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Abstract

One of the most acute problems in the world today is provision of a respectable living for the elderly. Today the process of aging population (as a result of a declined birth rate and increased life expectancy) has touched all countries of the world - developed countries as well as countries like Russia. Consequently, reforming traditional pension systems to deal with the changing situation has become an important issue around the world. These reforms typically center on the implementation of some form of funding of future pension benefits. This also holds for Russia, where in 1995 pension reform legislation introduced the so-called "accumulation pension". In this context, this article will deal with the issues concerning the establishment of mutual funds, legal aspects of their operating and their investing opportunities. There will be carried out a comparative analysis of mutual funds with the other forms of public investments, namely: Common Funds of Bank Management, Voucher Investment Funds and Joint-stock Investment Funds.

JEL Classification: G21, G23, G28

1. Introduction

One of the most acute problems in the world today is provision of a respectable living for the elderly. Today the process of aging population (as a result of a declined birth rate and increased life expectancy) has touched all countries of the world. This is true first of all for developed countries, although in recent years this problem has emerged in countries such as Russia. As a consequence government expenses to support the elderly have increased as percent of the GDP, placing a greater burden on working population.

Thus according to experts of Organization for Economic Cooperation and Development (OECD) from 1960 to 1985 government expenditure on pensions in countries – members of OECD has grown twice faster than the GDP. From the second half of the 1980's due to efforts undertaken in restricting social expenditure its rate of growth has decreased. At present countries OECD spend an average of 9% of their GDP on pensions and this figure varies from country to country. For example, government expenses on pensions in Austria amount to 15% of the GDP, Japan – 5% and Canada – 4,5%; and according to the forecasts the first decades of 21st century will see pension costs increase to 14-20% of the GDP in Japan and Europe.[1] Thus, pension reforms have become an objective necessity and they began in majority of countries of the world starting from 1980's.

In Russia the pension reform has begun with the Resolution #790 of the Government of the Russian Federation Measures to Implement the Concept of Reform of Pension Provision in the Russian Federation, August 7, 1995. According to this concept our country should have a pension system consisting of three levels: the first level is a 'base pension', second – 'working pension' or socially secured pension, and third – 'non-government pension' or accumulative pension". Its main goal is to move from purely distributive government pension model to a mixed, distributive-accumulative one.

It is believed that this reform will help solve two very important problems using the same financial instruments. First, it will provide an additional (to the governmental) social protection for population, and, secondly, substantially expand investment potential for the economy. At the present time the payment of government pensions is performed using the principle of 'solidarity of generations', i.e. pensions are paid from social tax of 26% (of which 20% goes to the Pension Fund, 2,8% - to the Fund of compulsory medical insurance, and 3,2% - to the Fund of social insurance) paid by employers on behalf of employees from the salary pool.[2] This system is viable when there are no less than 3 or 4 working citizens for each pensioner this allows to pay respectable pensions with a relatively small tax burden. In 2003 in Russia, the balance was 1,8 working citizens for a pensioner. According to some estimation, if today's rules for pension distribution are preserved, then by 2045 the ratio of working citizens to pensioners may approach to 1.[3]

This problem has been addressed by the accumulating part of pension, which is distributed among individual accounts so that the sum received by each individual depends upon his or her salary; also the accumulating part of pension accrues investment profits.

[1] Sorokina, E.G. "Foreign experience in modeling pension systems", Investment plus Nr.3, 2003.
[2] These rates are active since 01.01.2005 in accordance with Federal Act №70, July 20, 2004, before the social tax was 35,6% (28% went to the Pension Fund, 3,6% - to the Fund of compulsory medical insurance, and 4% - to the Fund of social insurance - Tax Code of the Russian Federation, chapter 24, art. 241, since 05.08.2000).
[3] See http://www.cic.ru/ci/whatisci/3_1/

Let's take a closer look at the options of investing accumulating part of the pension. First of all, at present time investment of pension savings is channeled into government securities by the Pension Fund of Russia through a government management company (at present this company is Vnesheconombank). Secondly, in accordance with the Act #111-FZ *Investment of Funds for Financing of Accumulating Portion of Pensions* enacted in 24.07.2002, beginning with the year 2003 all working citizens below certain age (men up to 1953 and women up to 1957 year of birth) will be given an option to transfer their pension savings from the Pension Fund of Russia (PFR) into a private management company (Article 23 of the Act). Transfer of funds to a management company doesn't change the form of ownership: pension funds still remain the property of the Russian Federation (RF) (Article 5 of the Act). The management contract will be put in place between the Russian Federation and the manager, and the beneficiary will also be the Russian Federation and not the citizen that initiated the transfer of savings to the manager. (Article 18 of the Act). Tax payments will continue to be delivered to PFR and transferred to the manager only by the year's end results. As soon as an individual becomes a pensioner the manager will have to return accumulated funds to PRF, and only the last will distribute pension payments. In addition, management companies will have to pass government's competition for the right to manage pension money (Article 19 of the Act).

In accordance with statistic data of 2004 the revenue structure of Russian Pension Fund budget composed of 441,3 billion rubles (approximately 15,9 billion US dollars at exchange rate as of 31.12.2004 27,7487 Rub= 1USD) received from social tax, 403 billion rubles (approximately 14,52 billion US dollars) - from insurance premium to the payment of the socially secured pension part , 70,6 billion rubles (approximately 2,54 billion US dollars) – premium for accumulative part of pension. In addition, the Russian Pension Fund received 83,8 billion rubles (approximately 3 billion US dollars) as an income related to the obligatory financing of accumulative pension part last year. The gross amount of income from temporary investing of pension funds totaled 5,7 billion rubles (approximately 0,21 billion US dollars), including 3,8 billion rubles (approximately 0,14 billion US dollars) from the investing into government bonds and 1,9 billion rubles (approximately 0,068 billion US dollars) from the investing into securities in foreign currency. The income of Pension Fund budget of the RF totaled 1,15 trillion rubles, the expenditures totaled 967.5 bln rubles.[4]

Finally, from year 2004 citizens have a third option of investing the accumulating part of their pensions – through non-government pension funds (NPF). According to data of Inspection NPF with Ministry of Labor and social development of the Russian Federation in June 2005 approximately 297 non-government pension funds were registered in Russia with authorized licenses. According to the amended Act N14-FZ *Non-Governmental Pension Funds* of 10.01.2003, the sphere of activity of NPF is expanding: along with voluntary provision of pensions, they will also be able to take part in compulsory funded pension system.

Unlike the case with management companies, pension savings transferred to NPF will become its property. Ownership rights in regards to these funds will be covered not by a management agreement, but by a contract on compulsory pension insurance between NPF and private citizens. However, in order to invest these funds NPF will be obligated on their part to arrange trust agreements with management companies. Current legislation

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[4] Income of Pension Fund of RF was 1,15 trillion rubles, expenses 967,5 billion rubles, Agency Praim- TACC, June 15, 2005

allows them not to use services of management companies while purchasing government bonds and opening bank deposits, but the government may expand this list. During last two years both on the legislation level and on the level of professional members of financial market there has been a discussion about the necessity to permit investing of pension reserves proposes to allow making deposits into mutual funds provided an investment declaration is given. It is worth mentioning the importance of this decision, because mutual investment funds all around the world are the leading players in the market of popular investments and a simplified system of investment of pension savings into securities and other financial assets via mutual funds may significantly increase the investment potential of Russian economy overall.

This article will deal with the issues concerning the establishment of mutual funds, legal aspects of their operating and their investing opportunities. There will be carried out a comparative analysis of mutual funds with the other forms of public investments, namely: Common Funds of Bank Management, Voucher Investment Funds and Joint-stock Investment Funds.

2. Legal regulation and history of mutual funds in Russia.

Russian market of collective investment began to form in 1992-1993 during the time of "voucher" privatization with appearance of voucher investment funds (VIFs), gathering vouchers from population and investing them in stocks of privatized companies. However, as a result of poorly thought legislation and economic base VIFs (numbered at around 500 in 1993) proved to be unable to survive. In 1998 a Presidential Decree #193 *Further Development of Investment Funds* gave investment funds an option to transform into either mutual funds or joint stock companies. However, transformation into mutual fund required closure of a voucher fund followed by re-opening of the mutual fund in the new form. Therefore the majority of funds transformed into joint stock companies. And since assets of these companies consisted of securities, the majority of them started to function as investment companies and holdings.[5]

Development of market for mutual funds was made possible in 1995 with the presidential Regulations: *Additional Measures for Increasing Effectiveness of Investment Policy in the Russian Federation* and *Further Development of Activities of Investment Funds*. However, it was not until 1996 when the appropriate legal regulatory base was created (over 30 normative documents) that the first mutual funds began to appear. When legislature on mutual funds was in development care was taken to consider negative experience of creation of voucher investment funds (VIF), which, as many other forms of collective investment were formed in legislative vacuum. As a result of contradictory normative base and, as a consequence, low effectiveness of VIFs, the latter gave space to mutual funds, some of which were formed through restructuring of VIF (such for example were the funds of "Nikoil": First, Second, and Third Funds of "Lukoil"; and "Alfa-Capital" funds).

The more prominent feature of mutual fund is that it is not a legal entity and thus is not responsible for payment of income tax. This removes double taxation issue, which "suffocated" voucher investment funds and non-government pension funds. Mutual fund is an owned structure, formed by united deposits of individual investors – residents and

[5] "Voucher funds: Where did you go?", *Investment plus*, Nr.1 (400) 15.01. 2003

non-residents of the Russian Federation for further management of this property by a specially licensed Management company, the founder of the fund.

Contractual relationships within a structure of a mutual fund are based on the Trust management agreement. Major points of this agreement are covered in the main document – "Rules of Trust Management of an Investment Fund" – a public document which is also a contract.

Investor joins the fund by purchasing mutual fund shares, issued by the Management company. The purchase is made either directly from the management company or via agents of the fund. Redemption of shares is also done through the Management Company or fund's agents. The purchase and sale price is calculated as a net asset value (by dividing funds assets on the shares outstanding) net of commissions and mark ups (or mark downs).

Today mutual funds are one of the most reliable and informatively open institutes in the Russian capital market. They are obligated to provide information not only to investors, but also publish in press information about net asset value, increase in asset value, balance sheet, etc. Due to stringent control from Federal Commission on the Securities Market (FCSM), a well thought-through management structure of mutual funds and strict rules governing activities of management companies, from the very start of operations of mutual funds there was not a single instance of fraud. According to the legislature, mutual fund should have the following structure (payments for services of infrastructure organizations are made from fund's assets):

- Management Company (Underwriter) – responsible for fund's management, makes decisions about investing of fund's capital.
- Custodian - keeps a record of funds assets, controls use of funds assets and overseas management company in its following legislation and the Rules of funds.
- Transfer Agents – provides issuance, redemption and exchange of fund's shares. Duties of transfer agents are often performed by bank's affiliate networks (for example management company "Montes-Auri" sells its shares via network of Guta-Bank, "OFG-Invest" – via offices of Sberbank) and affiliate networks of large investment companies (for example, management company "AVK-Dvortsovaya Ploshad" sells shares via investment company "AVK" and its affiliate offices).
- Independent Auditor - checks accounting records and procedures in respect to fund's property, calculation of net asset value, and transactions with fund's properties.
- Registrar - Keeps record of ownership rights of fund's investors..
- Independent Assessor - Evaluates non-marketable assets of a fund (only for interval funds).

Accordingly, that mutual fund is the subject to double examination – from one side by FCSM and from the other by companies providing infrastructure for the mutual fund.

3. Types of mutual funds in the Russian market: open funds, interval funds, closed funds

It is noteworthy, that closed and open funds are widely popular in practice of international collective investment. Thus, the first investment funds – investment trust companies (INC) were created in Britain in the middle of the 19th century. To this day they are very popular in that country, unlike investment funds of open type (OEIC), which appeared very recently.

Open investment funds are especially popular in USA, where the first mutual fund appeared in Massachusetts in 1924. In the period of financial crisis many Americans lost their money with various fraudulent organizations. Meanwhile asset structures of mutual funds were strictly controlled by the government – they were required to invest a significant part of their assets in government securities. Currently investments in USA open mutual funds amount to 95% of overall investment in investment companies. Meanwhile mutual funds are the leaders in investing of retirement contributions in non-government pension funds.

Corporate funds of open type appeared later in Europe and grow in a slow, but a fairly stable manner. In France they are called investment companies with variable capital (SICAV). Almost 25% of French families own their shares.

The important distinction between Russian and foreign mutual funds is that in majority of western countries the term "mutual fund" is equivalent to an "open-end fund", while a "closed-end fund" is included in definition of investment company. In Russia, on the other hand, mutual funds may be of three different types: open, interval and closed mutual investment funds.

In accordance with Presidential Decree # 765[6] of 1995 open and interval funds were established. While the Federal Act *Investment Funds*[7] of October 2001 legislated creation of closed mutual funds. Thus, according to the current legislature mutual fund may be divided by the time factor (open, interval and closed) and by types of investments (stocks, bonds, money market, and mixed investments, indices, real estate (with exception of open and interval mutual funds) and high risk (venture) funds.

In an open mutual fund purchase and sale of fund's shares is performed on the daily basis on investor's demand, and termination of shares – every working day based on investor's request. The management company is buying out its own investment shares following request from an investor within a period established by the rules of mutual fund, but not exceeding 15 working days from the day of receiving the request.

In interval investment fund purchase and sale is performed in certain intervals defined by the Rules of the fund, but not less than once every year. Intervals are open for 1-2 weeks. During this time new investors enter the fund and current investors may leave the fund, selling their shares to the management company. In open investment funds the value of each share and net assets (NAV) are determined daily. (NAV is the sum of all of the fund's assets minus all of the fund's liabilities). In Interval funds the value of shares and NAV is determined monthly before the opening of intervals.

In closed funds redemption of shares is done only at the end of the fund's life, which with few exception defined by the law. Shareholders of closed funds apart from their

[6] Presidential Decree "About additional measures of increasing effectiveness of investment policy in Russian Federation" Nr. 765 of 26.07.1995
[7] Federal Act "About investment fund" Nr. 156-FZ of 11.10 2001

rights to receive proceeds from scheduled fund liquidation also receive rights to participate in general shareholder meetings and also (if such is mentioned in *The Rules*) a right to receive profit from managing property (dividends).It is noteworthy that unlike open and interval mutual funds, where the purchase of shares is only allowed in Russian currency, closed funds allow purchases using other instruments (such as, for example, securities, real estate and titles).

Table one gives a short comparison of conditions for establishing and investment orientation of various types of funds.

Table #1 Comparative characteristic of mutual funds

Indicators	Open mutual fund	Interval mutual fund	Closed mutual fund
Minimum investment capital for establishing	2,5 mln. rub. (approx. $85 thousand)	5 mln. rub (approx. $170 thousand)	2,5 mln. rub. (approx. $85 thousand)
Limitations on number of shares issued by management company	Unlimited	Unlimited	Limited by the amount indicated in the Rules of the fund.
Liquidity of shares	Full liquidity, buy-out of shares is performed daily.	Fair liquidity, buy-out is performed within a time frame established by the Rules of the fund, but not less than once per year.	Buy-out of shares is performed by the end of the management agreement (not sooner than one year)
Possibility of exchanging	Exchange of shares of one open fund for shares of another open fund managed by the same management company.	Exchange of interval fund shares for interval fund shares managed by the same management company.	Not possible
Investor Orientation	The fund is created for the purpose of investing in liquid securities	The fund is created for the purpose of investing in less liquid securities	The fund is created for the purpose of direct investment, illiquid investment (in illiquid securities, real estate, and rights to real-estate).

The Regulation by the Federal Commissions on the Securities Market (FCSM) on August 14th, 2002 N31/pc *Ratification of the Provision on the Composition and Structure of Assets of Joint Stock Investment Funds and Assets of Mutual Investment Funds* implements strict requirements on the composition and asset structure, varying from fund to find. Meanwhile, a corporate label as JSIF may and a mutual fund must indicate the nature of the fund:

- Money market fund;
- Bond fund;
- Stock fund;
- Mixed investment fund;
- Fund of funds;
- Real estate fund (with exception of open and interval mutual funds)
- Index fund (with indication if index); or
- High risk investment (venture) fund (with exception of joint stock investment fund, and also open and interval mutual investment funds).

One *should* notice that mutual funds can invest not only into Russian assets but also into several foreign assets. In accordance with the Decree №03-21/пс T*he Number of Securities of Foreign States and International Financial Organizations Allowed to Be Included in Assets of Joint-Stock Funds and Mutual Funds, April 23, 2003* and Order №05-8/пз-н of the Financial Market Federal Office of the Russian Federation, March 30,.2005 the assets of joint-stock funds and mutual funds can be composed of:

a) the bonds of the following foreign countries:
   The United State of America, the UK, Germany, the Republic of Cyprus,

b) The bonds of European Bank of Reconstruction and Development

For an example of fund asset structures belonging to the first category, please refer to Appendix #1.

4. Characteristics of taxation: mutual funds and investors

Tax regulation of mutual fund's operations is conducted in accordance with the Tax Code of the Russian Federation. Lets examine the types of taxes that mutual fund, the management company and the investor has to pay.

A) Mutual fund taxation.

Mutual fund does not pay an income tax because it is not a legal person. Asset growth is not taxable either. This includes asset growth from sources such as bank interest, dividends and interest rates earned from securities, profits from sale of securities, profit from sales of real estate or rent earned from leasing). If mutual fund receives dividends and interest from securities, which are taxable at the source of income (i.e. an investment company that issued the stock and performs payments in regards to the stock), then the management company must notify the investment company that its shares are owned by a mutual fund and therefore proceeds should by delivered in full, without tax withholding.

B) Management company taxation

Payment of tax on behalf of mutual fund by the management company from assets of mutual fund is a gray area in Russian legislature. On one hand the management company as a legal person must pay the following taxes:

A value added tax (VAT) based on the amount of compensation paid to the company itself, special depositary, special registrar, independent assessor, auditor and agents responsible for sales and redemption of shares. In addition, VAT must be paid from the difference between the sales price and the actual cost of a share (resulting from commissions).

If an investment portfolio of a mutual fund has real estate, than VAT is payable at its purchase or sale as well as a land and estate tax (from the balance cost of real estate).

However, the management company may pay these taxes only from fund's property. On the other hand, the payer of taxes is an "organization" or physical persons (Tax Code, Part I, p.19). Because the term "organization" is meant to include legal persons, which mutual fund is not, no taxes should be paid from its property.

During registration of "Prospect for emission of investment shares" a tax on operations with securities is not payable.

C) Investor taxation

The tax burden of investor depends on his/her residence status and on whether or not he/she is a physical or a legal person.

Tax	Individual Investors, residents of Russia	Individual Investors, non-Russian residents	Institutional Investors, residents of Russia	Institutional Investors, non-Russian resident
Income tax	13% (also give tax privileges, such as choosing the taxation scheme)	30% (unless there is the Agreement on Avoiding Double Taxation between the Russian Federation and a country of residence and providing that the necessary documents submitted to the tax authority	24%	24% if there is a registed agent in RF 20% - from net sales proceeds at the time of payment transfer. (Unless there is the Agreement on avoiding double taxation between Russia and the country of non-resident
If resources of the fund are invested in government securities and income is earned only as a result of interest payments on these securities,	none	none	15%	15%

If investor is a physical person, a resident of the Russian Federation then he has to pay an income tax at the rate of 13% resulting from selling of his shares (from profit defined as a difference between the purchase and sales price including transaction costs). With this a shareholder receives tax privileges, such as choosing the taxation scheme. According to Articla 23 of the Tax Code shareholder is given a privilege on income tax (property tax withholdings) in the amount of 125,000 rubles, if investor was the owner of shares for a period of less than 3 years. If investor owned shares for over three years he is entitled to a full exemption.

In the second variant in Paragraph 3, Section 1, Article 220 the Code provides for deduction of factual and documented expenses for purchase of shares from the amount of overall income. When repeated purchase of shares during the year is conducted there is a question about calculating the amount of deductions. According to the current practice this question is solved using the following methods of estimating the value of investment shares (since a share of a mutual fund is considered a security provisions of Decree #40 of FCSM[8] to be applicable): average purchase price - FIFO; value of acquisition of the last shares in chronological order - LIFO – depending on the accounting policy, accepted by the Management fund.

Foreign physical persons, non-Russian residents for tax purposes given that there is an Agreement on Avoiding Double Taxation between the Russian Federation and the country of residence of an individual and also under condition of providing a document in accordance with Section 2, Article 232 of the Tax Code about income received and tax paid outside of the Russian Federation, verified by a tax authority of respective foreign country, may expect to be relieved of tax payment and respective accrual. Otherwise the investor will have to pay 30% from sales proceeds of funds shares, while property taxes are not deductible in this case. If a foreign physical person is also a resident of the Russian Federation for tax purposes, then he has to pay the same taxes as Russian tax payers.

Legal persons – investors of mutual funds pay a tax on income (defined as a difference between the redemption price and the purchase price, taking into account commissions and processing fees), received as a result of a sale of shares at the rate of 24%. The same tax burden is imposed on non-residents of the Russian Federation, acting via permanent representation under condition of presenting to Russian company – the source of income payment notification about the sources of income in the Russian Federation in accordance with a form in Appendix 1 to Instruction #34[9] of Russian Tax Service with a note by the Russian Tax Authority. In the case of absence of permanent representation, the tax is withheld at the source of income at the rate of 20% from net sales proceeds at the time of payment transfer. In case there is the Agreement on avoiding double taxation between Russia and the country of non-resident, if the agreement provides relief from tax burden for this type of income in Russia, then the source of income does not withhold a tax, if it has a properly documented petition on preliminary relief from tax at the source of income in the Russian Federation (Appendix #11 to Instructions #34 of Russian Tax Service)[10]. It is important, that the petition on reducing the rate of tax (submitted to a

[8] Decree by FCSM of Russian Federation "About establishment of rules on disclosure by participants of securities market and investment funds of select transactions in their accounting records" Nr. 40 of 27.11.1997

[9] Instructions of Russian Tax Service *Taxation of Income of Foreign Persons* Nr.34 of 16.06.1995 (amended as of 07.04.2000)

[10] Russia has made such agreements with many countries. An example is an agreement between Russian Federation and Federal German Republic as of 29.05.1996 *Avoiding Double Taxation in Regards to Income and Property Taxes*

local tax authority), or a petition on reimbursement of withheld tax (submitted to the Government Tax Service) is submitted by a foreign legal person in the period of not more than one year from the day of receiving the respective income.

If resources of the fund are invested in government securities and income is earned only as a result of interest payments on these securities, then income earned from such securities is not taxable for physical persons. In this case for legal person the privileged tax is 15%.

Apart from tax burden, mutual fund investor also bears expenses related to activities of a management company and working infrastructure. Thus, a management company or a fund's agent (whose services are used for regional operations) earns an incremental commission calculated as a percentage of share price. According to the current legislature the limit for such commissions is – 1,5% from share price; maximum percentage of a discount is 3% from share price. The amount of compensation earned by the management company, special registrar, special depositary, assessor and auditor for their services provided to the fund may not exceed 10% of an average yearly value of net assets of a fund.

5. Comparative analysis of mutual funds with other forms of collective investment – common funds of bank management and joint stock investment funds.

In line with mutual funds, joint stock investment funds (JSIF) and common funds of bank management (CFBM) also have a place in the Russian market of collective investment.

According to *Investment Funds Act* as of 11.10 2001 "Joint stock investment fund – an open joint stock company, whose exclusive area of activity is investment of assets into securities or other instruments, as provided for by this federal Act and company's name which contains the words "joint stock investment fund" or "investment fund".

JSIF forms investment reserves (property for investment) using emissions of common registered shares via open registration. Shares of the fund are paid in Russian rubles, and also (if this is provided by Investment Declaration of the fund) by other property (for example securities, real estate, etc). JSIF must have infrastructure facilities (if a number of shareholders exceeds 500), an auditor, assessor, whose compensation comes from fund's assets. Similar to a closed mutual fund, an JSIF may include illiquid assets, real estate and property rights to real estate and also assessment of these assets done by independent assessor, having a proper license, at the time of acquiring or denouncing such assets, but not less than once per year. Stockholders of JSIF have a right to participate in a general shareholder's meeting and receiving an income (dividends) on stocks, which is similar to the rights of mutual fund holders of a closed mutual fund.

The main difference between a mutual fund and a JSIF is that JSIF – is a legal person, and therefore, it must pay an income tax, which leads to double taxation.

A characteristic that differentiates common fund of bank management (CFBM) from mutual funds and JSIFs is that it is not an independent subject in the market of collective investment, and can only be established by banks and therefore operates within the limits of legislature governing work of banks. CFBM operates on the basis of *Banks and Banking Activities Act* (Article 6), Decrees of FCSM and Instruction of Central Bank of the Russian Federation #63, which factually legalized existing de facto banking operations in accordance with a trust agreement by creating a necessary legal support. CFBM blossomed in 1997-1998. According to data of Central Bank of Russia on 31st of 1998 there were 119 CFBMs created, while there were only 28 mutual funds at the time. However, financial crisis of 1998 left a lasting impact on CFBMs as well as overall banking industry in Russia. It became obvious that operating risks of CFBM are higher and they are less viable than mutual funds. There was a return of banks' interest to creation of bank funds for the last two years. For the period of 2003-2005 the share of assets in managing CFBM increased at 5,7 and now it totals about 4,5 bln rubles (approximately 158,6 million US dollars at exchange rate as of 03.06.2005 28,375 Rub= 1USD). A total number of shareholders invested their money into CFBMs reached 1500 (The analytics recognized as one of the most beneficial instruments of the financial market. /Агентство финансовой информации "М3-медиа", 3.06. 2005) In 2004 a total number of actively operating Common Funds of Bank Management grew to 45 (The Registrar of CFBMs Central Bank held records for 214 funds on 01.01.05. 31 of them were withdrawn from the Registrar.) Similar to the situation with mutual funds, the peculiar trait of CFBM market remains its high concentration. Thus, at the end of the year 2004 three the largest, in the terms of assets, funds owned 82% of summed up CFBMs assets. Nowadays CFBMs as an investment instrument are still much less popular than common bank deposits and their rivals in the industry of collective investments – mutual funds. At the beginning of December, 2004 individual deposits (in rubles and US dollars) held in banks outstrip 450 times the funds managed by CFBM. The CFBM assets by figures given at the end of the year were 50 times less than cumulative NAV of mutual funds.[11]

Economic mechanism of operations of CFBM is similar to that of mutual funds: in both cases it is a combination of assets (complex of property), formed as a result of combination of a given number of different types of investments by legal and physical persons, managed by an asset manager (Management company for a mutual fund or a Bank for CFBM).

Relationship between the founding manager and the bank - trust manager of CFBM is arranged by an agreement of trust management, which is signed using a formal black copy of which can be found in General rules of creation and trust management of CFBM, acting as a public offer. Unlike mutual fund, where a share is a securities, property of transferred by the founders to CFBM is a common proportionate property of persons who acted as the founders of a trust. No new securities are being issued when CFBM is formed. A certificate of ownership of a share in CFBM is not a unit of property and may not be traded or be a subject to other transactions. Meanwhile, instruction provides for a mechanism of transferring a certificate to another person or a group of person by changing the name of the holder. This process of reassigning a certificate of share ownership is established by a trust manager and is reflected in a trust management agreement.

A scheme for creating a common fund of bank management (CFBM) is much simpler and cheaper than mutual fund since a bank functions simultaneously as an institution participating in creation of CFBM, a trust manager, a depositary for its assets (on the basis of the general banking license and a license of special depositary). The bank already has infrastructure to support activities of a CFBM. In addition, CFBM does not need to have additional property capital (while the foundation of a management company of mutual fund must have a minimal proprietary capital). A depositary of CFBM, where

[11] Antonez O., "CMBMs in 2004", http://www.director-info.ru/

the securities are held or rights to securities in a trust are recorded, is not burdened by the functions of infrastructure facilities (depositary, registrar, etc) of a mutual fund.

Another advantage of CFBM is that payments for Bank services are established as a percentage of investment income earned by CFBM for a given period, and not a percent of value of assets under management. This allows to establish the exact correlation between income of a bank and its effectiveness as a manager.

In addition similar to the management company of a mutual fund a Bank may create and manage property of several CFBM (their amount is not limited), which may differ by types of founders and types of managed property). Equally advantageous to mutual funds and CFBMs is an absence of requirements for reservation of attracted funds.

Objects of trust management in CFBM may be cash resources in rubles of foreign currencies, securities, precious stones and metals, derivative financial instruments, bills, certificates of deposit, belonging to residents of the Russian Federation based on ownership rights.

Practically the only asset disallowed for management by CFBM is real estate, while the only limitation on volume of investing is that CFBM may not invest more than 15% of funds assets in securities of one issuer or a group of issuers linked by relationship of ownership or a written agreement (not applicable to government securities).

It is important to note the differences in the allowed investors of mutual fund and CFBM: government entities and entities of local self administrations may not act as investors in mutual fund. While non-Russian residents may not act as founders of CFBM, which makes CFBM less attractive for foreign investors.

Lets compare the means by which investors receive income from these funds

A) In case of mutual fund – investors income is derived from a difference between the sale and purchase price of a share, multiplied by the number of shares, submitted for redemption.

B) In case of CFBM investment income may have the following forms:

- a payment of interested accrued on a stake in CFBM addition of accrued interest from investor's stake in CFBM to this stake.
- Return of founder's stake in CFBM calculated as a proportion to the current assets of CFBM

Profits of CFBM net of management expenses are shared in proportion to each founders stake in assets of CFBM. The amount of compensation and expenses of CFBM is not regulated unlike that of mutual fund.

Similar to mutual fund, CFBM is not a legal person and is not responsible for paying income tax. However, tax authorities do not currently consider taxation of mutual funds and CFBMs as similar operations, interpreting for tax purposes trust relationships of CFBM as a joint activity. Unlike mutual fund, where investor acquires a stock, assets of CFBM will belong to him on common property rights. For this reason taxation of profits received from CFBM will depend upon the source of income, which are taxed at different rates (interest rates for government securities, dividends, rates on bank deposits, realization of securities, etc). Since a tax rate for various types of income is less than 13% (for physical persons) and 24% (for legal persons), the "average" tax rate may be less than 13% and more than 24% correspondingly.

Further development of CFBMs directly depends upon development of a banking system, risk reduction, and strengthening of banks. In addition, pension reform will play an important role in development of CFBMs. Firstly, all operations with assets from pension savings will be channeled through banks. Secondly, *Investing of Assets for Financing of the Accumulative Portion of Working Pensions in the Russian Federation Act* allows to deposit up to 20% of pension assets to bank accounts. These deposits may only be channeled into banks corresponding to requirements of the Central Bank of the Russian Federation applicable to dealers in government securities. As a result each year around $5-7 billion of pension money goes through our banking system.[12] Thus the growth of bank interest in CFBM is evident.

The above comparison of different forms of collective investment is summarized in table #2.

Table #2 Comparative characteristics of forms of collective investment.

Position	**CFBM**	**Mutual fund**	**JSIF**
Normative base	A single document – Instruction of Central Bank of the Russian Federation #63	*Investment Fund Act*, Government Decrees, Normative documents of FCSM.	*Investment Organizations Act*, *Investment Funds Act*, normative documents of Government and FCSM
Organizational structure	Infrastructure of a Bank is used	Management company, special depositary, registrar, auditor, assessor, (in interval and closed mutual funds)	Management company, special depositary (if the number of shareholders exceeds 500), auditor, assessor
Information disclosure and publicity of activity	Less than in mutual funds and JSIFs (press publications of General conditions, regular reporting to Central Bank, reporting to investors within a set time frame, indicated in General conditions)	Complete information transparency and publicity of operations	Complete information transparency and publicity of operations
Regulatory control	Regulated by Central bank (when the funds are registered)	Regulated by Central Bank. CB establishes strict regulation for activities of mutual funds and management companies (license, registration of Rules of a fund, reporting)	Regulator – FCSM – it establishes strict regulation.
Rights of investor	Redemption of one's stake within a time frame set by the General rules	Redemption of stocks within a time frame set by the Rules. In a closed fund additional rules apply. Such as participation in a General shareholders meeting and receiving profits from property management.	Receiving of dividends and participation in a General shareholders meeting

[12] Golikova L. "Pension money will be shared among 10 banks", *Kommersant (Moscow)*, 28.07.2003

Investor's Control	Absent	In an open and interval mutual fund investor control is absent. In a closed – it is provided for by legislature (general shareholders meeting)	Provided for by legislature (general shareholders meeting)
Necessity of a management company	Management company is unnecessary since management is performed by a Bank.	Not provided for by legislature.	Not provided for by legislature.
Payment methods	Fund may attract cash resources in rubles or foreign currencies and securities; redemption is done in cash in rubles or foreign currency.	Open and interval mutual funds – only rubles. Closed mutual fund – if purchase is performed using rubles or other valuables (securities, real estate, etc). Redemption in rubles only.	Stocks may be paid for in rubles or, if covered by Investment declaration, in other property (securities, real estate, etc).
Financial instrument	A stake in funds assets	An investment share – non-emission titled security	Common titled stocks, yeah
Potential for asset re-assessment	Reassessment is performed in accordance with bank rules: only assets having recognized quotations are reassessed. This is not applicable to illiquid assets.	Liquid assets having recognized quotation are reassessed. Illiquid assets are evaluated by an independent assessor at the time of acquisition and discharge, but not less than once per year (more frequent reassessment is not prohibited)	Liquid assets having recognized quotation are reassessed. Illiquid assets are evaluated by an independent assessor at the time of acquisition and discharge, but not less than once per year (more frequent reassessment is not prohibited)
Limitation on asset composition	Real estate is prohibited as an asset. Not more than 15% may go into stocks of the same issuer.	Strict limitations for all types of funds. Open mutual fund – securities, having recognized quotations and bank deposits; interval – a portion may be invested in illiquid securities; closed mutual fund – real estate and rights to real estate.	Strict limitations on types and structure: securities (both having recognized quotations and illiquid), real estate and rights to real estate.
Presence of the secondary market	Absent	Secondary market allowed	Secondary market allowed.
The extent of liquidity of financial instruments	"Average" and low liquidity (depending on redemption schemes established by General conditions)	Open mutual fund – unconditional liquidity; interval – high liquidity; closed – low liquidity	Depending on attractiveness of securities.
Taxation of fund	Since fund is not a legal person, an income tax is not applicable (there is not "double" taxation)	mutual fund is not a legal person and does not pay an income tax. (no "double" taxation).	As a legal person it is subject to income tax. There is a problem of "double" taxation
Taxation of investor	Relatively complicated – depends upon the type of income received and applicable tax rates.	Profit taxed as a difference between purchase and redemption price at a rate of 13% for physical persons and 24% for legal persons	Dividends accrued to investor are taxed at a rate of 6% at the source of payment (JSIF)

Non-Resident participation	Non-residents may not participate in CFBM	Non-residents may purchase stakes	Non-residents may purchase shares
The source of payment of compensation and expenses	From income derived from management	From fund's assets	From fund's assets
Limits to compensation and expenses	Not established	Not more than 10% of average yearly value of net assets of a fund.	Not more than 10% of average yearly value of net assets of a fund.

6. Current state and tendencies for development of mutual funds in Russia.

As we already noted, the first mutual funds appeared in Russian in 1996. By that time a well developed industry of mutual funds have appeared in the world. In USA there were around 6000 mutual funds, in France – 4900, in Britain over 1600, in Japan – 6500[13]. Today the total management assets of this industry are a little under 12 trillion USD, while the total number of funds in the world is almost 50 thousand.

In Russia a substantial progress in development of mutual funds occurred in 2003. It was linked to growth of the securities market and to perspectives opened for the industry of collective investment in connection with pension reform. In addition, a positive role in growth of interest to mutual funds from the point of view of investors was played by an improved economic environment of that year. This included decline in interest rates on bank deposits, continuous decline of USD to ruble (until recently USD was the main form of personal savings). According to official data in 2003 the total number of registered mutual funds in Russia has increased more than two fold from 61 to 145, while their net assets increased more than 4,5 times from 12,7 billion (approximately 399,62 million US dollars at exchange rate as of 31.12.2002 31,78 Rub= 1USD) to 59,4 billion rubles (approximately 2,01 billion US dollars at exchange rate as of 31.12.2003 29,45 Rub= 1USD). Russian market saw appearance of new types of funds: index funds, industry funds (buying stocks of oil, energy, telecommunication and metallurgical companies), closed funds, real estate funds, money market funds in 2003. Shares of mutual funds started trading on the market (Moscow Interbank Currency Exchange (MICE) and Russian Trading System (RTS))[14].

On the whole for the period of 2002-2004 the gross value of net assets of MF rose more than by 12 times. The year of 2003 became a period of the most intensive development of Russian mutual funds in their entire eight- year history. According to the data of National League of Managers, on December 31, 2004 the value of net assets of funds totaled 109,6 bln rubles, or 3,95 bln dollars.[15], the number of those who got the licenses as management companies increased from 129 to 177, the number of management companies which holds operating mutual funds increased from 57 to 103[16].

[13] Chekulaev M. "Who should we trust our money?", Banking review, 24.06.2003, Nr.6
[14] "Vedomosti", 30th December, 2003
[15] http://www.rbcdaily.ru/index1.shtml, 23.06.2005
[16] Kapitan M. "What the temperature of mutual funds in 2005?", *Investments plus,* Nr. 1 (63) 2005

Tables #3 and #4, #5 present statistical data on the number and NAV of various types of mutual funds on 7th of June 2004 and 10 of June 2005[1]. (Also you could see Appendix #2)

Table #3 The number of operating mutual funds by groups

Asset structure	Type						Total	
	Open		Interval		Closed			
	07.06.04	10.06.05	07.06.04	10.06.05	07.06.04.	10.06.05	07.06.04	10.06.05
Money Market	1	2	0	0	0	0	1	2
Bond fund	29	42	3	3	0	0	32	45
Mixed	45	65	29	32	2	2	76	99
Stocks	34	53	15	16	7	16	56	85
Index	0	8	1	1	0	0	1	9
Fund of funds	0	2	0	0	0	0	0	2
Real Estate	These types of funds are not covered by legislature				11	43	11	43
High risk (venture)					2	9	2	9
Total	109	172	48	52	22	70	179*	294**

* There are 179 working funds from 190 registered funds on 7 of June 2004.
** There are 294 working funds from 317 registered funds on 10-of June 2005.

Table #4 NAV of working mutual funds by groups (mln. Rubles*) on 7 of June 2004**

Asset Structure	Type			Total
	Open	Interval	Closed	
Money Market	0.12			0.12
Bonds	3 159.37	34.94		3 194.30
Mixed	4 433.76	5 115.98	445.92	9 995.67
Stocks	4 903.09	16 744.73	53 626.43	75 274.26
Index		141.38		141.38
Fund of funds				
Real-Estate	These types of funds are not covered by the legislature		3 684.49	3 684.49
High risk (venture) funds			806.89	806.89
Total	12 496.34	22 037.03	58 563.73	93 097.10

*** for the purpose of calculating the equivalent in USD please use the exchange rate of Central Bank of Russia 1USD = 29,066 rubles (June 7, 2004)

[1] statistics are taken from official site of collective investments http://www.cic.ru/analysis/stat/index.html

Table #5 NAV of working mutual funds by groups (mln. Rubles***) on 10 of June 2005				
Asset Structure	**Type**			**Total**
	Open	**Interval**	**Closed**	
Money Market	250.05			250.05
Bonds	4 218.02	59.64		4 277.66
Mixed	5 854.04	4 655.68	153.82	10 663.54
Stocks	6 386.81	19 318.96	68 531.72	94 237.50
Index	198.18	90.07		288.25
Fund of funds	26.97			26.97
Real-Estate	These types of funds are not covered by the legislature		10 060.21	10 060.21
High risk (venture) funds			8 461.33	8 461.33
Total	16 934.08	24 124.34	87 207.09	128 265.52

*** for the purpose of calculating the equivalent in USD please use the exchange rate of Central Bank of Russia 1USD = 28,4457 rubles (June 10, 2005)

In the years of their existence mutual funds have shown a positive dynamic in growth of their net assets. However, once growth of NAV is analyzed the following conclusions may be reached. From 1998 to 1999 the assets of mutual funds have increased almost 9 times due to transformation of voucher fund "Lukoil" into three mutual funds. In year 2000 mutual fund industry experienced a stagnation – the total growth of assets coincided with growth of liabilities, which kept the value of net assets at roughly constant level. A rapid growth of net assets of mutual funds in 2001 was determined by market growth by 97%. Thus from 4,08 billion rubles of growth, 3,95 billion rubles came from market growth and only 120 million rubles (or 3%) came in as net inflow to the mutual funds from investors. In 2002 net assets of mutual funds increased by 40,3% (from 9,05 to 12,7 billion rubles). But this was also linked to a positive dynamic of the market. While the balance of sales to redemption of mutual fund shares resulted in a net outflow of 12,87 million rubles. Investors were redeeming their money from interval stock funds and open bond funds, preferring to invest in open stock funds and mixed investment funds. Thus, the main reason for growth of NAV of mutual funds in 2003 was not the inflow of funds from investors, but rather a dynamic growth of the Russian securities market.

While there is no direct connection between volume of assets of investment funds and macro-economic indicators, such as capitalization of the securities market or the volume of savings, there is a general trend for all countries that shows growth of share of assets of investment funds in GDP. As indicated by the data of European federation of investment funds and companies (FEFSI), an indicator "assets of funds/GDP" increased in Europe in the past 5 years by 2,3 times: from 23% in 1995 to 53% in 2000. Meanwhile there is an 8 fold difference in this indicator across countries: from 6% in Germany to 46% in USA. In Russia, according to experts, the optimal indicator "assets of funds/GDP" should be around 3%. By the end of 2004 according to our calculations this indicator was at 0,65%[18] (in 2001 it was 0,1%, in 2003 approximately 1%)

[18] in 2004 GDP of Russia was 16,751 trillion rubles (www.gks.ru)

Another indicator, characterizing the level of development of mutual funds is the funds assets per capita. In 2003 this figure is a little over $3 per person. For comparison, this indicator in former socialist countries is the following: Hungary – 230 USD, Poland – around 40 USD, Chez Republic – 210 per person.[19]

Considering substantial dollar savings by the Russian population and the tendency for decline of USD on international markets, the potential for development of collective investments is quite high.

The distinctive trait of mutual funds industry in Russia is a very high level of concentration, though you can see it is steadily declining. In the first years of activity mutual funds concentration merely continued to grow and only in the last three years a break from the past have occurred: in 2001 a market share controlled by the top 5 management companies declined from 95,2 to 94,3%, while in 2002 this figure fell to 91,5% and in 2003 even deeper to 85,4%, and in 2004 it was just 71,02% of the market. Meanwhile, the composition of the top five leaders by "assets under management" remains unchanged. There are Management – Center, Management –Consulting, Uralsib, Nikoil, Interfin-Capital. Troika Dialog and Alfa Capital rates are now 7 and 8 accordingly. In addition, in 2002 the assets of mutual fund families of Nikoil and Alfa Capital (formed as a CIF) composed two thirds of this entire industry in Russia. 2004 saw a redistribution of market shares among management companies, however Management Center, Management – Consulting and Nikoil were able to retain their positions (Appendix #4, #5).

A favorable situation for formation of mutual funds has developed in the Russian securities market in 2002-2003 years. Stock market grows at high rates – RTS index has grown 38,08% in 2002 and 46,4% in 2003 (both measured in rubles). In 2002 average rates of return on investments in mutual funds were as follows: stock funds 35-50%; bond funds 22-28%; mixed investment funds 25-40%.

In 2003 investing into mutual funds became one of the most attractive forms of investment in the Russian capital market. According to data of National League of Managers the average rate of return of a mutual fund share in 2003 was 47%. At the same time ruble index S&P/RUX, which includes 54 "blue chips", including shares of "Gasprom", has increased by 48%, while ruble values of RTS index, as was mentioned before, increased by 46,4%. Income of mutual funds, investing into corporate and government bonds was much smaller and amounted to 18% by the end of the year. This is comparable to income received this year from investing in Euro. Investments into more liquid corporate bonds in 2003 provided an income at the rate of 25%, while income from government securities only gave 10-12%. Mixed investment mutual funds provided a return of 30%.[20] Data on income that an investor could have received from investing into one of the top 10 Russian mutual funds in 2003 is given in Appendix #6.

[19] Chekulaev M. "Who should we trust our money?", *Banking review*, 24.06. 2003, Nr.6

[20] "In 2003 you should have invested in mutual funds", Interfax, 16.01.2004

7. The Development of mutual-fund industry in 2004 and first half of the year of 2005

While the year of 2003 was very successful for the development of stock market both in terms of quantitative and qualitative indexes, the year of 2004 has shown less than modest results. According to the analysis of the stock market for the period of the year 2003 the growth accounts for 57%, and for the year of 2004 – 0%. The main reason for such a situation is a rise of political instability. First, the liquidation of YUCOS, which resulted in the collapse of the stock market and proved to what degree it is risky to invest into Russian assets. Second, the contradictory position of the Russian government in the undergoing pension reforms cut the possibilities that a client's base would tend to grow as it did in the fourth quarter of 2003. I'd like to remind you that the average rate of growth of new market shareholders is usually 20% per quarter, but in the fourth quarter of 2003 the increase accounted for 43%. In addition to the downfall of market shares, there was a bank crises provoked by the suspension of licenses of Sodbusinessbank and Credittrust bank followed by the statement that there is a special so-called 'black' list of banks.

Thus, the shareholders of mutual funds received the major part of their profit in the first quarter of 2004 when there was a rise in stock exchange indexes. (At the beginning of the year 2004 the index RTS (Russian Trade System) reached its record high at 780 points, however, due to the YUKOS case went down to 540 points. It never reached that highest point again. In the result in 2004 the index of RTS rose only at 8.3%. It is the worst showing for the last four years. The average annual income of mutual funds in 2004 totaled a bit more than 13% while the inflation got 11.7%. According to the results of the year of 2004, the mutual fund *Maxwell Capital* was recognized as the most profitable.

The mutual funds went on developing. The aggregate assets of mutual funds increased by 42%. According to the opinion of the management companies, the key achievement of the year of 2004 is the great expansion of customer's base. The companies of Moscow and St. Petersburg come to the regions and vise versa. The cooperation with CityBank gave a powerful incentive in availability of funds to the companies *Troika Dialog* and *Pallada Asset Management,* while *Pio Global Management* and *OFG Invest* used the network of Sberbank. As the mutual funds entered the regions , now you can buy stocks in 204cities of Russia (for comparison - in 2003 – only in 82 cities). Unfortunately, the options are frequently limited by the assets of only few management companies.

The beginning of the year of 2005 was more beneficial for mutual funds, experts said. A lot of funds managed not only to secure the savings of their shareholders against hasty growth of inflation (5,3% in the first quarter) but also build them up. Nowadays the experts recommend choosing funds which prefer "the second - and third – tier stock" to "blue chips". This advice is implicitly proved by a new tendency appeared recently, namely, the management companies showed increasing interest in establishing special funds, for example in March Management company *Nivelir* began forming OMF *Optima Privileged*. The significant part of its portfolio will be composed of high yield bonds. The other example, in April MC *Finam Management* finished the set-up of the fund *Finam Low-Liquid Assets. Troika Dialog* organized two interval Mutual funds aimed at low liquid, penny stock but highly yield instruments. The portfolio of interval mutual fund *Risky Debentures* will be mainly composed of corporate and municipal debentures, interval mutual stock fund *Potential* will be formed by the second – and third – tier stocks.

Some mutual funds were created as “relevant to the current situation”.

- The Management Company of *Bank of Moscow* set up the mutual fund *Red Squire – shares of public corporations*. The Management Company said that the fund assets allocated mainly to liquid stocks of corporations laid in the sphere of strategic interests of the state and as a matter of fact controlled by the state. To name a few: «Gazprom», «Transneft», RAO «EES Russia» and its power-industry subsidiaries, some companies of the holding «Sviazinvest», «Sberbank Russia», «Aeroflot», a number of enterprises included in military industrial complex, some sea ports and others".

- In April 2005 The Federal Office of Financial Markets authorized the rules of the first closed Mortgage REIT – *Yugra REIT* under the management of Management company *Region Development*. This trust is deemed to operate for 15 years with the capital 340 bln rub. (approximately $12,2 mln). The payment of interest shares is to be done quarterly; the expected annual income is not less than 10%. This market segment appears to be highly promising. Under the estimation of The Russian Banks Association, cumulative portfolio of mortgage trusts (considering non-credit institutions) exceeded $1 bln by the end of the year of 2004. I should notice that the market players believe mortgages need to be equated with other securities for further development of mortgage trusts. At present, only 1.5% of real estate was bought on mortgages, but the number is steadily increasing. It is not surprising that such trusts draw a great interest of real-estate market players.[21]

However at this time there are a number of factors that restrain development of mutual funds.

- Lack of widespread knowledge about services provided by mutual funds.
  The findings of the researches, conducted by “Savings gazette” and an agency “Medialine” with the help of National League of Managers, state that individuals know next to nothing about management companies and of mutual funds managed by them. Russian media gives little attention to activities of mutual funds. There is very little instructional information on this subject. Most individuals associate mutual funds with voucher investment funds of the past, which were often dishonest.
  In order to improve this situation it is necessary to give greater attention to collective investment in the media. This not only applies to mutual funds, but also to non-government pension funds.
  An example of such approach is practiced by KIT management company, a leader in terms of attracting new investors, which leads an active marketing campaign on television and on billboards.

- Lack of infrastructure development of mutual funds
  Majority of mutual funds are concentrated in Moscow and Saint-Petersburg, while their representation in the regions is insignificant. In addition, according to expert opinion of Tacis, growth in a number of depositaries is deceptive: majority of them were created to service non-government pension funds. However, as we mentioned before the have been dramatic changes in the development of agency nets in the regions.
  According to my opinion, this problem will be eliminated as industry for collective investment develops and competition continues to grow.

[21] Dmitrieva E., Ladigin D. “Mutual funds accumulate money for mortgage”, *Commersant,* April 21, 2005

- Low operating efficiency on the capital market of management companies.
  In 2002 three quarters of management companies were operating inefficiently. Only 5 stock funds (23,81%) out of 21 interval and open funds, operating for a full year in 2002, surpassed RTS index, which increased by 45,62% (taking into account a change in ruble to USD). In 2003 these indicators were better – approximately a third of mutual funds managed to surpass RTS, while some of them outperformed it by two times. In 2004 the professionalism of management staff became higher.
  This problem is closely linked to lack of qualified specialists in industry of mutual funds and the need to prepare specialists in this field.

- Unjustifiably high expenses carried by investor
  At present it is much less expensive for an individual to invest directly into stocks rather than into a mutual fund. Thus, an aggregated expenses of mutual fund investment average at 5% (in 2003 this figure was 5-11%) per year relatively to a maximum of 1% expense related to individual retail purchase of shares. To make things worse this aggregated expense of mutual fund investing will be carried regardless to the performance of a mutual fund. For example, in 2002 the most costly class of mutual funds became “Ermak”, which showed the worst financial results of all mutual funds.
  Expenses on infrastructure and management of assets of a closed investment fund may reach 3-4 % (in 2003 this figure was 5-7%)22 of funds assets exclusive of expenses on independent assessors, investment analysts and consultants. It can only be added that recently there is a trend to reduce investor expenses.

- Relatively high cost of a share
  All around the world industry of collective investment, such as mutual funds, are oriented toward a middle class. In Russia mutual funds are clearly oriented toward individuals with above average income. In 2003, only one fourth of funds offer minimum share price at 1000 rubles (around $34) or less. Most mutual funds require a minimal investment of 5000 rubles (around $170). According to a survey of management companies conducted by “Profile” journal, an average sum of investment by private clients amounts to 60-150 thousand rubles. Only 10-15% of clients invest minimal allowed sum.23 The tendency remains the same in 2004.

8. Conclusion

The current development of the pension reform shows that mutual funds could be the driving force behind this reform in Russia. The main causes of this are:

- The problem of investing the pension money becomes more and more complicated year by year. By 2012 when the pension payment will begin, the amount of pension savings will have been over 2 trillion rubles (approximately $ 69,7 billion). The governmental management company Vneshekonom Bank managed 96,4% (accordingly non-government management companies managed 3,6%) pension money in 2004, but it is allowed to invest this money mostly in state bonds (as a result, last year yield of this investments was 3% per year, but the inflation amounts to 12%). Therefore, it is necessary to extend the amount of

[22] S Mihailov, “Yet another opportunity for strategic investments”, *Investments plus*, Nr 3, 2002
[23] Arakcheeva J. ”Kolkhoz for investors”, *Profile (Moscow),* 14.07.2003

the financial instruments for pension money investing into Vneshekonom Bank as a non-governmental pension fund. And mutual funds made a good example of an appropriate way for investing of pension savings all over the world.

- In accordance with Decree №266 cl. 6a dated May 8, 2003, The *Competition to Choose a Special Depository and Management Company in order to Make an Agreement for Depository Service and Trust Management of Pension Savings between the Pension Fund of the Russian Federation and Such Companies* only the management companies having the license for managing investment funds, mutual funds and non-government pension funds are permitted to participate.

Management companies may simultaneously receive licenses for management of mutual funds assets and non-government pension funds (and many companies have done so). Thus, the scope of their operations includes not only management of mutual fund monies, but also of accumulating portion of pension funds. By results of this competition in September 2003 there have been chosen 55 management companies authorized to invest pension savings on the financial market. If they invest into shares of mutual funds it leads to additional diversification of pension money.

- Money
- Increased investor trust in mutual funds.

There is a room for transfer of accumulating portion of savings into private management companies. In 2003 only 3,5% (1,6 billion rubles or 54,3 million USD) of the total amount of pension savings have been managed by non-government management companies, whereas the rest remained in the hands of the government pension fund managed by Vneshekonom Bank.[24]

Wide-spread advertisement and promotion associated with pension reform attracted not only individuals seeking to invest accumulating portion of their pensions with a private management company, but also individuals interested in investing their savings. The interest in mutual funds begins to spread from Moscow and St. Petersburg to regions of Russia.

It is noteworthy that the initial plan of pension reform approved by the government in 2002 has undergone serious changes in beginning of 2004. A decision has been made on reduction of social tax. Today 28% of payments is made by employer from the salary pool to the pension system: 14% is directed to formation of the base pension (this percentage is planned to be lowered to 6%), 12% goes toward insurance, and 2% is the accumulative portion.

A decision on reduction of social tax will lead to deficit in Pension Fund in the amount of 150 billion rubles. In connection to this was a proposal to exclude citizens born between 1953 and 1967 from accumulating pension savings system. Therefore, the generation of 40 year olds, which attracts the highest salaries, will be denied certain benefits of the pension fund system. According to forecasts of the chairman of Pension fund of Russia by 2010 the total funds in accumulating portion of pension will amount to 1,3 trillion rubles or 44,7 billion USD and only 800 billion rubles or 27,5 billion USD if citizens born before 1967 are excluded.[25]. Because of the reduction in expected pension fund savings many management companies have stated that they plan to change their orientation from pension funds toward closed real-estate funds. Having appeared only in

[24] Salin, P "Who is the weak link?", Motherland News Paper(Moscow), 04.06.2004
[25] Aleshina I "Pension money are strangling management companies", gazeta.ru, 01.06.04

2003 real estate funds became very popular. Russian real estate market has a high investment attractiveness in general. In addition, there is a stable growth of real-estate prices and potential for future development of real estate market is enormous, especially due to the development of mortgages and related securities.

Appendix #1 Assets structure of money market funds[26]

Assets	**Joint-stock Investment Fund (% of asset value)**	**Open mutual fund (% of asset value)**	**Interval mutual fund (% of asset value)**	**Closed mutual fund (% in asset value)**
Cash resources in checking accounts and deposits of one credit organization	Not more than 25%	Not more than 25%	Not more than 25%	Not more than 25%
Securities	Not more than 50%	Not more than 50%	Not more than 50%	Not more than 50%
Municipal securities	Not more than 10%	Not more than 10%	Not more than 10%	Not more than 10%
Government securities of the Russian Federation or government securities of subjects of RF of one emission	-	Not more than 35%	Not more than 35%	-
Bonds of Russian companies	Not more than 10%	Not more than 10%	Not more than 10%	Not more than 10%
Unlisted securities	-	Not more than 10%	Not more than 50%	-
Bonds of foreign commercial enterprises, securities of international financial organizations and foreign government securities	Not more than 10%	Not more than 10%	Not more than 10%	Not more than 10%
Shares of investment funds belonging to category of money market funds	*Not more than 10% (shares of open and closed mutual funds)	*Not more than 10% (only shares of open mutual funds)	*Not more than 10% (shares of open and closed mutual funds)	* Not more than 10% (shares of open and closed mutual funds)

*The amount of investment shares of a mutual fund may not exceed 30% of the amount of outstanding investment shares of this mutual fund.

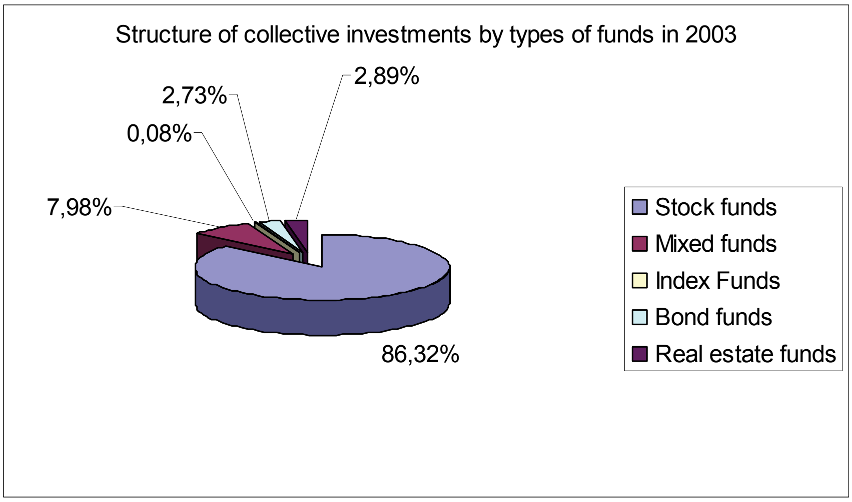
[26] Decree by the Federal Commissions on the Securities Market (FCSM) on August 14th, 2002 N31/pc "About ratification of a provision on the composition and structure of assets of joint stock investment funds and assets of mutual investment funds"

Appendix #2: Temporal changes of the management companies amount

Date	Management companies which obtained the license	Management companies which created the mutual funds
31.12.1999	28	16
29.12.2000	29	23
29.12.2001	42	28
31.12.2002	82	31
31.12.2003	129	57
31.12.2004	177	103

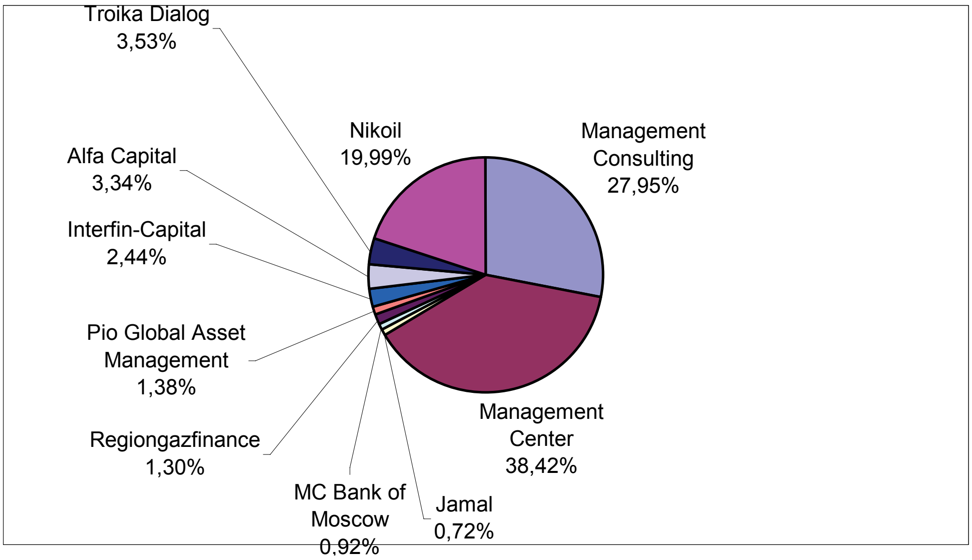
Kapitan M. "Mutual Funds in 2004", *Investments plus* , Nr.31 (630), 2005

Appendix #3: Structure of collective investments by types of funds in 2003*



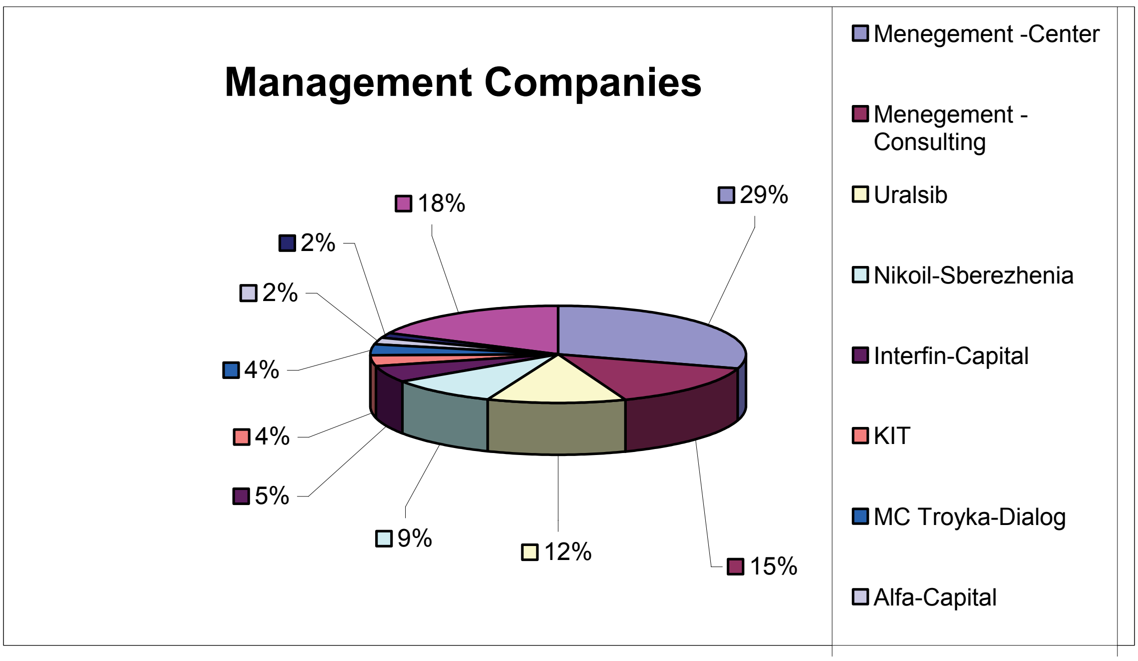
*"Development of the market for collective investment in Russia in 2003", *Russian Economic Review,* 02.06.2004

Appendix # 4 Diagram. Top 10 largest management companies in September 2003.**



**Information gathered from Internet site of collective investments http://www.cic.ru

Appendix # 5 Diagram. Top 10 largest management companies in December 2004*.**



***Kapitan M. “Mutual Funds in 2004”, *Investments plus* , Nr.31 (630), 2005

Appendix #6 Investor income from investing into one of the top 10 Russian mutual funds (from 01.01.03 to 01.01.04)

Annual performance, %	Mutual Fund	Management Company
67.07	Podderzka	Pallada Asset Management
65.64	Lukoil Industries Investments	Nikoil Management Company
65.26	Lukoil First	Nikoil Management Company
64.90	Lukoil Perspective Investments	Nikoil Management Company
57.01	Bazoviy	Management Company of investments funds “Capital Asset Management”
56.24	High Technology	Management Company “Management Center”
52.03	Solid -Invest	Solid Management
51.43	Peter Stolipin	Associated Financial Group -INVEST
47.02	Energy	Management Company “Monomah”
46.61	PioGlobalFA	PioGlobal Asset Management
	Comparative Characteristics	
61.40	MICEX Index changes	
57.98	RTS Index ($)	
46.40	RTS Index (Rub)	
-7.33	Exchange rate of USD	
11.2	Average rate on deposits of physical persons in Russian rubles (data on October 2003)	
11.8	Yearly inflation (for the past 12 months) (data on November 2003)	

Formation gathered from site http://www.cic.ru

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