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DIRECT VS INDIRECT INVESTMENTS: THE IMPLICATIONS OF A CHOICE FOR A SHORT-TERM PRIVATE INVESTOR

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The subject of this article is the implications of a choice between direct and indirect investments for a short-term private investor. The purpose of this article is to produce a review of scientific research, conducted on the topic, and with its help to define short-term private investors' necessities and to examine money market instruments versus money-market mutual funds as tools for short-term private investors. The conducted analysis of the recent research publications has shown that theshort-term private investors require high liquidity low risk instrument and can tolerate comparatively low returns, and that the best tools for such investments are money market instruments. During the research, we noted the trade-off between the T-bills and commercial papers with regards to risk, liquidity and yield, and considered the benefits of indirect investments via MMMFs; however, we came to the conclusion that the riskiness of such investments outweighs their benefits.

Keywords: direct investment, indirect investment, short-term private investor, T-bills, commercial paper, MMMF.

Introduction

In the modern times of a fast-paced globalized economy, every common person knows about the main features of inflation and money devaluation over time. That is why many people prefer to invest their money in order to make it "work". Money can be invested either short term (one year or less) or long term (over one year), depending on the risk and liquidity appetite of the investors. Due to the economic instability and budget constraints, private (or personal) investors often choose to invest into money markets as the safest and the most liquid option. They also have a choice to invest directly or via financial intermediaries.

We attempt to have a closer look at the short-term investment instruments and investment options. The purpose of this article is to produce a review of scientific research, conducted on the short-term investment within the last 5 years, and to:

– Identify main needs of short-term private investors.

– Analyse money market instruments and mutual funds as tools for short-term private investors.

– Make an argument on which investment strategy is more beneficial to a short-term private investor.

The remainder of this paper is organised as follows. Section 2 presents the methodology. Section 3 identifies main needs of short-term private investors. Section 4 analyses money market instruments as a tool for short-term private investors. Section 5 analyses money market mutual funds as a tool for short-term private investors. Section 6 makes an argument on which investment strategy is more beneficial to a short-term private investor. The last section summarizes the findings and states the conclusion.

Methodology

The analysis is exploratory in nature and is based on an extensive review of earlier relevant studies on the various aspects of the short-term investments. The basis of the analysis is a collection of articles, published in credible scientific journals within the last 5 years.

Short-term private investors' necessities

As the question is asking about the "requirements of a short-term private investor", let us see the definition of a private investor. According to the Financial Times, a private investor is "a person or a private company one, whose shares are privately held and not traded on a stock market that makes investments, rather than a public company one whose shares are traded on a stock market."As this definition does not reflect the meaning of the question, let us consider the term "personal investor". According to the same source, a personal investor is "a person who invests their own money in financial markets, and is not working for a financial institution or as a professional investor." The latter definition is more suitable in the context of our question, so we will keep using the term "private investor", but with the meaning of a person, who invests his or her own money, as opposite to the institutional investor, which invests someone else's money.

The research on the decision-making process, used by private investors, is scarce. Feeney, Haines and Riding (1999) believe that private investors make investment decisions in a similar way that the institutional investors do with some differences in the scale and stage of investment and the nature of the agency relationships between investor and investee. However, private investors, investing their own money, "face the full consequence of their decisions at the personal level", while the employees of institutional investors are not adequately rewarded for high profits, apart from their salary, and are not heavily penalized for losses.

Feeney, Haines and Riding (1999) list the needs of private investors, presented in Figure 1.

Private investors want an interest to be received as a risk premium, the gains to be easily realised, the risk to be adequate and manageable, and the opportunity to be there for improvement of the investment prospects.

Based on the aforementioned list and the nature of the short-term investments, we have derived the needs of short-term private investors, which are presented in Figure 2.

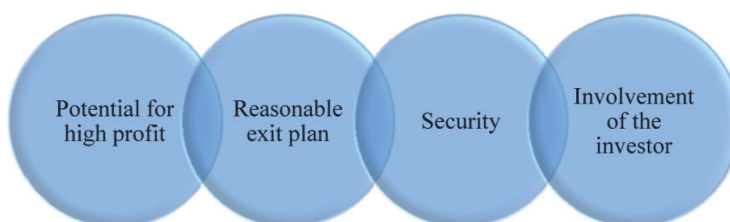

Fig. 1. Private investors' needs

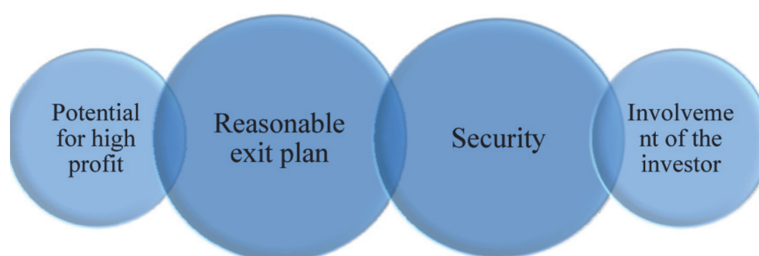

Fig. 2. Short-term private investors' needs

As the figure implies, the focus of the short-term private investors is shifted towards the liquidity (reasonable exit plan) and lower risks (security) at the cost of potential for high profit and the opportunity of involvement. Indeed, short-term private investors normally experience a shortage of money, so they would like their investments to be easily withdrawn in the case of emergency. At the same time, such a shortage of funds presumes the absence of a back-up plan; thus, it is crucial for such investors to keep the risks low, and low risks mean low profits. Short term does not allow the time to get involved in the investee's affairs.

Money market instruments as a tool for short-term private investors

The main features of money market instruments are their liquid, short-term, and "safe" nature – their money-like attributes (Carlson, Duygan-Bump, Natalucci, Nelson, Ochoa, Stein & Van den Heuvel, 2016). Due to its high liquidity and low risk, money market instruments answer the needs of the short-term private investors the best. In the variety of money market instrument, let us consider the most convenient for short-term private investors, using the diagram of Golec and Perotti (2017) (Figure 3).

Having a closer look at the diagram, we can exclude Repo Secured by Government Debt and Repo Secured by Liquid but Risky Assets from our analysis, because repurchase agreements, contracts in which the vendor of a security agrees to repurchase it from the buyer at an agreed price, are used mainly by central banks and not by private investors. In addition, we can exclude illiquid Securitized Senior Tranches. Long-Term Treasuries are not the target of a short-term investor either. Currency, Reserves and Bank Deposits can also be excluded from our analysis, as we do not consider them an investment, worth the analysis. Thus, we are left with Short-Term Treasuries (also called treasury bills, or T-bills), commercial paper and MMF shares. Let us compare the first two instruments.

Treasury bills are "a short-dated government security, yielding no interest but issued at a discount on its redemption price". They provide owners with liquidity service benefits. In monetary terms, it is liquidity premium, strongly positively correlated with the short-term interest rate level. Thus, the higher are the interest rates, the higher is the opportunity costs of holding money, and the more T-bills the investors are willing to buy (Nagel, 2014). However, this is not the only one correlation: Nippani and Parnes (2017) found that political brinkmanship and the consequent delays in passing the debt limit reduce the T-bills' price, which leads to increased yields. Thus, the more unstable the political situation in the U.S.A is, the better is for private investors, but worse for the taxpayers. Nevertheless, it is commonly agreed that as the T-bills are issued by the government, the risk of their default is almost non-existent. At the same time, their premium is one of the lowest at the money market. Thus, T-bills are the best suitable for risk-averse investors.

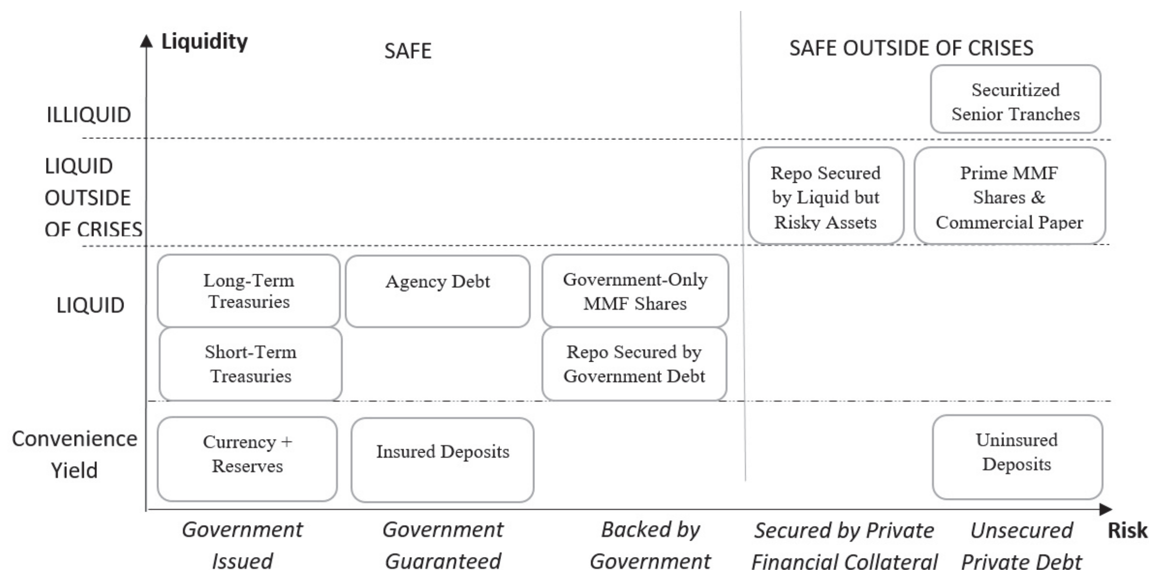

Fig.3. Liquidity and Risk of Assets

Commercial Paper is “short-term publicly traded, unsecured debt of large and well-established companies”. Commercial Paper is a popular investment instrument for those investors, who would like to receive higher returns and do not mind bearing higher risks. All the Commercial Paper issuers are rated by established rating agencies, depending on the risk of their default. The interest rate of the Commercial Paper reflects the assigned rating. Thus, the investors do not need to collect private information about the company – they just need to define their risk appetite (Kahl, Shivdasani & Wang, 2015). Both Commercial Paper and T-bills are issued at a discount, meaning that the price of the instrument is less than its par value, and the difference is the interest earned. Commercial Paper is considered low risk because of its short maturity; however, the default risk still exists (Perotti, 2016). Due to the presence of default risk, Commercial Paper is less liquid than T-bills. That means if a private investors needs to urgently sell the Commercial Paper, he or she might not be able to do it fast enough, unless the price is reduced, which is not the case of the T-bills, as they are freely traded on the market and are always in demand. That is why interest rates on Commercial Paper are usually slightly higher than those on Treasury bills (Wiggins & Metrick, 2016). This trade-off between Commercial Paper and T-bills illustrates the positive correlation between risk and yield, liquidity and yield, and the negative correlation between risk and liquidity.

Money-market mutual funds as a tool for short-term private investors

Money markets mutual funds (MMMF) are relatively new financial intermediary institutions, connection short-term debt issuers with short-term investors (Gordon & Gandia, 2014). Legalised in the U.S.A. in 1970s, they became important suppliers of liquidity to financial institutions. MMMFs invest in Treasury bills, deposit certificates, commercial paper, and telephone or notification of money (Sharma & Varshney, 2018). Moreover, MMMFs are the main investors in commercial paper (Perotti, 2016). Sharma and Varshney (2018) believe that MMMFs are ideally suited for short-term investments, because under the condition of uncertainty, short-term investor obtain the market-market interest rate and guaranteed liquidity. Also, the MMMFs are considered less dangerous than private investments, because MMMFs can split the investment throughout asset classes by investing in various grouped funds. As it is expensive to maintain the records of thousands of microinvestments, there is usually a lower limit of amount of money to be invested in a particular asset. As the funds of a private investor are limited, he or she can normally conduct a small number of distinct investments at a time. The fact that individual households own little commercial paper confirm this hypothesis (Perotti, 2016). Thus, individual investors face high portfolio risk. At the same time, MMMFs’ funds are not so limited, so their portfolios are well diversified. Another benefit of investing in MMMFs is the saving on the brokerage fee.

Acknowledging all the benefits of investing in MMMFs, we need to discuss the associated risks as well. One of them is the instability of MMMFs, which became prominent in the financial crisis of 2007- 2009 (Gordon & Gandia, 2014). While investing in MMMFs is considered to be a reduction of portfolio risk, we should not forget that in practice, we invest not in a variety of assets, but in only one asset, that is an MMMF that has its own default risk, which can be even higher than the default risks of each individual investment in the portfolio.

Another drawback is that unlike bank deposits, investments in MMMFs are not insured by the gov-

ernment. Finally, MMMFs are allowed by law to invest only to the instruments with highest or second-highest rating (Perotti, 2016). Also, the regulations, which became effective in 2016, aim to decrease the liquidity of MMMFs' liabilities. The change in MMMF regulation has made their liabilities less money-like, which forced safer funds exit the industry. The remaining MMMFs increased the riskiness of their operations in order to provide the same level of returns, excluding safe borrowers from their portfolio (Baghai, Giannetti & Jäger, 2018). Thus, private investors have more freedom in choosing the money market instruments and might get higher return, if they increase their risk appetite, or might obtain safer investments, if they choose to invest in safer assets.

Before the Global Financial Crisis, it was considered a benefit of investing in MMMFs that the investor was relieved from checking the creditworthiness of the investee. However, after the crisis, the U.S. Government introduced a new legislation, encouraging the investors to check MMMFs' liabilities (Baghai, Giannetti & Jäger, 2018).

Parlatore (2016) has created a model to analyse the above mentioned risks and benefits and came to the conclusion that even in the absence of investor runs, the MMMF industry may be fragile. We agree with the researcher that the risks of the MMMF market far outweighs its benefits.

Conclusion

The conducted analysis of the recent research publications on the case of short-term private investment has shown that the short-term private investors require high liquidity low risk instrument and can tolerate comparatively low returns, and that the best tools for such investments are money market instruments. In the paper, we compared the T-bills with commercial papers and noted the trade-off between them with regards to risk, liquidity and yield. In addition, we considered the benefits of indirect investments via MMMFs; however, we came to the conclusion that the riskiness of such investments outweighs their benefits.

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ПРЯМЫЕ И КОСВЕННЫЕ ИНВЕСТИЦИИ: ПОСЛЕДСТВИЯ ВЫБОРА ДЛЯ ЧАСТНОГО КРАТКОСРОЧНОГО ИНВЕСТОРА

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Предметом статьи являются последствия выбора между прямыми и косвенными инвестициями для частного краткосрочного инвестора. Цель данной статьи – подготовить обзор научных исследований, проведенных по данной теме, и с его помощью определить потребности частных краткосрочных инвесторов, а также изучить инструменты денежного рынка и паевые инвестиционные фонды как инструменты для частного краткосрочного инвестора. Проведенный анализ недавних научных публикаций показал, что частные краткосрочные инвесторы нуждаются в высоколиквидном инструменте с низким риском и могут терпеть сравнительно низкую доходность, и что лучшими инструментами для таких инвестиций являются инструменты денежного рынка. В ходе исследования мы отметили баланс преимуществ и недостатков между ГКО и коммерческими бумагами в отношении риска, ликвидности и доходности, а также рассмотрели преимущества косвенных инвестиций через паевые инвестиционные фонды. Однако мы пришли к выводу, что рискованность таких инвестиций перевешивает их выгоды.

Ключевые слова: прямые инвестиции, косвенные инвестиции, частный краткосрочный инвестор, ГКО, коммерческие бумаги, паевые инвестиционные фонды.

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