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INVESTMENT MANAGEMENT STRATEGY IN FINANCIAL MARKETS

Nenad Vunjak
High School Modern Business, **Belgrade, Serbia**
Jelena Vitomir, Tamara Antonijević, Petra Stojanović
Agricultural High School, Bijeljina, **Bosnia and Herzegovina**

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SUMMARY

The subject matter of this research is investment management and its forms practiced in developed financial markets. The goal of this research is to elaborate on the strategies and characteristics of investment companies, hedge funds, venture capital funds, and LBO funds. Investments companies deal with professional management of financial assets of individual and institutional investors. Investment companies also deal with funds management.
Hedge funds establish a pool of assets to invest in securities. The strategy of hedge funds is: aggressive growth, unpayable securities, financial markets, and market neutrality.
Venture capital funds use the capital of investors to finance entrepreneurs and promising companies. They function as general partners, while the investors are limited partners. LBO funds use credits to finance acquisitions of companies. They collect their assets by: issuing shares, speculative bonds, and private placement of debt securities.

Keywords: investment companies, hedge funds, venture capital funds, LBO funds, general and limited investment partners.

INTRODUCTION

In the financial literature, the definition is that the financial market represents an organized space in which the supply and demand of money funds (expressed in money, foreign exchange, and equity), securities and financial transactions are involved. The financial market is the most influential segment of a country's economic policy. Through the financial market, the authority of the monetary authorities in the respective country is realized. The structure of the financial market can be viewed differently depending on the criteria according to which markets are classified (time maturity, execution of obligations, trading method, territorial affiliation, broadcasting and trading in securities).
The efficiency of the financial market can be viewed from the aspect of: operational (internal) and price (external) efficiency. The internal efficiency of the financial market relates to its operational functioning. The price effectiveness of the financial market refers to the speed of responding to participants in relation to changes in the price of market materials. The basic elements of each financial market are related to: (1) the market (the place where the supply and demand for financial instruments meet), (2) financial instruments (subject to trading in the financial market), (3) financial market participants' intermediaries).
A special place in the financial market belongs to investment management which includes: [1] (a)

investment companies, (b) hedge funds, (c) venture capital funds, (d) LBO funds. Their presence is particularly evident in highly developed financial markets (with a growing number of financial instruments, financial investors and market intermediaries).

INVESTMENT COMPANIES IN THE FINANCIAL MARKET

In the financial market, it is characteristic that investment banks establish their own investment companies, which exclusively deal with fund management activities. Starting from the fact that investment companies issue securities, investment banks appear on the financial market as "underwriters of securities issue" and as investment advisers in many other financial transactions. It is characteristic that investment banks can provide banking services to hedge funds, such as Merrill Lynch and Goldman Sachs, when they managed hundreds of billions of dollars. Investment banks have an obligation to manage a portfolio of securities, perform administrative tasks, conduct investment research, issue securities and pay dividends.

A distinction should be made between private and investment companies in the financial market. Private companies are focused on providing advisory services in the field of banking, the formation of portfolios management, of investment funds and the like. For private companies it is often said that they are custodians of investment funds, because they manage assets of individuals and institutional investors. Each client has its own special account, which is not the case with investment companies that group investors' funds in order to manage them jointly.

Investment companies, as intermediaries in the financial market, stimulate economic development and earn revenue from dividends and interest, managing securities in their portfolio. The revenues of investment companies can be increased due to the increase in prices in the sale of securities. The organizational structure of investment companies is comprised of: shareholders' meetings, board of directors, investment advisors, and distribution and sales networks. For investment companies, it is characteristic that they bring financial decisions on the basis of professional knowledge, work experience and assessment of current trends in the financial market.

STRATEGY OF HEDGE FUNDS APPLICATION

Hedge funds fall under private investment funds which appeared in the early 90s of the 20th century. It is said that hedge funds are able to use the financial instruments not available to open investment funds, therefore they better manage the investment risks. Hedge funds form "a pool" of funds to invest in securities. Business activities of hedge funds include: government securities, foreign exchange and financial derivatives.

Key features of hedge funds can be presented in the following way: [2]

(1) hedge funds use different financial instruments in order to reduce the risk, stimulate revenues and link the stock market and bonds,

(2) hedge funds to a large extent have unstable investment income with present risks,

(3) many hedge funds generate revenues without being correlated with the financial market,

(4) many hedge funds prioritize capital preservation to generation of revenue,

(5) most commonly, hedge funds are managed by professional and experienced investment professionals who are above all highly professional, conscientious and disciplined,

(6) pension funds, private banks and insurance companies often invest in hedge funds to minimize the overall variability of the portfolio of securities,

(7) A large number of hedge fund managers are highly specialized in conducting trading only within the scope of expertise and competitive values,

(8) The managers of hedge funds invest own capital in the funds, along with bringing in highly-ranked investors into investment business,

(9) most of hedge fund managers are specialized in relying primarily on the specific expertise of "team" of managers,
(10) a large number of hedge fund strategies aim at reducing market risks, particularly those which include the use of financial derivatives,
(11) academic research confirms that hedge funds generate higher revenues with lower total risks than investment funds do.

Practical experience of highly developed countries shows that there are several strategies for implementing hedge funds. The aggressive growth strategy starts from investing in shares that are expected to achieve accelerated yield growth per share. The strategy of non-performing securities proceeds from the fact that hedge funds buy shares, or discounted receivables from companies that are reorganizing or are facing bankruptcy (liquidation). Increased sales of such securities result in a large discount and the ability of hedge funds to buy them at a lower value, or to sell them at a higher value.

The strategy of developed financial markets starts from the fact that hedge funds invest in equity or take credits in less developed markets. Such financial markets are usually accompanied by increased inflation, unstable growth and development, which allows hedge funds to hedge effectively (switching from high risk to less risky investments). Hedging is usually done through futures contracts and other market derivatives.

Market neutrality strategy starts from taking a market counter position in different securities of the same issuer. Managers of hedge funds often take a "short" position with the same security or different securities, calculating that they can lose their yield at one position, while in another position they can generate it. "Short" sale of securities strategy is based on the anticipation of their repurchase in the future at lower prices.

Analysis of hedge funds in relation to other funds (investment and pensions funds) indicates that they hedge funds are more flexible in terms of their investment options. Hedge funds use financial instrument not available to other funds (joint funds). It is characteristic that hedge fund managers have the option, which is not the case with other funds, to achieve an incentive commission with the investor. Namely, if the managers of the hedge fund efficiently manage the risks and generate revenues, then in addition to the regular fee, they can generate an incentive fee. This form of rewarding the hedge manager directly influences that the best practitioners (experts manage securities) leave other funds and switch to working in the hedge funds industry. At the beginning of the 21st century, the rapid growth of hedge funds was present in the financial market (their number increased by 20% annually). It is estimated that over 7,000 hedge funds are present on the global financial market, which manage assets over 500 billion dollars.

Investment bank is usually in the role of a primary broker in providing operational services to hedge fund managers. Primary broker operations involve a group of services that investment banks provide to hedge funds. Services are mostly related to: clearing of securities, custody services, lending of securities, financing of funds, management of funds, etc.

CHARACTERISTICS OF VENTURE CAPITAL FUNDS (JOINT VENTURE FUNDS)

Joint venture capital is the capital secured by investor for financing entrepreneurs and promising companies. Capital is invested in the manner that investors establish a fund and then invest the capital of the fund in the portfolio of a certain company. By investing the capital, investors acquire shares in the company's portfolio. It is the company's venture capital obligation to periodically raise funds (every two, three, four or five years) and maintain good relations with investors in that period.

Practical knowledge indicates that venture capital funds are most often organized as limited partnerships, and that in their organizational structure they have a general partner and limited

partners. It is usually a venture capital company acting as a general partner, and investors are in the function of limited partners. The task of the general partner (venture capital fund) is to find a portfolio company (into which the capital will be invested), to prepare a prospectus of the company concerned, and to prepare the offer to potential investors for the purpose of collecting on the "free" capital market. Limited partners are passive investors who invest their capital without the right to manage the fund. The partnership relationship in the fund, between the general partner and the limited partners, usually lasts from 3 to 10 years, and sometimes longer (prolonged by the decision of the majority of partners).

Venture capital companies have active role in: [3]

(1) financing entrepreneurs and promising companies,

(2) finding portfolios of companies (negotiation about investing in the company),

(3) replace the investment for ordinary shares (they receive shares-based shares in the company's management board),

(4) development of financial products and services,

(5) management of the portfolio of a company being invested in ,

(6) leaving the investment 3 to 7 years after the initial investment (the decision to leave is made before investing capital).

Investors in venture capital fonds are: pension funds, insurance companies, investment banks, commercial banks, trust funds, academic institutions, wealthy individuals ("angels") and the like.

Considering that several funds are established within a venture capital company, each has its own life cycle and goes through four phases. The first phase is gathering funds to establish the fund (funds are gathered for several months, a year at most). The second phase is a detailed analysis of the business plan of the company being invested in (company is offered several business plans within a year). The third phase relates to the assistance to the portfolio company (in which it invests) for its profitable business. The fourth phase relates to the closing of the investment, as the fund takes its capital from the portfolio of the company.

For the venture capital of funds, it is characteristic that they invest in phases, which allows the fund to collect valid information about a portfolio company in which it intends to invest funds.

Exit strategy of venture capital companies from a particular investment implies that the company makes a public issue of shares or sells its share in the company's portfolio. This is in practice the most common form of exit from the investment concerned. If it is decided to leave the investment concerned, the venture capital company can: (1) sell the shares and give money to investors; (2) allocate the shares to investors (this case is more present in practice). Previous research on this type of capital investment shows that portfolio companies using these sources of funds: (1) create more jobs, (2) increase export opportunities, (3) invest more in research and development.

Application of venture capital funds in countries in transition means creation of adequate economic, legal, and social requirements in the area, as well as development of entrepreneurial spirit. Economic requirements are: strong financial market and stock exchanges, high profit for investors, efficient infrastructural support in the sector of financial services, etc. Legal requirements are: new corporate and tax laws, publicly available information for all investors, efficient procedure of incorporating companies, etc. Social requirements are: favourable research conditions, readiness of entrepreneurs to take risks, socially acceptable business failure, etc. Entrepreneurial spirit means: business partnership, orientation to growth of capital, developed financial market, readiness for risks and profit, new initiative and creativity.

CHARACTERISTICS AND ROLE OF LBO FUNDS IN THE FINANCIAL MARKET

LBO funds (leverage buy out) start from the fact that customers use a loan to finance the acquisition (merger) of a company, thereby privatizing the company. Buying companies, using credit and cash is a daily practice in highly developed countries. LBO transactions involve the engagement of a large amount of cash, which can be obtained through bank loans or through the issuance of share capital. The source of funds for LBO transactions may also be the issuance of speculative bonds, as well as the private placement of debt securities.

In the last one decade of the 20th century the largest investors in LBO funds were pension funds, even up to 1/3 of the capital of the funds. It is characteristic for investors of LBO funds that they bear a high risk, realize high yields and invest money for a longer period of time. The funds most often last 10 years.

All LBO transaction go through three phases :

(1) purchase of a company (public company), which becomes a private company,

(2) restructuring of a company to increase its performance and reduce its debts,

(3) further development or bankruptcy of the company (after 3 to 5 years it is either successful or ready for bankruptcy).

It is characteristic for LBO companies that every financial transaction was carried out through a new company. In order to realize transactions (acquisition), the buyer decides to create new companies for this purpose. The largest number of LBO transactions is directed towards the purchase of small and medium-sized companies, or organizational parts of these companies. In order for LBO companies to conduct transactions (acquisitions), it is imperative to have the following performance: [4]

(1) stable inflow of cash (inflow of cash from the previous period forms the basis for future inflow projections),

(2) stable management "team", which has significant experience (according to its business results in the past)

(3) space for additional savings (decease expenditures after LBO transaction),

(4) Shares investment by the company owner (greater security for creditors),

(5) limiting the debt in the balance sheet (possibility of obtaining new loans),

(6) organizational parts outside the seat of the company (getting new or repaying old loans by selling those organizational parts).

LBO translations are finances through shares, secured credits (credits with a collateral) and unsecured credits (credits without a collateral). Financing through shares is done in 10% to 20% of all transactions where shares are the buyer's portion in the company in question. Secured loans as sources of financing LBO transactions involve the existence of the debtor›s assets as collateral (shares). Secured loans include revolving loans (can be used as needed), and repayment of these loans is from 5 to 7 years with an interest rate of 2% to 3% above the LIBOR. These loans are present between 50% and 70% in the financing of LBO transactions. In the case of unsecured loans, there is no collateral, so the guarantee for loan repayment is the projected cash flow of the respective company. The maturity of these loans is from 10 to 15 years, with an interest rate of 4% to 5% above the LIBOR. These loans are present between 15% and 30% in the financing of LBO transactions.

Bankruptcy risks in LBO transactions are very high.

There are several types of LBO transactions described in literature:[5]

(1) MBO (management buyout), whereby managers of the company buy shares from existing shareholders and privatize the company,

(2) EBO (employee buyout), where employees buy shares from existing shareholders and privatize the company,

(3) a group of investors who, on the basis of bank loans, buy shares and privatize the company,

(4) the reverse LBO (reverse LBO), with the company already privatized by LBO, again publicly offering to sell its shares.

In MBO transactions, there is often a case where managers want to buy a part of a company without having enough money. In such conditions, managers usually withdraw a part of the credit funds, form a new company, and this new company buys a part of an old company that managers had shown interest for. By buying shares in a newly formed company, managers become owners of the company concerned.

CONCLUSION

Previous analyses related to investment management show that financial markets, especially in highly developed countries, would be impoverished without the participation of investment managers. The imbalance would be created both in supply and demand for financial assets and financial instruments. With the presence of investment management, investment companies are established that perform fund management activities. The participation of investment companies in the financial market is especially evident in terms of investment financing, where investment decisions on the financial market are passed on to professional staff. The analysis of the position of investment companies shows their dynamic presence lately in developed financial markets (with a large number of special investment funds).
Thanks to the presence of hedge funds in the financial market, there is a global strategy for investing large amounts of cash in stocks, bonds, currencies, goods and gold, using the principle of leverage. Due to the use of various financial instruments , hedge funds reduce the financial risk in the financial market. Trading in a financial market is done only within the expertise and competitive values because of the high specialization of hedge funds. Earlier research suggests that hedge funds have higher yields with lower risks than investment funds. Hedge funds are more flexible in the financial market compared to other funds when considering investment options. The flexibility of hedge funds in the financial market involves the use of a hedge strategy at a given moment, as it provides the opportunity for the fund to manage investment risks in the best way.
In highly developed financial markets, risks are diversified by establishing several funds within a venture capital company, since the raised capital is invested in several different portfolios that require capital. Within a venture capital company, each fund has its own life cycle, from fundraising to fund formation, through the company's business plan, defining the portfolio of the company, to the end of investment in the portfolio of the company. The exit strategy of a venture capital company from an investment can be done by: public issuance of shares or sale of shares in the company's portfolio. Practical experience from highly developed financial markets shows that venture capital funds: (a) create more jobs, (b) increase export opportunities, and (c) invest more in research and development. The application of venture capital funds in transition countries implies the creation of adequate economic, legal and social requirements in a wider regional environment, as well as the development of an entrepreneurial economy. The mentioned requirements are related to: development of financial markets and stock exchanges, investment returns , efficient infrastructure support to the financial services sector, new legislation, public availability of information for all investors, favourable research climate and willingness of entrepreneurs and investors to take risks.
For highly developed financial markets, it is characteristic that LBO funds (credit funds) acquire companies with exceptionally low share of their own capital. In order for LBO companies to carry out transactions it is necessary to have the following performance: (a) a stable cash inflow, (b) a stable management team, (c) cost savings, (d) credit support by commercial banks. Examples from the practice of highly developed financial markets show that LBO transactions can be in the form of MBO transactions, where company managers buy shares from existing shareholders and vice versa, EBO where the privatized company again publicly sells its shares. LBO transactions are related to merchant banking, whereby investment banks buy equity interests in the company and thus become investors in LBO funds.

The process of investment management is at its beginnings in the transition countries, where only some of these funds appear occasionally in the form of smaller investment transactions. With the development of the financial market, the application of more efficient legislation, international financial standards of greater interest of domestic and foreign investors for new forms of investment, more practical application of investment management in the countries in transition is expected.

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