation into holding companies, we do not expect any other large funds to follow this path. Nearly all large funds that have not yet been transformed are bank funds. Banks generally cannot afford to endanger their reputations and partial state ownership is likely to make the largest banks behave conservatively. Moreover, banks would need to decide quickly, because the amended law, which makes the transformation virtually impossible for most of the funds, will come into effect on July 1, 1996. Because they are not very flexible, it is questionable whether they would even be able to act quickly enough.

- As far as corporate governance is concerned, we are not amazed by fund activity in this respect. On the whole, we believe that funds (investment companies) do not have the necessary expertise to be able to substantially increase the value of companies they own large stakes in, nor have other kind of resources that a strategic partner as an owner might provide to the companies. In our view funds are generally not the ultimate owners of large stakes and in the medium term they will start selling big stakes to strategic partners of companies.

2. Introduction

The purpose of this study is to provide an overview of the Czech fund industry and to describe, analyse and possibly predict the behaviour of funds. Its primary focus is on investment privatisation funds as opposed to privatisation unit funds and crown investment and unit funds.[1] The investment privatisation funds are the most important as measured by market capitalisation, have been in existence for a longer time than some other fund categories and exhibit some special behaviour features that cannot be observed in the case of unit funds. Crown funds, despite expected growth, are relatively unimportant, as of early 1996. On the whole, investment funds are in our opinion the most suitable for this type of study. Moreover, some features of their behaviour can be easily generalised to other types of funds, as investment companies constitute the link between behaviour of various types of funds.

As the origin of the investment privatisation fund lies in coupon privatisation, let us start with a very brief explanation of this privatisation method. After 1989, basically the entire Czech economy was state owned and there was no domestic capital that would buy the property from the government. In an attempt to privatise the economy as quickly as possible and in this way bring new owners to the companies that would run them more effectively, the coupon method was chosen. Every adult Czech citizen (in the first wave every citizen of former Czechoslovakia) was given a chance to buy a coupon booklet with 1000 investment points for a fee covering transaction costs.[2] There were two so called privatisation waves. The first was in 1991/92, the second in 1993/94. Every individual had a choice—either to invest his investment points directly into privatised companies or to put his points into a fund. Funds invested acquired points into privatised companies and the individuals obtained shares of the fund.

3. Industry overview

3.1. *Regulation*

The fund industry is governed by the Investment Companies and Investment Funds Act (Act No. 248/1992 Coll., as amended). This act, passed in 1992, was subsequently amended to allow unit funds (*podílové fondy*)[3] to be set up for the second wave of privatisation. From the regulatory viewpoint, the law has weaknesses. Some of these have become particularly apparent as, in early 1996, a number of investment funds have been converted into holding companies. Additional amendments to the law were passed just days prior to this writing. To summarise these latest changes, no regulations were abolished outright, stricter conditions were set for transforming funds into holding companies, and the positions of state supervisory bodies were strengthened.

- A fund cannot put more than 10% of its assets into any single holding, with the exception of government bonds.
- No investment or unit fund can own more than 20% of a single company. Likewise, the investment funds managed by one investment company cannot in combination own greater than 20% of a single

[1] The differences between the funds categories are explained below.

[2] The fee amounted to 1,000 CZK for each wave. For comparison, according to the Czech Statistical Office the average monthly wage amounted to 4,644 CZK and 6,894 CZK in 1992 and 1994 respectively.

[3] The Czech term "podílový fond" literally translates as "share fund" or "participation fund." The British term "unit trust" also is commonly used, although a Czech podílový fond is rather different from a UK unit trust. To minimize confusion with the more common "investment funds" (which issue shares), we have settled upon the term "unit fund", the US readers should be most familiar with, and refer to the units sold as "participation certificates."

company. The same is true for the investment company's combined unit funds. (The investment and unit funds, together, may therefore own as much as 40 percent.)

- Funds are prohibited from purchasing shares or participation certificates in other funds.
- An investment fund (or an investment company on behalf of the unit fund it manages) cannot buy securities at prices above, or sell at prices below, those prices on the stock exchange or a similar securities market.
- An investment fund (or an investment company on behalf of the unit fund it manages) cannot issue bonds, lend money from the fund, or offer the fund's property as collateral for another entity's liabilities.
- Participation certificates cannot be purchased with non-cash property.

It is probably fair to say that state supervision over funds is insufficient. The same could be said, in fact, in regard to overall supervision of the capital market. In our opinion, the biggest problem is the lack of minority shareholders protection. Besides the neglected position of minority shareholders in the companies that were taken over, the lack of timely and accurate information is one of the most apparent issues. Shareholders mostly do not have a chance to find out what is happening in the company (including shareholders meetings). Therefore, shareholders are in need of timely and detailed information about the economic development of companies they own.

Amendments to the Securities Law and Commercial Code, passed in late April 1996, should strengthen the safety and transparency of the market and of the fund sector as well. At least until the new legislature becomes effective (July 1, 1996) the insufficiency of the current legislature will be more apparent. The development after this date will depend on actual implementation and enforcement of the amendments and even then there will be a need for new, well constructed legislature.

3.2. *Types of Funds*

An investment fund is a joint stock company. It has Articles of Incorporation and Statutes. The Statutes are a speciality of funds and include the fund's mission and principles of its economic activity. The owner of an investment fund share has the standard rights of an equity holder.[4] On the contrary, a unit fund is not a legal entity. As such, it has Statutes but no Articles of Incorporation. Since there are no voting rights attached to the participation certificates, all decision-making power rests with the investment company that set up the unit fund. Obviously, it is possible to take over an investment fund, while it is not possible in the case of a unit fund.

Although they are subject to the same diversification rules, unit funds have more restricted investment possibilities--basically just securities. Furthermore, unit funds can be closed-ended or open-ended. Closed-end unit funds are similar to investment funds in the respect that a limited number of participation certificates is issued. These are traded on the capital market and the manager is not obliged to buy the participation certificates. In the case of an open-ended unit fund, the holder of a participation certificate has the right to have the certificate bought back by the investment company that manages the fund, and participation certificates are mostly not traded on the market. There are, however, some kind of hybrid funds in the Czech Republic. These are funds that will become opened after some time and, at least up to that time, will be traded on the capital market.

[4] According to the Commercial Code the basic shareholders rights are as follows: A shareholder is entitled to receive a part of the company profits (a dividend) assigned for distribution by the General Meeting, to receive proportions from the liquidation balance in case the company should be wound up and liquidated, to attend the General Meeting, to vote, to ask for explanations and to submit proposals.

The last distinction is that between privatisation funds and so called "crown" funds. While coupon points were invested into privatisation funds and these funds took part in the coupon privatisation, crown funds are created to receive cash (not coupon) investments. Both types of funds are governed by the same legislation. As mentioned in the introduction, crown funds are, at the time of writing this study, not very important and we will ignore them in this study.

3.3. *Fund Industry Structure*

It is not fully possible to discern an official intended role for privatisation funds before, during and after privatisation. What is unmistakable, however, is that they gained substantial influence over Czech industries and were very successful in accumulating investment points. Funds obtained 73% of all investment points in the Czech Republic during the first wave and 64% from the second wave.[5]

The first property of the industry, which suggests an early stage of development, is the large number of subjects. Since basically anybody was able to set up an investment company and a fund, a large number of them sprung up. The biggest funds are those established and managed by major Czech financial institutions–banks and an insurance company–and just a few private ones. Nevertheless, the vast majority of funds is extremely small and very illiquid, if even traded at all.

Only the largest 65 investment funds and 38 unit funds are traded at the Prague Stock Exchange (PSE).[6] Besides the 123 second wave privatisation funds, which have still not issued their shares,[7] about 180 funds are traded on the RM-Systém. The biggest funds are traded on both markets. The development of the number of funds and investment companies is depicted in the exhibit below:

Exhibit 1: Overview of Investment Companies and Funds

	31.12.1994	30.6.1995	31.12.1995	1.3.1996
Investment companies	158	159	159	161
Investment funds	280	277	258	254
Unit funds	275	273	272	286*

*Source: Svět Hospodářství, Hospodářské Noviny. *out of these 120 were open-end and 166 closed-end.*

Thus far, the numbers both of investment companies and of unit funds have been stable. Restructuring has already begun in the investment fund subsector. Some investment funds have been merged (either with other investment funds or with their founding institutions). Nevertheless, as most of the funds are very small, we believe the number of funds remains too high. We expect substantial restructuring in the near future. Restructuring in the unit fund subsector will be more difficult and will take longer. Under valid law, unit funds cannot be merged as they are not legal entities.

The vast majority of the largest and most liquid funds are traded on the PSE. Overall capitalisation of PSE-traded funds was 63.7 billion CZK as of 23 April 1996. The importance of investment funds is expressed by their share in this capitalisation: 54.1 billion CZK, or 85% of the total. Unit funds account for only the remaining 15 percent. Both investment and unit funds well exemplify the 80:20 rule. In the investment and unit fund subsectors, respectively, the top 20% of entities account for 82% and 75% of the capitalisation.

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[5]"Fondy ve druhé vlně kuponové privatizace (Funds in the Second Wave of Coupon Privatization)," *Burzovní Noviny*, 15 August 1995, p. IV.

[6]As of April 23, 1996.

[7]"Transformovaných fondů nadále přibývá (The Number of Transformed Funds is Growing)", *Burzovní Noviny (Stock Exchange Newspaper)*, April 3, 1996, p.I.

Exhibit 2: Top 15 Investment Funds, by Market Capitalisation (as of 23 April 1996)

Name	Manager	Market Capitalisation (000 CZK)
RIF	1.IN	7,767,901
KOMERČNÍ BANKA IF	IKS KB	6,557,930
SPIF ČESKÝ	SIS	6,381,751
P.I.F.	KIS ČP	4,084,952
HIF DIVIDENDOVÝ[a]	HC&C	3,382,658
SPIF VÝNOSOVÝ	SIS	2,920,135
SPIF VŠEOBECNÝ	SIS	2,631,989
HIF RŮSTOVÝ[a]	HC&C	2,597,481
1.IF ŽIVNOBANKA	ŽB Trust	1,832,604
PPF-PRVNÍ ČESKÝ IF[a]	PPF	1,715,804
BANKOVNÍ IF	1. IN	1,638,601
RENTIÉRSKÝ IF 1.IN	1. IN	1,503,339
IF YSE[a]	YSE	1,476,005
IF BOHATSTVÍ	1. IN	1,456,411
CREDITANSTALT CEIF[a]	Creditanstalt[b]	1,167,340

Source: PSE. [a]Indicates funds which have been transformed into holding companies. [b]After being taken over by Agrobanka/Motoinvest early in 1996, the name of this investment company was changed to Optimus.

Investment companies are by no means homogeneous in their approaches to strategy and investment policy. Strategies for specific funds managed by a single investment company are never completely independent. Still, there is great differentiation in the degree to which strategies are coordinated. Some pursue the same investment policy for all funds under management, as if they were a single fund. Others develop a unified umbrella strategy which coordinates the individual investment policies of the various individual funds. Some attempt rigorously to carry out the investment policies which they had proclaimed to their clients. Others abandoned purported policies altogether once the marketing job of attracting coupon points was completed.

The law allows maximum management annual charges of 2% of average asset value or 20% of profit. Most investment companies have chosen the percentage of assets charge. By our calculation the average charge of the top 15 investment funds amounts to 1.57% of average asset value.[1]

4. Prices, Net Asset Values and Discounts

4.1. Determinants of Price and Discount

It is useful to look at fund price determination from the supply and demand point of view. Early on, the supply was very dispersed; only individuals who invested in funds during the coupon privatisation process owned fund shares. At the same time, many of these individuals wished to sell their shares.

[1]Simple average used in the calculation.

As the privatisation funds were created from investment points - and not hard cash - individuals sometimes were not very price conscious and would sell at virtually any price. That attitude has now changed to a large extent, but not entirely.

From individuals, then, there was a constant flow of shares to the PSE's continuous auction market and through the RM-S. Institutional investors, the vast majority of which are firms in the same groups as the management companies themselves, were buying fund shares and accumulating larger blocks. That is why it is possible today to buy blocks of fund shares. There is still a flow of sell orders from individuals. Information from January 1996 shows that about 30% of accounts in the Securities Center are empty - that is to say, these people already have sold all their holdings.[9] Judging from the ownership structures of large funds, we estimate that at least two-fifths of investment fund shares are now in the hands of institutional investors. In order to preserve their management contracts, investment companies have had strong incentive to bring shares of the investment funds under their management within the control of parent or related firms. Further, some banks have ended up with shares in funds managed by their subsidiaries. This is because they had previously granted loans collateralized by these funds' shares and which were not repaid.

On the demand side, other than management-related parties, only international investors represent substantial demand. This is due to the fact that investment and unit funds, whose managers are the predominant players in the Czech capital market, are prohibited from holding shares and certificates in other funds. This situation will change as, for instance, local pension funds grow and seek investment opportunities. Nevertheless, this will come about gradually. In the immediate term, once management companies have sufficient shares under their own effective control to feel safe in their positions, the only substantial demand will come from international investors.

The question of price determination, then, largely concerns which factors determine the demand from international investors. These factors may be divided into several groups. Firstly, some factors cause them to invest in the Czech capital market rather than in more developed markets or other emerging economies. Among these, we can list global diversification needs and risk/return preferences. The Czech Republic offers a high degree of economic and political stability, the highest international credit rating among former socialistic countries, and strong economic growth.

Secondly, other factors draw international investors into investment fund shares and participation certificates of unit funds rather than directly into industrial companies' equity or bonds. These factors include: needs for greater and easier diversification, expectations that discounts will close, high discounts relative to those seen in other markets, and low liquidity in some industry sectors.

The particular fund, or funds, into which one elects to invest depends upon a third level of factors. From our experience, the most important of these are: perceived competence and trustworthiness of management, portfolio quality, size, liquidity, past and expected net asset value (NAV) performance, and dividend policy.

All of the above mentioned factors are driving the overall price (discount) level of investment funds, besides some extraordinary events, like Motoinvest actions described below. The next subsection examines the development of prices, NAVs and discounts during the last 12 months.[10]

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[9] "Největší 'banka' (The Largest "Bank")," *Večerník Praha*, 19 January 1996, p. 2.

[10] Discount is calculated as (Price-NAV)/NAV*100%, i.e. the outcome is negative if the price is below the net asset value per share.

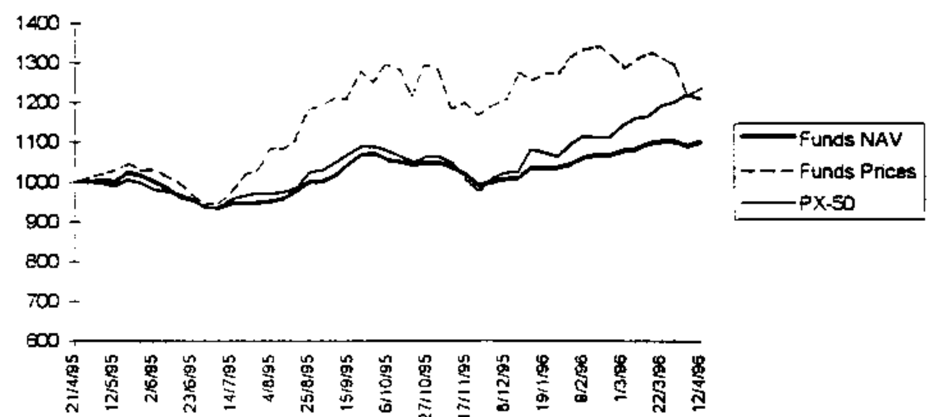
4.2. *Prices, NAVs and Discounts Development*

Better understanding of the fund industry and its development can be gained from comparing NAV, price and PX-50 developments.[11] We have created indices of investment fund NAVs and share prices. For this purpose, we selected the 15 largest investment funds traded on the PSE. Combined, these account for 74% of the market capitalisation of all funds on the exchange. Prices and NAV data are weekly. Calculations are weighted by size of the individual funds (i.e., by market capitalisation in the case of price and by asset size in the case of NAV). Indices were calculated for the period of one year (from 21 April 1995).

Both indices were set to initial values of 1,000 points. On the beginning date, the aggregated discount was 43.9 percent. If an individual fund's price index value is higher than its NAV index value, the discount has narrowed. As the overall fund price index is always above the NAV index, the actual aggregate discount during the period was always lower than it had been at the beginning.

Also shown in the graph below, as a measure of broad market development, is the PX-50 index. To facilitate comparison, we have recalculated the market index also to base 1,000 for 21 April 1995.

Exhibit 3: Development of Investment Fund NAVs, Prices and PX-50.

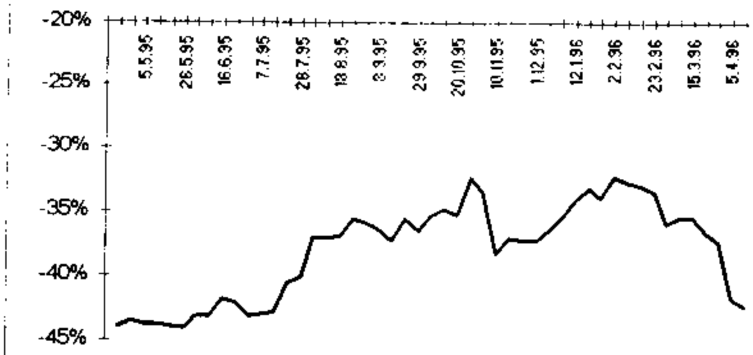


Source: Investment Companies, AFT Calculation, Hospodářské Noviny

The aggregate NAV performed more or less in line with the PX-50 until early December 1995. At that time, PX-50 growth accelerated and has remained strong during the first months of 1996. Fund NAVs, however, have not matched this growth. The most probable explanation lies in the composition of the PX-50. The largest index movers have been banks and SPT Telecom, and these have greater weights in the index than in the portfolios.

[11] PX-50 is the official index of the PSE.

Exhibit 4: Discount Development (April 1995 - April 1996)



Source: Investment Companies, AFT Calculation, Hospodářské Noviny

Average discounts are explicitly depicted in Exhibit 4. Data for the same group of funds were used. The only difference is in the method of calculation, which, in this second case, is to take simple arithmetic averages. As both methods of calculation point to similar conclusions, we can conclude that, at least within this group of large and liquid funds, there is not a strong relationship between size and discount. Also, the fact that the outcome is not greatly distorted by choice of calculation method gives us greater confidence in our conclusions.

To examine developments of fund prices and discounts, it is useful to divide the April 1995 - April 1996 period into five parts. In the first period, from 21 April 1995 through June 1995, no large changes occurred. The overall discount was practically unchanged.

The second period, from early July to late-October, might be called the "Motoinvest" period. It was at this time that Plzeňská Banka, controlled by Motoinvest, a young and aggressive company, having noticed that discounts were unreasonably high, was buying investment fund shares. Motoinvest attempted several hostile takeovers, and the affected investment companies (or related parties) also began to buy shares in order to defend their funds. That pushed prices up. In the third stage, during which contenders for control were negotiating with one another, this buying diminished. Discounts widened again, but remained much narrower than before. This third stage lasted until mid-November 1995.

The fourth stage can be characterised by another round of increasing prices and decreasing discounts. This lasted until early February 1996. In our opinion this development was largely due to international investors' increased interest in funds. The final stage is marked by a subsequent decline in prices and widening of discounts. This probably was due to decreasing international investor confidence in the fund sector. Uncertainty related to fund transformations to holdings was the principal cause.[12] Judging from the PX-50 development, this activity did not damage confidence in the Czech market as a whole.

As this survey deals primarily with investment funds, only a very brief comparison with unit funds is in order. Unit funds have had significantly greater discounts than investment funds for most of 1995. We see two main reasons for these greater discounts: 1) investors feel less safe without voting

[12] Funds transformations into holding companies are described in the Behaviour of Funds section

rights, even though, in the vast majority of cases even among investment funds, real decision-making power rests with the investment company, and 2) there is no danger of a hostile takeover and, therefore, nothing driving fund managers to keep discounts as narrow as possible.

The difference in average discount between the two types of funds has started to decrease in February 1996 as confidence in investment funds has suffered. The average discount for the 15 largest investment funds stood at 43.01 percent in late April 1996, while that of the top nine unit funds is just 2.09 percentage points greater at 45.10 percent.[13]

4.3. *Development of Discounts in the Future*

We believe the selling stream of investment fund shares from individuals will not dramatically decrease in 1996, even though total supply of that source must, of course, gradually diminish.

On the demand side, international investors' interest will continue to be the most important factor. The consensus regarding the overall market remains positive and is reinforced by the Czech Republic's attractive macroeconomic parameters. GDP growth should be in the 5-6% range during 1996 and 1997, inflation should gradually decline, and the growing current account deficit is regarded as sustainable in the medium term.

There is a clear trend toward more focused portfolios, which can be regarded positively. NAV performance should catch up with that of the PX-50 index, as early 1996 massive price growth in the largest stocks must run its course. Nevertheless, the most crucial factor - trust in management - is very difficult to project. It will depend to a large extent on the enforcement of legal changes and the pace at which the Czech capital market matures.

Numerous examples can be used to show how important trust is in fund management. We have chosen two, both of which relate to Motoinvest. The first regards the AGB unit fund (AGB PF), a fund that is presently closed-end but which will open 1 January 1998. In spring 1996 market consensus is that Motoinvest has at least significant influence over Agrobanka (the fifth-largest Czech bank), if it does not in fact control it. AGB PF is managed by A-invest, an Agrobanka fully owned subsidiary. Since the market is afraid of Motoinvest, as it does not know what to expect from that group, it prices AGB PF's management risk relatively high. The magnitude can be assessed by comparing AGB PF with Alpha Effect, another fund that should open basically at the same time. Alpha Effect is managed by IKS ČP, a subsidiary of the Czech Insurance Company (Česká Pojišťovna), which is regarded as reliable. Alpha Effect's charge for buying back the shares will be 20 percent of NAV, while that of AGB PF will be just 3 percent. Nevertheless, Alpha Effect's discount is currently 33% while that for AGB PF is 41 percent. Even if we assume that the higher redemption charge in the Alpha Effect case is balanced by a higher quality portfolio, the market's charge for management risk stands at 8 percentage points.

The second example is that of the Creditanstalt Czech Investment Fund. This fund had a very high quality portfolio. Nevertheless, after it became known that Motoinvest would be taking over the fund the discount widened to more than 10 percentage points greater than was the average for comparable funds. That can be explained by nothing other than a fear of what Motoinvest would do after it took over the fund.[14]

On the whole, we expect discounts to narrow. Their levels at the end of April 1996, in our opinion, reflect the market's overreaction to the fact that several large funds were transformed into

[13]As calculated from 25 April 1996 prices and 19 April 1996 NAVs.

[14]Subsequently, a 29 April 1996 extraordinary shareholders meeting approved that the fund be renamed ICS Holding and be transformed into a holding company

industrial holdings and, in this way, fund managers escaped governmental supervision. We believe there is fear in the market that the management companies will steal the NAV. This situation creates opportunity. Firstly, relatively honest managers do exist, and, since discounts are almost uniformly significant, it is possible to find bargains. Secondly, on the whole, we believe the fear exceeds the real danger. The average discount should narrow as the market regains confidence in funds. Particularly in consideration of past discount developments, legislative changes and foreign interest in the Czech market, we expect average discounts to be 5-10 percentage points smaller at the end of 1996 than they are today.

5. Behaviour of Funds

In this section we will look at the behaviour of investment funds. In the first part the development of portfolio structure will be examined, then we will try to answer questions about reasons leading to controlling efforts and the role investment funds play in corporate governance. Behaviour of bank funds and the transformation of investment funds into holdings will be other topics. The final part of this section will deal with the likely future behaviour and the impact of fund behaviour on the capital market.

5.1. *Structure of Portfolios*

In order to follow the structure of portfolio development we had to identify the group of funds to be investigated. For the reasons of relevance and of data availability, the largest 15 investment funds were selected. Their names and management companies can be found in Exhibit 2 in the Overview section. Portfolios dated 31 December 1994, 30 June 1995 and 31 December 1995 were examined.[15]

Various funds, or more exactly various investment companies, employed various strategies during the coupon bidding, especially in regard to the type of companies they invested in. Nevertheless, with a few exceptions, the biggest funds ended with a more dispersed portfolio than desired. One of the very few exceptions were the two Harvard funds--Harvard Dividend and Harvard Growth funds, which invested their points into a limited number of companies. On the whole, substantial restructuring was necessary.

This large number of companies can be observed in our sample. For instance, at the end of 1994, after some restructuring took place, there still were on average 182 Czech stock titles in the 15 portfolios.[16] After excluding Restitution Investment Fund due to its special origin and composition, the figure stands at 128 titles.[17] The development of this average confirms the expectations about portfolios restructuring: in the middle of 1995 the figure decreased by 5.5% to 121 titles and till the end of the year another decrease of 18.2% to 99 titles was recorded (RIF excluded from all figures).

Three funds with the highest decrease of the number of holdings included PPF První Český, IF YSE and SPIF Všeobecný. All of them decreased the number of stock titles by more than 40 percent. The first two mentioned funds were clearly working to focus on the ongoing struggle for controlling

[15] It was necessary to estimate some data. That was the case of, for instance, Harvard funds portfolios at the end of 1995, when changes over the period just since June 1995 were known, but the portfolio at the end of 1995 is not available.

[16] We restrict the discussion to the Czech shares, despite the fact that some funds invested in Slovak companies during the first wave of Coupon Privatisation. Nevertheless these Slovak holdings are unimportant relative to their market capitalisation.

[17] Restitution Investment Fund is a governmental creation, and its main purpose is to satisfy individuals' restitutional claims. Three percent of every privatized company went to this fund. That resulted in an extremely broad portfolio. Due to its special origin and composition we exclude this fund from calculations in this section.

stakes and both have transformed themselves into holding companies in early 1996. SPIF Všeobecný is a special case as it will be gradually liquidated. On the other side, SPIF Český and funds managed by 1. Investiční (First Investment Company) exhibited the highest degree of portfolio stability and on average sold off several percent of their portfolios' stocks. On the whole, bank funds were less active in the portfolio pruning as measured by the change of number of titles in the portfolios. We expect the decrease of the number of stock titles to continue in 1996, because major fund managers indicated the intention to clean their portfolios further and to increase their focus. On the other hand, very low liquidity of most of the smaller companies shares is likely to slow down the process significantly.

Exhibit 5: Development of Portfolios Structure

	31.12.1994	30.6.1995	31.12.1995
Avg. number of Czech share titles	128	121	99
Avg. percentage of all tradable shares	7.49	7.11	7.00

Source: Investment Companies, AFT Calculation

Another interesting aspect of portfolio structure is the ownership share of companies in the portfolio. The average holding as a percentage of all tradable shares stood at 7.49% as of December 31, 1994. This figure has gradually decreased to 7.11% in the middle of 1995 and 7.00% on December 31, 1995.[18] This development is rather suprising, because during the pruning of portfolios and struggle for control we would expect this number to increase. This is, in our opinion, caused by the fact that most of the holdings, large funds sold off during the year, were small companies. On the other hand, most companies they tried to gain control of were medium and large companies. Due to equal weighting of all companies in the calculation of the average, the net effect of selling large stakes in several small companies and buying a large stake in one large company causes the average to decrease. Another aspect that influences the percentage held in the companies is the fact that investment funds must get round the ownership restrictions. That is usually done by repo operations. Placement of shares outside a fund's portfolio causes the portfolio not to tell the whole story. The development of average share in companies would probably be different if funds were allowed to own legally more than 20% of a company shares.

For the discussion to be complete we have to mention briefly one more factor related to fund portfolios that has an impact on a fund's behaviour. It is the accounting for shares received from coupon privatisation that were all recorded at their nominal values. This accounting treatment has had significant influence on the behaviour of funds--in order not to show an accounting loss funds were reluctant to sell shares below the nominal value. Several funds solved this problem by a special repo operation--they sold all the shares to a agreed upon counterparty and bought them back on the next day. In this way they recorded a big accounting loss, covered this loss by capital funds and continue with a balance sheet which better reflects the reality. Several funds intend to conduct this operation in the near future. On the whole, the accounting treatment legislature cannot be too seriously criticised as there were no market prices at the time when the first wave of coupon privatisation ended.

5.2. *Struggles Over Controlling Ownership*

As described above, after the coupon privatisation most of the major fund portfolios were too diversified. The trend of holdings concentration was a natural development. Although several large

[18]Due to the lack of suitable information sources we are using the percentage of companies' <u>all tradable shares</u>, not the percentage of registered capital. Generally, this approach to some extent overestimates the funds ownership share. Nevertheless, this method of calculation is sufficient for the investigation of development over time. Simple averages were used in the calculations.

funds specialised early in strategic holdings, nearly all funds now are involved in desperate efforts to gain control over companies. This is in spite of the fact that they generally have neither the expertise nor the intention to increase the companies' value by actively improving management. Some funds paid huge premiums for their controlling stakes., as described in the next subsection. Some of them paid huge premiums for their controlling stakes.

In fact, this behaviour is not restricted just to funds. There is an overall effort to get control over companies. That to a large extent disables funds from behaving as portfolio investors and forces them to try to gain control over as many companies as possible in order not to lose their money. Staying "locked" in the minority position means having basically no influence on what is going on in the company and seeing the value of the minority holding substantially diminish. Hypothetically, that would be the case even if the minority interest amounted to 49% of the company's shares.

Under conditions where minority shareholder rights protection was virtually non-existent, the majority stake in a company was perceived to have a value close to that for the entire company. Minority holdings in companies that became majority owned lost their value. There seemed always and everywhere to be somebody willing to launch a takeover effort. Funds seemingly have had two choices: 1) to sell off everything and, once the majority owners were known, buy back shares at low prices reflecting the majority ownerships, or 2) to fight for control.

A third possibility, which would be to form large scale defensive coalitions with other investment funds, was probably not viable. There are exceptions, of course, but attempts to coordinate the largest funds' activities on a larger scale reportedly failed. Once a defensive coalition can be formed, the incentive to cheat becomes very strong. Nevertheless, according to industry sources, voting coalitions in particular companies work well in respect to minority shareholders in that those outside the majority voting coalition do not have any chance to influence decisions that are being made .

In the end, funds are not trying to take over companies just because they decided it was a nice thing to do. Most simply are compelled, under existing conditions in the capital market, to behave in this way.

Another question is whether the lack of minority protection justified premiums both over the market and fair prices paid by funds for large stakes in the companies. Even though according to industry sources funds clearly overpaid in some cases, we are not able to answer the question in general. It would be necessary to investigate the way funds are going to get value from the companies they control, get data about the premiums they paid and estimate the fair value. Data concerning the first two items especially is impossible to obtain as it is very sensitive information. Investment companies would not be willing to provide this information and the Czech capital market is not sufficiently transparent for us to be able to estimate the premiums from publicly available data.

The approved minority protection legislature should speed up the process in the immediate term. After it is in force, this behaviour should practically disappear--if the legislature will be enforced--because it will be much more difficult and expensive to acquire a majority stake in any company and minority shareholders will be in a better position. This only will be true, of course, if the law is properly implemented and enforced.

5.3. *Role of Funds in Corporate Governance*

The main source of information in this sub-section are interviews with managers of ten top investment companies, conducted in late March 1996.[19] One of the question areas was concerning details about investment company (investment fund) representatives on the Board of Directors and Supervisory Board of the companies they have larger ownership interest in, because this is an area that indicates the actual strategy and approach to corporate governance.

The legislature states that the representatives act independently, representing individual views rather than views of the investment company. They are therefore actually not responsible to the investment company. Nevertheless, there are different attitudes on the part of investment companies toward this issue. The managers' answers revealed that there are two basic approaches to the representatives question. Several investment companies (including PPF and LinhArt) that are strongly oriented towards strategic holding are quite logically trying to exert a higher degree of influence over their representatives--e.g. by mandate contracts. This type of investment company tries to find people, both internally and externally, who have experience in the particular business the owned company does and who would increase its value by helping the management make the right decisions.

The rest, mainly bank funds and investment companies, generally do not have ambition to actively participate in the management decisions. Their representatives are mainly employees in various positions with the investment or parent company. They are usually not forced to behave in any specific way and have just vague goals. There is no specified strategy in managing the firms. These people are monitoring rather than actively pursuing given goals.

These two types of approaches translate into the actual policies within the firms. The first approach results are hard to evaluate due to the short time period. The most visible and publicly discussed were high dividend demands from this type of investment company. If we judged only according to this factor, the second, passive approach was predominant--the payout ratio is rather low. On the other side low dividend payout can have several other reasons--the need for large investments in Czech companies or sourcing cash out of the companies in another way, and consequently, a lower need to pay out money to all shareholders.

Another interesting question concerns the popular theory about the conflict of interest a bank experiences when it is acting as a creditor and owner of a company through its fund management subsidiary. We have addressed this issue during our visits with bank fund managers. Some banks have tried to build Chinese walls, but according to our information not very effectively. Nevertheless, the managers were mostly unwilling to admit the existence of the conflict of interest in reality. They mostly argued that there is a theoretical possibility of conflict of interest, but in reality they are under scrutiny of the other owners and management, even in the case of having a large ownership stake in a given company. Since this question would require development of special methodology in how to assess the existence of conflict of interest, and the information is, for obvious reasons, very sensitive, we did not continue further in this direction.

On the whole, we believe that funds, investment companies, do not have the necessary expertise to be able to substantially increase the value of the companies they own a large stake in, nor do they have the other kind of resources that a strategic partner as an owner might provide to the companies--e.g. know-how, distribution and new products. This supports the remark often heard in government circles that the first owners after privatisation are not the final ones. We think that the role of

[19] The attended investment companies included 1. Investiční, Spořitelní Investiční Společnost, IKS KB, KIS ČP, A-Invest, PPF, IS Expandia, IS LinhArt and ŽB Trust. HC&C was visited earlier this year. Interviews were conducted by Richard Podpiera and Jiří Roháček

(investment) funds is not to be strategic owners--of course, with possible exceptions. On the other hand, due to the disciplining effect, a rather uncapable owner is better than no owner at all, at least until the next owner is found.

5.4. *Transformation into Holdings*

Several large investment funds have turned themselves into holding companies or expressed an intention to do so in early 1996. Among them Harvard funds, PPF První Český IF, IF YSE, former Creditanstalt fund and funds managed by A-invest are the most significant.[20] To be precise we have to acknowledge that a number of smaller, less important funds did the same thing earlier. Altogether 15 investment funds have completed their transformation, another 15 shareholders meetings approved the change and several others are getting ready for this action.[21] The higher transformational activity of investment funds in early 1996 was probably caused by two factors: 1) the legislature passed in late April 1996 makes this type of action much more difficult, if not virtually impossible, because two thirds of all shareholders have to approve this action and those who do not agree with the conversion will have to get an exit option. 2) Struggles for controlling stakes are becoming ever more difficult. Transformation to a holding can give an investment fund a competitive edge.

The transformational scenario was usually as follows. An extraordinary shareholders meeting was called rather quickly and the Articles of Incorporation were changed. The main changes included altering the company name and changing the scope of its activities. The original Articles defined these activities as those standard for an investment fund and corresponded to the Czech Act on Investment Companies and Investment Funds. These activities were replaced by broadly defined activities for an ordinary commercial company.

Such changes mean that the firm no longer exists as an investment fund. It therefore is not subject to state regulations. Ownership restrictions no longer apply. The firm now can invest into shares of investment funds. Diversification rules will not apply. On the other hand the holding companies are subject to higher profit tax.

Only investment funds can turn into ordinary companies, because they have both the Articles of Incorporation and Statutes. Unit funds have just Statutes. In both cases, any change in Statutes - but not in Articles of Incorporation - must be approved by the Ministry of Finance. As of spring 1996, the Ministry's policy is very strict--they approve just formal changes and it is virtually impossible to change the Statutes in any important aspect. In the investment fund case, however, the Articles of Incorporation supersede the Statutes in that, if the firm is no longer a fund governed by the Investment Companies and Investment Funds Act, the Statutes no longer apply. Due to the fact that this loophole is not open to unit funds, these might be considered somewhat safer.

The management companies' main arguments are usually in support of increased flexibility to manage the assets and the holding's profitability. They do not mention increased risk. The market reacted strongly and the new holding companies saw their prices drop sharply. Afterwards, initial overshoot prices increased, but did not return to their original levels.

The changes described above are not universally positive for fund owners. While management companies are better positioned aggressively to govern, and perhaps even to actively manage the

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[20] Harvard Capital and Consulting, YSE and PPF are private investment companies. A-invest is a subsidiary of Agrobanka, the fifth largest Czech bank, which is closely connected with Motoinvest.

[21] "Transformovaných fondů nadále přibývá (The Number of Transformed Funds is Growing)", ***Burzovní Noviny*** *(Stock Exchange Newspaper)*, April 3, 1996, p1

holdings, the absence of regulation and state supervision increase the risks of this investment. An additional risk factor is the reduced diversification. For instance, the former Harvard Dividend Fund decreased the number of holdings to 20, and, because the company is not subject to any regulation, it can reduce the number even further.

As to future development, we see two possible scenarios. In the first scenario, other large funds will not follow the transformation path. In scenario two, virtually all large funds will be transformed into holding companies before the new laws come into effect. We believe the first scenario is more likely. Nearly all large funds that have not yet been transformed are bank funds. Banks generally cannot afford to endanger their reputations - and the market does not now regard the new holding companies favourably. What's more, partial state ownership is likely to make the largest banks behave conservatively. It is true that, if they cannot defend their positions in companies, after some time they might actually be forced to transform. The new minority shareholder protection law, though, should to a large extent address this problem. Moreover, banks would need to decide quickly, and, as they are not very flexible, it is questionable whether they would be able to act quickly enough.

5.5. *Impact on the Capital Market*

We believe that the question about the impact of fund behaviour on the capital market is not the most appropriate as we think that fund behaviour does not affect the capital market as much as the conditions --especially legislature--of the capital market affect the behaviour of funds, as was described in the sections above.

The development towards majorisation of companies' ownership does not prove itself to be positive for the capital market. The liquidity of majority-owned companies is low, as well as their attractiveness and price, because portfolio investors will get only what the majority owner(s) allow them to have. From the more aggregated point of view--this development will lower the attractiveness of the Czech capital market from an international perspective, decrease the inflow of portfolio investment and retard the development of the capital market towards a standard, developed market.

The funds will have to earn money--to get back the money paid for majority stakes in the companies. It is almost surely bad news for minority shareholders in the companies. The effect on companies - their restructuring and efficiency - might be positive. The overall effect on the capital market will be negative due to the fact that the capital market can develop to standard form only under the conditions of the investors' trust.