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SCIENTIFIC REVIEW

The Role of Investment Funds in Countries with Transition Economies

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ABSTRACT – *Investment funds, their foundation and development in Serbia, as a country with transition economy, should be viewed in the context of overall economic reforms, which are necessary for these kind of countries, to enable them to emerge from decades of stagnation and poverty, and create conditions for establishing an open market economy. Only within financial reforms, investment companies provide a significant contribution in the improvement of the national economies of the countries in transition. Through knowledge of their managers and scope of resources they possess, they have greater opportunities than individuals - from quality and professional market analysis, to the dispersion of risk by investing in various securities.*

This paper presents the impact of investment funds as institutional investors on financial market development, as well as their role in the privatization process and points out the problems and possibilities of development of investment funds in the countries in transition.

KEY WORDS: *country risk, credit rating, macroeconomic indicators, Spearman's rank correlation coefficient, South-East European countries*

Introduction

Investment funds have emerged as a result of the very fast development of the securities market in developed countries, as well as the inability of the classic banking sector to respond to the needs of investors and users.

With the advent of these funds, the structure of the banking sector has been enriched, increased competition, deepened of capital markets and enabled the execution of transactions in a modern way. Their rapid development has led to the explosive growth of, especially, the securities market. Therefore, these funds are considered the best form of development and successful functioning of the securities market, in countries where this market is developed, as well as in countries in which there is not.

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The starting point for Pan-European history of investment funds has been the so-called UCITS directive (Undertaking for Collective Investment in a Transferable Securities), which came into force on 1. October 1985. and was later implemented into national law of the member states of the European Union and the European economic community. The aim of UCITS is the harmonization of laws, administrative regulations that relate to joint investment in transferable securities. In addition, a secondary aim of the directive was to simplify international marketing and to assist the creation of a European capital market. UCITS are, by definition, only open-end investment funds, while the remaining (non-UCITS) are closed-end funds and other special funds. During its brief existence UCITS directive has already become a globally recognized model of regulation of funds, which provides a high level of protection of investors.

Getting to know the investment funds is in the interest of the general public, and all those who will have the opportunity to acquire shares at privileged conditions. Their permanent orientation to small investors, in our situation, only later will come to the fore. Then they will exhibit the basic advantage of investment funds, as well as the best form of investment of small investors who do not know and cannot take advantage of investing in shares of companies and want to avoid the risks that arise from there. Investment funds in developed countries have strengthened their positions in the financial market, evoking great interest of the holders of small savings. Their expansion over the past decade was lightning and today it is in a diverse range of financial institutions, the indispensable institution. In modified form, funds have confirmed their expediency in countries in transition, realizing the tasks posed by these specific economic and social circumstances. In ambitious tasks of the privatization, investment funds are not provided only a mere infrastructure support, but they secured a substantial reform of ownership and management structures.

It should be stated that the Serbia, relatively late, legally regulated and enabled business of investment funds. Other countries in transition have been done so a long time ago. The privatization process, the spread of shareholding and accelerated circulation of shares is necessary to assume the existence of investment funds. Although in developed market countries, financial markets cannot be imagined without their existence, about this institution in our country very little is known. Therefore, it was expected that their implementation in our country will follow a certain caution and fear of the new. This imposes the necessity to coordinate quality law on investment funds, from the start.

Investment funds in Serbia have started with the founding in 2007. Until the global economic crisis in October 2008., the funds achieved positive yield rate. Investors in Serbia are expecting similar yields accomplished in Croatia after the arrival of funds, however, the effects of the global crisis reflected on the market of Serbia, but also on the markets of all countries in the region. In this period, there was a decrease in demand and a decline of securities price on the stock market, which resulted in a decrease in investment units of funds and negative yields over the coming years.

The paper, conceptually, is composed of two parts. The first part talks about investment funds in general, summarizing their characteristics in general, while the other is more focused on the experience and perspective of development of investment funds in the countries in transition, as well as the legal framework of the privatization process and investment funds in Serbia.

The role and significance of investment funds

The role of investment funds is reflected in the intensification of circulation of securities through (Lajović, 1998, p. 46):

- portfolio diversification,
- professional portfolio management,
- increasing the level of marketability of securities.

Investment funds founded and managed by investment companies, brokerage houses and banks. It is usually part of the proper "family of funds". Individual funds are relatively rare, created with the ambition to cover a wide range of securities of different types. So, in most cases, funds are specialized on the basis of securities which they manage or by the management style, as well as by sector or region in which they invest.

Investment objectives, which are the reason of the existence of investment funds can be classified into three categories (Kidwell et al., 2016, p. 552):

- realization of current income,
- ensuring future growth / appreciation of capital,
- combining the first two objectives.

The advantages available to individual investors, if they invest in an investment fund could be:

- does not require large funds to invest,
- clearly defined investment objectives,
- offering simple reinvestment opportunities,
- provide liquidity.

Sociologically, investment funds had experienced an expansion in the world with the strengthening of the middle class, which saved up for: home purchase, education for children, pension reserves. The funds have enabled to the average citizen that, based on small stakes and regular savings, participating in the securities market, hitherto reserved for investors with significant capital. Investment funds affect the development of capital markets through several roles: Through the collection of domestic savings by providing investors higher yield rates and greater security than commercial banks, diversification in placements and reducing risk by ensuring adequate liquidity of investments, enabling reinvestment of dividends and accomplished capital profit, providing new sources of funding for corporations, small and medium-sized enterprises, through an increase in competition over the banks raise the quality of financial institutions, and finally, encouraging circulation on the financial market, as investment funds also appear as buyers and sellers of securities.

Today, the world is dominated by open-end investment funds. In almost all developed market economies, investment funds have become big players in the financial market, and the process of privatization in the former centrally-planned economies, enabled their presence in economies in transition.

At the end of 2015, according to data from the Investment Company Institute (2016), the world has 100,494 open-end investment funds, managed with net assets worth 37.2 trillion US dollars (USD), which represents an increase in net assets from 0.3% compared to 2014. In

Europe, at the end of 2015, it operated 45 427 open-end investment funds, which are managed by total net assets of 12.77 trillion USD. Most open-end investment funds in Europe, at the end of 2015, was registered in Luxembourg, a total of 12,074 open investment funds, which are managed net assets of 3.57 trillion USD.

According to the same data The Investment Company Institute (2016), open-ended investment funds from the United States manage with almost half of the total assets of all open-end investment funds in the world, namely with around 48% of global assets. Assets of open-end funds, which are registered in Europe, make 34% of the total assets of all open-end funds in the world. Participation of other continents is much less than in Europe and the United States.

By passing the institutional regulations for the operation of investment funds in Serbia (the Law on Investment Funds in 2006), have opened up perspective of development of a propulsive nonbank financial deal which is very important for the further development of banks. Banks should, through its investment funds, keep under control and manage transfers of significant funds from their savings toward investment funds, as well as new net investments in shares of investment funds.

Table 1. Number of investment funds and management companies in Serbia in the period 2010-2015.

Types of investment funds	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
open-end	15	15	16	11	12	12
closed-end	2	2	1	1	2	1
private	3	3	3	2	2	-
Number of companies for managing investment funds	9	8	6	5	5	4

Source: Commission for Securities in Serbia, Annual Report of the Commission and market developments in the period 2010-2015.

In the industry of fund, there is an open-end, closed-end and private funds. The largest part of the assets of these three types of funds is in the open-end investment funds, in which investors can every day buy and sell investment units, so that they have secured liquidity. During the crisis, despite the large decline in the value of shares, liquidity of investments is held on, and until now has not happened that the investor is not paid the value of assets within the legally prescribed period (5 days). A year before the advent of the crisis, and in 2007, the investment policies of many investment funds have been directed toward investments with high yields, which led to the creation of high-risk portfolio. The yields of these funds in Serbia had a positive correlation with the movements of the index Belex15. As the crisis continued, increasingly appeared funds with conservative investment portfolios. Investors who had optimistic expectations about the recovery of the stock market, they chose the balanced open-end funds, which in its portfolio have government securities with fixed yield. (Korenak et al., 2013)

On the other hand, view of the fact that the stock market indexes experienced a record decline, property of funds also experienced a large decline and failed to fulfill expectations of investors, who have invested funds, hoping for high yields in the first years of business activities of funds. The decline was interrupted in 2010, when it re-established the confidence of investors and continuous growth trend in the number of investment units in the coming years.

Table 2. Basic indicators of movements of sectors of open-end investment funds in Serbia in the period from 2007 to 2015

Year	Number of open-end fund	Number of investment units	Total net asset of all open-end fund (in dinars)
2007	6	3.644.829	4.012.075.402
2008	14	2.402.647	1.340.474.105
2009	15	2.156.867	1.035.981.297
2010	15	1.744.493	1.078.883.380
2011	15	1.947.097	1.607.044.353
2012	16	2.331.690	2.324.588.939
2013	11	4.416.264	5.277.371.251
2014	12	6.952.001	9.156.460.680
2015	12	11.003.640	16.986.007.038

Source: Commission for Securities of the Republic of Serbia (2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015, 2016)

Transitional reversal in Serbia

The impact of geopolitical shocks and rigidity of the political system by the year 2000, as well as errors in the implementation of the transition and the inability of the coalition government to implement its plans, after the October changes, had an unambiguous impact on competitiveness and economic growth. The best indicator of the impotence of the Serbian economy is trade deficit. Consequently, the maintenance of macroeconomic stability implies permanent inflow of capital. However, inadequate entrepreneurial capacity and instability in the business environment, on the one hand, and the effects of the crisis, on the other hand, talk about the poor perspectives of investing in Serbia. This kind of situation, combined with a constant increase in external debt in order to finance of the gap in resources, can lead to reduced inflow and the withdrawal of existing capital, primarily from financial institutions. Consequently, this would lead to a negative domino effect (monetary crisis, devaluation and inflation) that would lead to macroeconomic instability. To avoid this scenario and ensure sustainability, current, shallow reforms, it is necessary to create conditions for (re) industrialization through the growth of institutional capacities and investment opportunities.

In the period after the October changes, a lot has been done on the understanding of macroeconomic stability. However, macroeconomic stability is a necessary, but not a sufficient condition for the sustainability of reforms and development. The foundation of sustainable development is located in a special and original strategies and institutions, which form and create a business environment in which economic subjects can compete. However, the question arises: Is the problem of development and growth of economies in transition formulating and implementation of the adopted strategies (and their continual improvement in a turbulent and changing environment)? By abandoning the path of pragmatic solutions and through transitional turn, and switching from macro to micro-economic reform, it is possible to achieve sustainable development of fragile and weak economy. Consequently, it is necessary to create a new transitional strategy (Pavicevic, Albijanić, 2015), deeper market reform.

The essence of the market economy, however, is that economic power is limited by competition. Ownership over the large economic resources may not be directly related to economic power, if there is competition in the market. So, with deeper market reforms and by strengthening market mechanisms eliminates the concentration of economic and political power, which could have the most funds as majority owners of economic resources.

The basic prerequisite for the increased volume of trading on the capital market is the existence of supply and demand. Serbia has emitted a significant amount of securities, but still there is not enough of satisfactory offer, and not enough demand for the securities.

There are plenty of reasons that cause the low demand for securities in Serbia. Lack of knowledge of local investors in the business with securities, as well as the lack of information about prices and transactions, discourages investment in securities. Low living standards and the lack of a middle class are not good conditions for savings and investments. Political instability, inflation, lack of tax incentives is another reason that contributes to this situation. Until the establishment of domestic investment funds be postponed, foreign investment funds will become owners of the increasing number of best companies. This is corroborated by cases with companies: Salford, Midland, FPP Balkan Limited. (Maksimovic, Marčetić, 2014)

Problems and perspective of development of investment funds in the countries in transition

Guided by the experience of the most successful transition economies, that have joined the European Union, it is concluded that the most important indicators of a successful completion of the transition process: the dominance of the private sector in the overall economy and the creation of gross domestic product, hard budget restrictions at the micro and macro level, the efficient functioning of financial markets and a high degree of economic freedom. (Petraković, 2004)

Countries in the region substantially lag behind high-income countries when it comes to investment funds. The main reasons for this are as follows:

1. Underdeveloped capital markets,
2. The dominance of banks, and credit as a source of funding,
3. The low level of investment culture - poor awareness of population and insufficient knowledge of the operations of investment funds. (Lekovic, 2014)

European Bank for Reconstruction and Development (EBRD) published a set of indicators of development of countries in transition (Transition Indicators) based on which estimates the reform process in these countries from planned to an open market economy.

Transitional indicators are ranging from 1 to 4+, where 1 represents little or no change compared to a rigid planned economy, and 4+ represents the standards of an industrialized market economy.

Table 3. Transitional indicators for the financial sector of countries in the region for 2016-2017

	Financial sector			
	Banking	**Insurance and other financial services**	**Private equty**	**Capital market**
Albania	3-	2	1	2-
Bosnia and Herzegovina	3-	2+	2-	2
Bulgaria	3	3+	3-	3-
Macedonia	3-	3-	1	2
Montenegro	3-	2+	1	2
Serbia	3-	3	2	2
Romania	3	3+	3-	3-

Source: (EBRD, 2016)

The competitiveness of Serbia is not on enviable level. According to the Global competitiveness report for 2015.-2016. Serbia is one of 140 ranked countries, is on the 94th place. Serbia was in 2014. and 2015., also occupied 94th place in terms of competitiveness, but of 144 ranked countries, with global competitiveness index of 3.9 in both periods. (World Economic Forum, 2015) This points to a very slow progress of the Serbian economy and economic environment. According to the model of Porter's diamond, business environment of Serbia has many flaws: poor infrastructure, poor and slow state administration, the mass outflow of professionals and scientists, the emergence of market dominance, poor efficiency antitrust policy, bad regulation of property law, lack of investment in research and development, slow acceptance of modern technologies, not quality vendors, bad cluster development, poor development of research services and training. So, these are the deficiencies in the areas that are about to be a priority for the country. (Mitrovic, Mitrovic, 2015)

When we talk about the capital market, the market capitalization on the Belgrade Stock Exchange, at the end of 2016., amounted to 592.4 billion dinars, compared to the end of 2014 is lower by more than 15%. (BSE, 2017) On the Stock Exchange is traded shares and bonds of the Republic of Serbia, and by now there were no initial public offering of shares of the company. Overall, capital market is characterized by low liquidity and quality of investment options.

Before the advent of the global crisis, investment funds were focused on risky investments with high returns, and already in 2008. its investment policies directed towards more conservative portfolios. During 2008. there is a significant withdrawal of foreign investors from the stock markets of countries in transition. Foreign investors are very important participants in the transition countries, which do not have a large market capitalization, have low liquidity and poor active domestic investors. In the period from 2005-2009. participation of foreign investors moved up 42.77%, and their withdrawal after this period had an impact on all stock market indicators, including the volume of circulation, the number of transactions, indexes and market capitalization. Only in 2008. compared to 2007., the volume of total circulation dropped by 56.45%, in order to 2009. decreased by 41.86% more, in comparison to 2008. (Pavlović, Muminovic, 2010).

Moradi, Mirzaeenejad and Geraeenejad (2015) conducted a study on the level of developed countries and developing countries where the results show that the type of financial system affects the distribution of income in the sense that market-oriented financial system leads to a better distribution of income in developed countries, while bank-based reduces income inequality in developing countries. (Moradi et al., 2016). The financial system of Serbia belongs to the domain of bank-based market with the participation of banks over 90%. Serbian financial market functions under the principle that credit is the most common financial instrument, because the market of corporate and municipal bonds in Serbia is underdeveloped.

As in other countries in transition, and in Serbia, venture capital still plays a minor role in the financial market. Besides the initial activities of the Network of business angels of Serbia, which was founded in 2010, investments through venture capital are just getting started. In Serbia, there is still no effective law that regulates the establishment of investment funds, as well as venture capital funds, business angels and other forms of financing. Besides some changes of law relating to these forms of funding, are not made significant steps to motivate and facilitate the business of venture capital funds. According to the Index of attractiveness for the venture capital and investment in shares of companies, Serbia in 2016. was in the 74th place among 125 countries, which is an improvement compared to 2015., when it was in 81st place of 120 countries observed. (IESE) Such a bad evaluation Serbia could fix with the new laws concerning the capital market, which should provide greater protection to investors, to reduce the systemic risk of the country and create a more transparent market.

Transition economies can have many economic benefits from private investment funds that operate in their own territories, and these funds can greatly help the economic transition and recovery. The operations of private equity funds have greatly hampered by legal regulations, institutional, legal and political framework for business, but also the great distrust in the financial sector, due to fraud and malfeasance that occurred in the past.

Private investment funds will play an important role in investment companies and this trend will continue in accordance with the economic prosperity of the economy, especially for the reason that this type of financing has obvious advantages over the financing of loans and credits. They have a special role and importance for the economies of countries that are candidates for accession to the European Union. The largest investor of private investment funds in Central and Eastern Europe is the European Bank for Reconstruction and Development. In forthcoming period, it is expected the entry of new private investment funds in the Balkans and in countries in transition, which tend to institutionally regulate their markets in order to become members of the European Union. Changing the ownership of the company, beyond the opportunities, for private equity investment which furthers their development and create better conditions for their functioning. Continuous improvement of economic conditions, intense economic reforms and radical institutional changes have led to the creation of a suitable environment for investment and development of the private equity industry in large parts of Eastern Europe and the Balkan countries.

Developments in private equity investments and the capital market in the last year, gives hope that the situation on this issue fix it. In Serbia, recently, government bonds are listed on the stock exchange, which provides institutional investors an adequate price benchmark. Also, what is important for the business of institutional investors in the transition economies of the region is that the Belgrade and Zagreb Stock Exchange joined the SEE Link Platform, thereby improving access to capital markets in the Serbia and Croatia. This should expand the investor base of countries and improve the availability of funds.

In the future, it can be expected that foreign management companies are increasingly establishing specialized funds for investing in the markets in countries in transition. In these countries, the banking sector has largely lost the public's trust, so that other forms of savings or financing may gain in significance. Investment funds generally offer investors higher yields with high liquidity of assets, so that in the future may represent a more attractive form of investment.

Legal regulation of the privatization process and investment funds

In order to accelerate the privatization process, the Government of the Republic of Serbia in 2005 and 2006 proposed and the Parliament subsequently adopted amendments and additions of relevant laws: the Law on Privatization, concerning the Privatization Agency and the Share Fund. The important amendments to the Law on privatization related to the fact that the companies that went on sale, the state wrote off debts to funds and public companies and thus made them significantly more attractive for potential investors. The mentioned debts would be settled subsequently from the sale proceeds of these companies.

Adopted the Law on Investment Funds (June 2006), which regulates the operation of investment funds in the privatization process, thereby achieving greater public in their business. Other laws were adopted and with the aim of creating suitable environment for foreign investors. Law on Privatization stipulates that the privatization should be completed in 2007, with the exception of public enterprises, which expects the preparation of the organization and status for the privatization. Namely, it was necessary that these companies strengthen and reduce the costs of their operations, and it was necessary that the government as soon as possible, adopt the Strategy of restructuring of public enterprises, which would stipulate the general conditions of the privatization of these companies, reducing redundancy in them (by approximately 10 %), as well as specific social programs for workers, which would be financed from the so-called. transitional funding, while the additional funds provided for this purpose through a process of restructuring of public enterprises (companies selling those parts that are far away from the basic activities). According to the adopted amendments and additions to the Law on Privatization, from December of 2007, is scheduled to complete the privatization of public companies by the end of next year. It also stipulates that companies that do not find buyers by that deadline privatized through the bankruptcy and thus find strategic partners.

Particular problem in so far completed privatization are private investors who have in recent years purchased the company from the state, which in many cases do not respect their contractual obligations relating to social and investment programs.

In the process of privatization of public enterprises is considered that there are two scenarios for the takeover of public companies. The first is that major parts of the company sale to strategic partners and the rest of the capital appeared on the market. The second scenario involves an investment by the investment fund. In the case of strategic takeover, the company is unlikely to expand beyond existing markets, while in the case of investment by the investment fund objective would be the faster growth of the company increasing its value to that extent, so that its value will increase as more. (Kvrgić, 2013)

Besides the foreign investors, very significant investments are made by domestic investors and their level also needs to be raised. Only 13% -16% of Serbia's GDP goes to investment. It is difficult to count on an increase in foreign investment, before the domestic investment does not significantly raise, because the domestic entrepreneurs first test the quality of the business environment in the country. (Roskić, 2007)

Private funds are not subject to the general provisions of the Law on Investment Funds concerning the issuance of permits for the investment fund, investing assets of the fund the investment restrictions of the Fund assets, restriction of disposal of the fund's assets, determining the income of the fund, issuing prospectus, marketing and intermediary. On the private fund, do not apply the provisions of this law, except the submission of annual financial statements.

Private investment fund may be indebted without restrictions, in accordance with its policy and rules of operation.

Managing private investment fund exclusively provided by the management company, in accordance with the Contract on Management concluded with the private fund. The management company submits to the Commission a contract on management and business rules. The Commission registered private investment fund in the Investment Funds Registry. On the private funds, accordingly, apply the provision rights which regulate business companies.

However, there is still no harmonization of the legal framework for the "private equity" on the territory of Europe. On the EU level a large number of regulations govern only indirectly operations of these investors. Some of the relevant regulations are: MiFID, UCITS, the directive on pension funds (Pension Funds Directive) and directives which are loosely linked to capital requirements (Capital Requirements Directive). Prior to defining the legislation is desirable to spot potential unwanted activity of funds in terms of the impact on global economic trends in the country. It happens often, cases where the legislation passed before the identification of potential situations that should be allowed and those that should be controlled and prevented. It is especially important to consider these aspects, for the reason that in our country there is still no clear regulations for these investors, although for years there are institutions that operate in this region. (Erić et al., 2012)

Conclusion

The privatization process, the spread of shareholding and accelerated circulation of shares necessarily assume the existence of investment funds. This is especially evident in the fact that they were one of the key pillars of the privatization programs of many countries in transition. This type of privatization was usually accompanied by the establishment of privatization investment funds, which had a key role of financial intermediaries during the privatization and in post-privatization period. However, due to a series of problems in their functioning, investment funds did not achieve the expected role in countries in transition, primarily in terms of enterprise restructuring and improvement of corporate governance.

There are different roles that investment funds have in developed countries, countries in transition and finally in Serbia. In developed countries, they are the biggest investors in shares and work over management companies and thus influence on the competitiveness of the economy and the diversification of risk. In countries in transition, they appeared at the beginning of the transition, were the favorites, but did not lead to the expected development of the financial markets.

Financial experts see the primary advantage of investment funds in the fact that they reduce the investment risk, because they invest in shares of several companies. Enables easy transport, because the small investor has no need to register and participate in the public offering of shares. All this, for him, makes an investment fund. Their work is regulated and monitored by the Commission for Securities, and we must not neglect the fact that investment funds managed by professional people.

For further development of the financial market in Serbia are important institutional investors, because institutional investors in international financial markets, especially in OECD countries over the last ten years, had a very high growth and played a key role in the financial market. About this institution in our country do not know much, which applies to entrepreneurs, although in developed market countries the system of financing cannot be imagined without their existence.

Advantages of investment funds are well known - the diversification of the portfolio, portfolio management and corporate governance - are particularly current, at the present time, in our economy, so should not miss their expression through the activities of these institutional investors. It would be extremely important, not only the presence of foreign investment funds, but also the formation of domestic, because it would fill noticeable cracks in the capital market. We need someone to offer the market the new securities which would be safe enough and sufficiently attractive to ordinary depositor.

Law regulations would, of course, be necessary to define a number of issues related to the establishment and operations of investment funds, starting from the required capital, qualification of personnel, types of investment fund, the restrictions regarding allowed percentage of investments in certain securities, preventing manipulation, etc. Also, the state should, through tax incentives, stimulate investment in investment fund.

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