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**Original scientific paper**

**Diana BOSKOVSKA<sup>1)</sup>**  
**Biljana ANGELOVA<sup>2)</sup>**

## **INVESTMENT FUNDS AND THEIR INVESTMENT STRATEGY IN THE REPUBLIC OF MACEDONIA**

### **Abstract**

Investment funds are institutions with primary interest to invest free resources of individuals and companies in order to achieve higher returns with lower risk level. To realize this goals, investment funds have to select an appropriate investment strategy and portfolio of assets.

The paper analyzes the performance of investment funds in the country in order to investigate the development of investment funds in the past. The analysis is done in terms of change in the total value of the property and portfolio of the investment fund from several aspects: assets structure, geographical allocation and sectorial structure of an investment.

The research provides an opportunity to review the functioning of this type of institutions in the capital market which is not developed enough, in this case with the example of the Republic of Macedonia. At the same time this gives us an opportunity to make a comparative analysis with the performance of investment funds in other countries (developed and underdeveloped countries) in the future. It also gives us an opportunity to bring a conclusion whether the global financial crisis had an impact on the performance of investment funds, i.e. what changes occurred in the investment policy and strategy in these institutions in response to the financial crisis.

The research is based on secondary data obtained from publications of relevant domestic institutions (National bank of

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<sup>1)</sup> Ph.D., Institute of economics, University Ss. Cyril and Methodius, Skopje,  
e-mail: diana@ek-inst.ukim.edu.mk

<sup>2)</sup> Ph.D., Institute of economics, University Ss. Cyril and Methodius, Skopje,  
e-mail: angelova@ek-inst.ukim.edu.mk

Macedonia and Commission for Securities of the Republic of Macedonia).

**Key words:** investment funds, investment strategy, portfolio of investments, Republic of Macedonia.

**JEL classification:** G11

### **Introduction**

The main reason for investing hundreds of billions of dollars in the investment funds every year lies in the fact that through investment funds higher profits can be achieved than the profits achieved with standard investment in banks or savings banks. The money invested in funds do not constitute term obligated funds and they are always available to investors. Investing in investment funds provides greater ability to separate (diversify) the risk of the investments. Funds are managed by a team of professional experts who manage and lead the portfolio fund, adhering to basic rules of profitability, safety and liquidity and enabling achievement of lower costs in trading with securities compared to the individual venture. Investment funds may invest in domestic and foreign capital markets, further enabling greater diversification of risk. The funds allow individual investors to reduce the risk by diversifying the portfolio, liquidity, responsible cash management and lower transaction costs.<sup>3</sup>

Investment funds as a kind of financial institution differ from other types of financial institutions such as banks, savings and others, which are obtained as financial assets through deposits from the corporate sector and the household sector and are basically invested in the form of loans as a main source of funding. The investment funds, on the other hand, collect their funds through issuance of stocks and shares, investing them in a number of different assets (stocks, shares, bonds, deposits, etc.). The diversification of the assets means diversification of the risk, but it also creates an opportunity for increased return on investment.

The advantages of investing in investment funds are numerous, however, the important ones being:<sup>4</sup>

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<sup>3</sup> Brown, F.K, Reilly K.C., Investment analysis and portfolio management, 7-th edition, Thomson South Western, 2002, p.1074.

<sup>4</sup> Bodi Z., Kejn A., Markus A., Investicii, 8-th edition, Tabernakul, Skopje, 8–th edition (translated in macedonian language), 2010, p.12.

- Pooling - Investment Fund collects funds from number of individual investors in the market and then acts as a major investor creating favorable conditions and allowing investment of individuals;
- Diversification - an investor is limited to the lower part of the stock or bond (unless they have a great amount of money). The investment fund owns many different securities. If some of the securities experience decrease in the price, the remaining of the securities would reduce the decline in the value of the investment fund or would completely annul it. Diversification reduces the risk of investment;
- Professional Management - the majority of investors have free funds, but lack the knowledge or time to monitor the development of the market. An investment fund has a team of professionals (portfolio managers) who constantly analyze and monitor the trading of securities on the capital market;
- Liquidity - investors can withdraw the money invested in the investment fund for a very short period of time.

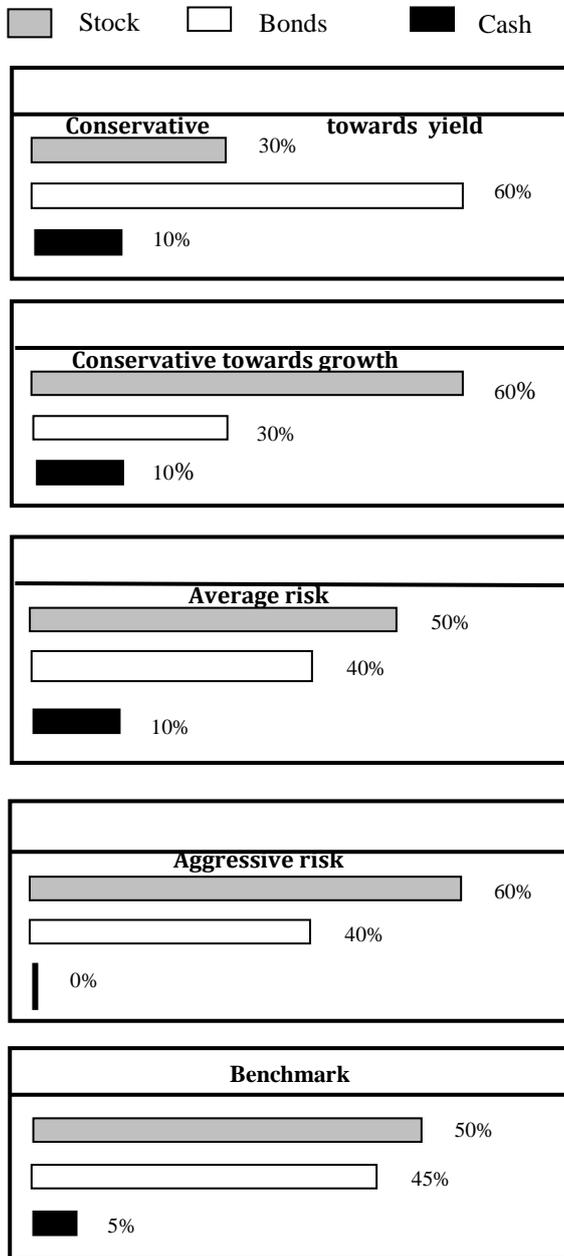
### **1. Investment strategy as a key stage of the investment process**

Since there was a correlation between yield and risk of investment, for the purpose of investing in a particular security or portfolio, it is very important to define these terms in order to achieve the projected yield. In assessing the return on investment specifically, if the risk preferences of the investor are not taken into account, the real investment decision might not be brought. It stems from the fact that different types of securities exercise different contributions and different risk.

In terms of risk, we can differ between several types of allocation of capital among different groups of assets - stocks, bonds and cash (see Figure 1):

- Conservative towards yield;
- Conservative towards growth;
- Average risk;
- Aggressive risk;
- Basic type of venture (benchmark).

**Figure 1: Categories of risk and capital allocation**



Source: Reilly K. Frank, Brown C. Keith: "Investment analysis and portfolio management", seventh edition, Thomson South Western, 2002, p.43.

As the example shows, the preferences of the management of the corporation will depend on whether there is a commitment to: 1) invest in order to provide a constant yield by investing most of the assets in bonds, or 2) preference growth through investing in stocks at most, or 3) attitude towards the average level of return and risk, and therefore more balanced correlation between investment in stocks and bonds, or 4) aggressive way of investment with investing a greater percentage in stocks and bonds without any cash. Hence, the conclusion of the initial needs of analysis of the tolerance (preference) of investor of risk. Moreover, if it comes to individual investors, the preferences of the owner or the management of the corporation would be taken into account. Unlike this case, with the institutional investors – pension funds, investment fund, etc., they are obliged to take into consideration the preferences of their customers, which can be physical persons or legal entities, from financial or non-financial nature. In developed countries, because of the high degree of development of the capital markets, funds have developed their own categorization of customers according to their risk level. In magazines and books in the field of investment various kinds of tests are published which help potential investors to assess their level of tolerance to risk preference.

## **2. Role of the investment funds in the financial sector in the Republic of Macedonia**

In Macedonia, the first investment fund based on resident portfolio investors was founded in 2007. The lack of investment funds in Macedonia for long periods, despite the existence of adequate legislation since 2000, was due to several factors. But undisputedly the key factors are the following:

- Insufficient development of the Macedonian capital market;
- Certain limitations in the law on investment funds, which primarily relate to the amount needed for establishing an investment fund and lack of ability to open a closed-end investment funds.

Changes in the Law of Investment Funds<sup>5</sup> reduced the required capital to establish an investment fund. At first 2,000,000 German marks

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<sup>5</sup> Law on Investment Funds, Official gazette of Republic of Macedonia no. 12/2009, 67, 2010, 24/2011, 188/2013.

were required, but the new changes in the legal regulation provided capital requirement of 500.000 EUR, and ability to open investment private funds which require basic capital of 50.000 EUR. The increase in the turnover at the Macedonian Stock Exchange was an additional factor in the revival of the investments funds in 2007.

**Table 1: Structure of the financial system in the country for the period 2006-2012 (in %)**

	2006	2007	2008	2009	2010	2011	2012
<b>Banks</b>	88,91	90,5	89,25	88,6	89	88,5	88,5
<b>Saving houses</b>	1,19	1,17	1,23	1,1	0,9	0,8	0,7
<b>Insurance companies</b>	7,46	4,48	4,24	4	3,7	3,5	3,3
<b>Leasing companies</b>	1,4	2,02	3,07	3	2,5	2,5	1,7
<b>Pension funds</b>	0,63	1,26	1,79	2,9	3,6	4,3	5,3
<b>Pension fund management companies</b>	0,1	0,08	0,09	0,1	0,1	0,1	0,1
<b>Brokerage house</b>	0,31	0,44	0,29	0,2	0,1	0,1	0,1
<b>Investment funds</b>	0	0,03	0,03	0,1	0	0,1	0,1
<b>Investment fund management companies</b>	0	0,01	0,01	0	0	0	0,003

Source: Adapted from data from reports on financial stability in the country for the period 2006-2012, the National Bank of Macedonia.

The short period of existence of the investment funds conditioned small participation, and consequently negligible influence on the financial sector in Macedonia (see Table 1). Based on the data from Table 2, the participation of investment funds from all financial institutions in the country (banks, savings banks, insurance companies, leasing companies, etc.) is the lowest - 0.01%. In 2007 and 2008 there was a revival of investment funds, primarily as a result of the revival of

the Macedonian Stock Exchange in 2007, where significant purchasing transactions on the stock market could be witnessed, in which a significant portion was made by individuals with hope to achieve gains from investments in securities, primarily referring to the shares of Macedonian companies. But under the influence of the global financial crisis, which was negatively reflected on the Macedonian Stock Exchange, a sharp drop in share price (stock price dropped below its book value) happened, which greatly reduced the interest in purchasing shares, which in turn influenced the decrease in the activities of the investment funds, and situations resurrected when investment funds again had no impact on the financial system.

### **3. Investment strategy of the investment funds in Republic of Macedonia**

In order to see the characteristics of the investment strategy of the investment funds we have analyzed only a 3-year period (2010-2012), because of their short period of existence and functioning in Macedonia. The analysis of the characteristics of the investment strategy is focused on the assets' structure of the portfolio, geographic exposure to investments and sectors structure of the investment of the investment funds.

As evident from the data in Table 2 and Figure 1, in the period 2010-2012 the total value of the assets of the investment funds, and the total net value of investment funds were constantly increasing, so that in 2012 the total value of the assets of open-end investment funds was increased by 95 %, while the total net value in 2012 compared to 2010 had increased by 98 %. Despite these increases in the value of assets of the investment funds in a period of three years, it is an undisputable fact that there is underdevelopment of this type of fund industry in the country.

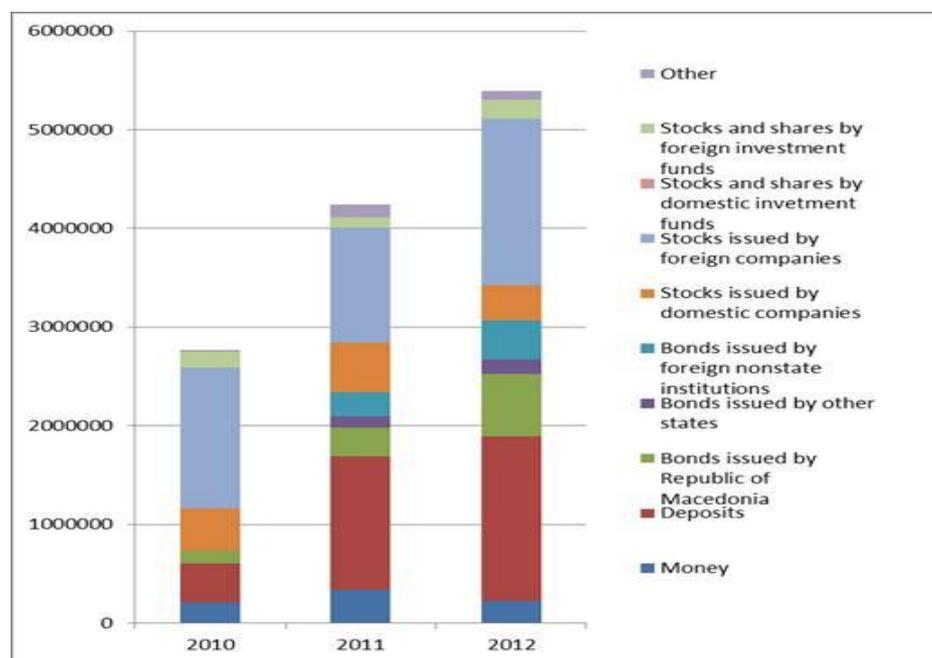
Consideration of the assets' structure of the investment funds depicts a change in the structure for a three-year period. In the structure of the open-end investment funds in 2010 investments in equities of 67.5% (while the share of stocks issued by foreign joint stock companies is 51.71 %) dominated.

**Table 2: Assets' structure of open-end investment funds  
(in EUR)**

	<b>2010</b>	<b>%</b>	<b>2011</b>	<b>%</b>	<b>2012</b>	<b>%</b>
<b>Money</b>	208561	7,5	335807	7,9	224781	4,2
<b>Deposits in domestic banks</b>	397593	14,4	1351251	31,9	1667232	30,9
<b>Bonds issued by Republic of Macedonia</b>	122903	4,4	297720	7,1	635131	11,9
<b>Bonds issued by other states</b>	/	/	106576	2,5	142364	2,6
<b>Bonds issued by foreign nonstate institutions</b>	/	/	244602	5,8	394054	7,3
<b>Stocks issued by domestic companies</b>	433887	15,7	505277	11,9	359986	6,7
<b>Stocks issued by foreign companies</b>	1429679	51,7	1163271	27,4	1686860	31,3
<b>Stocks and shares by domestic investment funds</b>	/	/	/	/	/	/
<b>Stocks and shares by foreign investment funds</b>	159931	5,8	110541	2,6	196692	3,6
<b>Other</b>	12289	0,4	126516	3,0	88634	1,6
<b>Total value of assets of investment funds</b>	<b>2764844</b>	100	<b>4241562</b>	100	<b>5395733</b>	100
<b>Total liabilities</b>	70214		56274		39375	
<b>Total net value of assets of investment funds</b>	<b>2694630</b>		<b>4185288</b>		<b>5356358</b>	

Source: Adapted from data from reports of the Commission for Securities of the Republic of Macedonia for 2010, 2011, 2012.

**Figure 1: Displaying the asset structure of open-end investment funds**



In 2011 and 2012, reducing the share of this type of investment in a portfolio at the expense of increased placements of funds in terms of deposits in domestic banks (31.86% and 30.90%, respectively speaking) and buying bonds where the larger share of bonds is issued by the Republic of Macedonia). The reasons for such changes in the structure of the portfolio was incurred due to the influence of the financial crisis in the country, which led to a change in portfolio strategy of the investment funds, introducing a more conservative way of investing funds in order to reduce the risk of the portfolio of investment funds. Compared to investment funds in the Euro area in which a change in the investment policy and strategy occurs in 2008 under the impact of the global financial crisis, in Macedonia such changes occur even in 2011.<sup>6</sup> The reason for this is primarily overdue reaction of the Macedonian capital market on the impact of the global financial crisis.

<sup>6</sup> Boskovska Diana, Contemporary trends and prospects of economic recovery, CEMAFI International, Nice, France, p.480.

At the same time, conservative investment policy of the investment funds in 2011 caused changes in the geographical allocation of investments of funds, with increased investments in the domestic economy compared to investments abroad (42% in 2010 to 58.8% in 2011). In terms of investments abroad, the investment funds are present on the markets of Europe, America, and the BRIC countries.<sup>7</sup>

In terms of sectoral structure, in 2010 investments in the oil and pharmaceutical industry dominated, but with the changes in the investment strategy of investment funds in 2011, investment in banking and finance hold the highest share, which is a result of high interest rates on deposits of the domestic banks.<sup>8</sup>

### **Conclusion**

The research analysis of investment funds in the Republic of Macedonia, taking into consideration the short period of existence of this type of institutions, only applies to 3 years (2010-2012). The total value, and the value of net assets of investment funds for the three-year period was increasing steadily, so that in 2012 compared to 2010 total value of open-end investment funds increased by 95% , while the total net value in 2012 compared to 2010 increased by 98%. Despite this large increase in the value of the investment funds, their participation in the Macedonian financial system is at a negligible level, which presents the need for increasing awareness of the population and the corporate sector for the benefits from investment funds, which would contribute to greater investments in such financial institutions, and thus to further develop and increase their position in the financial sector in the country.

This paper at the same time analyzes the impact of the global financial crisis on the investment strategy of the investment funds in the Republic of Macedonia. By recognizing the changes in value of the investment fund are coming to the conclusion that the global financial crisis didn't have negative effect to the value of the investment funds. Rapid adjustment of investment funds to the new situation is made by changing the strategy and investment policy (by increasing the share of

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<sup>7</sup> Reports from Commission for Securities of the Republic of Macedonia for 2010, 2011, 2012.

<sup>8</sup> Reports from Commission for Securities of the Republic of Macedonia for 2010, 2011, 2012.

bonds in the portfolio) that caused the value of the funds to increase with lower risk in the same time.

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