Steven L. Pomeranz
FINANCIAL MANAGEMENT

A Brief History of Mutual Funds

Many of us think of mutual funds as a relatively modern invention however, the first mutual fund dates back a number of centuries. Interestingly, it was another severe financial crisis that led to this new invention and resulted in the predecessor of the modern, diversified mutual fund.

The Catalyst

In the mid-eighteenth century, the British East India Company had borrowed heavily from British banks to expand its far-flung colonial interests. By the 1770s, the Company's financial troubles came to a head. At the same time, the royal treasury was stressed due to dropping revenue and rising expenses related to unrest in its colonies in North America. Ultimately, a severe financial crisis ensued around 1772-1773 bankrupting British banks due to an over-concentration of investments in the East India Company.

As it happened, the Dutch too were actively in colonial politics and investments and their banks suffered the same fate as the British - much like the copycat risk-taking and banking contagion of 2008.

1774: The First Mutual Fund

Born from this crisis was the forerunner of the modern mutual fund, created in Amsterdam in 1774. The fund's name, translated from the Dutch, meant "Unity Creates Strength". The fund offered smaller investors a way to pool their monies and held diversified investments in government bonds of Austria, Denmark, Germany, Russia, Spain and Sweden.

Some of its investments were in securities backed by income from plantations in the West Indies and the United States - forerunners of the mortgage-backed securities that we are so familiar with today.

The details of the investments and cautionary warnings in the original Dutch documents were in essence, the same as cautionary statements in today's mutual funds (without the high priced lawyers, no doubt) warning investors about putting all their eggs in one basket and touting the benefits of diversification.

Mutual Fund Evolution

Over time, more of these funds were created but the first investment trust *outside* the Netherlands was founded in London in 1868 - it was called the *Foreign and Colonial Government Trust* and mirrored the original Dutch fund.

In 1873, Robert Fleming launched the Scottish American Investment Trust which invested in U.S. railroad bonds and made a fortune. As an aside, Robert's grandson, Ian Fleming, created the James Bond character keeping the family-name alive albeit in a completely different context.

The investments up to this point were similar in nature to today's closed-end investment trusts. In other words, a fixed number of shares were created to raise money for the funds' investments. After which, if an investor wished to buy or sell he would have to find a willing investor to trade shares with him.

In 1924, the Massachusetts Investors' Trust introduced the first open-end fund. It allowed holders to sell shares back to the Trust at the day's current value (what we call the Net Asset Value). Similarly, buyers could purchase new shares directly from the Trust at any time.

In 1929, the majority of funds were still based on the original Dutch closed-end structure and only a few were open-ended. The crash of 1929 changed that - closed-end funds lost their popularity and open-end funds skyrocketed in popularity.

Today's mutual funds are predominantly open-ended yet, to the credit of the original Dutch creators, closed-end funds still exist today in a form mostly unchanged from their predecessors 235 years ago.