

Mutual Funds as Potential Source of Equity Capital for Traditional Ag Co-ops

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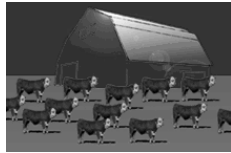


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Agenda

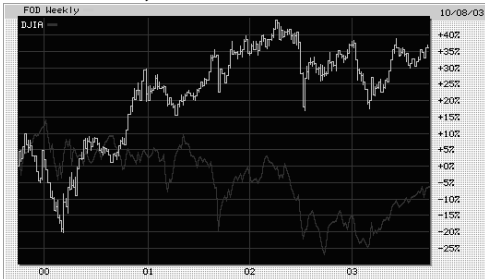
- ❖ Discuss equity capital problem among ag co-ops
- ❖ Examine mutual funds as potential solution



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Food Processing Index vs DJIA, U.S., Most Recent 4 Years



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Co-op Background

- ❖ Co-ops started in Europe
- ❖ Embody a sharing philosophy – where group bands together for mutual benefit
- ❖ Regulation in U.S. encouraged co-ops through Capper-Volstead legislation
- ❖ Significant restrictions on ownership, control apply

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Mutual Fund Background

- ❖ Has similar background – originating in Europe
- ❖ Started in London in 1868 as the Foreign & Colonial Government Trust
- ❖ Originated to allow smaller investors to pool capital to achieve efficiency in investing [Gremillion]
- ❖ Fund soon copied, but most stayed in Europe, few created in US in late 1800s
- ❖ However in 1873 a fund based in Scotland targeted US investments as main investment objective

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Early Mutual Fund Characteristics

- ❖ Looked much like today's "Unit Investment Trust" (a closed end fund)
- ❖ UP front sales charge (front end load) of 3%
- ❖ Yearly management fee of .25%
- ❖ Held to a published Investment Policy
- ❖ Restricted investment to not more than £100,000 for any given government

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Early Mutual Fund Characteristics, continued

- ❖ Specific number of shares sold
- ❖ Traded like stock
- ❖ Liquidation available only via sale of shares
- ❖ Objective was always income generation

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US Participation in Mutual Funds

- ❖ In early mutual funds:
 - Tiny fraction of investment \$s were from US investors
 - Almost exclusively from the very wealthy
- ❖ Then WW I – US citizens urged to invest, industrial goods markets expanded
- ❖ More funds created in US – initially all the same closed end model

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Open End Mutual Funds

- ❖ First envisioned and championed by Edward Leffler (mid-westerner of Swedish descent)
- ❖ Fourth guiding principle defined this type:
 1. Professional management
 2. Diversified holdings
 3. Low costs (relatively speaking)
 4. **Liquidity** (ability to redeem shares at any time)

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Why Mutual Fund Regulation?

- ❖ Crash of 1929 resulted in major regulation
- ❖ Many closed end funds incorporated risky (and sometimes abusive) practices – doubling or tripling the investor impact
- ❖ Legislation to protect investors came in the 30's alongside that which shaped cooperatives

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Major Legislation for Mutual Funds

- ❖ Securities Act of 1933:
 - Registration required
 - Written prospectus provided to disclose “adequately”
 - Restrictions on advertising allowed
 - Prohibited deceit, misrepresentation & fraud specifically

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Major Legislation continued

- ❖ Securities Exchange Act of 1934
 - Created the SEC to enforce federal securities law
 - Required exchanges and broker-dealers that trade securities to be registered with SEC
 - Dictated compliance dealing with
 - ✓ Record keeping & reporting
 - ✓ Financial responsibility
 - ✓ Staff qualifications
 - ✓ Business practices

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Major Legislation continued

- ❖ Revenue Act of 1936 set up tax environment so that Mutual Investment Companies need not pay taxes on income
 - If all taxable income and capital gains were distributed to shareholders
 - Shares were redeemed upon demand!
- ❖ Now codified under IRSC Subchapter M Appendix A in 1986

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Major Legislation continued

- ❖ Securities Exchange Act of 1934 for Mutual funds
 - Specified rules that distributors and transfer agents must follow (or face de-registration)
 - Transfer agents must register w/appropriate regulatory agency
 - ✓ Banks = Federal Reserve
 - ✓ Others = SEC

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Major Legislation continued

- ❖ Investment Company Act of 1940 is foundation for all subsequent MF industry regulation
- ❖ Eased in compromise under shadow of impending WW II
- ❖ Prohibited eight specific bad practices
- ❖ Granted SEC broad discretionary powers to keep this Act current

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Major Legislation continued

- ❖ Investment Advisors Act of 1940 required
 - Any company (except banks) **and** which provides investment advisory services to MF must also register w/SEC
 - Limited contract between advisors and MF companies to 2 years w/ability to terminate given 60 days notice **w/o** penalty
 - Needed majority of BOD approval for renewal

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How is Co-op Equity Capital "Normally" Acquired?

- ❖ Additional capital sought from current members as new shares of ownership
- ❖ Preferred shares sold to non-members which do not carry voting rights
- ❖ Joint ventures or strategic alliances may be forged
- ❖ A new business entity may be spun off as an Investor Owned Firm (IOF)

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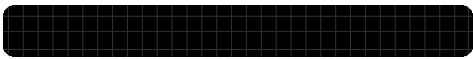


Can Mutual Funds Be Another Source?

- ❖ Managers need to purchase preferred stock which can be reliably valued
- ❖ Only large cooperatives able to afford underwriting costs
 - A smaller percentage of the total stock issue to be floated
 - Organization large enough to provide ongoing financials at required depth

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