Structured finance and the origins of mutual funds in 18th century Netherlands

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Mutual funds have become popular in recent decades. But their origins go back to the early days of organized stock trading.

Prior to the 18th century, a number of investment vehicles were created in which investors had a joint interest in pool of financial and non-financial assets. The first major type was a contract of survival. This type included life annuities and tontines. The second type included plantation loans.

In a tontine, a borrower promised to pay a group of individuals an annuity that would be divided among the surviving members. As group members died, pay-outs to the survivors would increase. Many early tontines were floated by governments but some were also privately promoted.

In case of plantation loans, mortgages to planters in the West Indies were securitised. Bonds were issued in the Netherlands and the proceeds used to provide mortgages to plantation owners in Surinam. The owners were obliged to ship the crops back to the fund manager, who acted as the commission agent. The proceeds from the sale of the crops, the real estate, the equipment and the slaves served as security for the interest and principal payments to the bond holders. Plantation loans were the forerunners of modern mortgage backed securities.

In July 1774, Amsterdam broker, Abraham van Ketwich invited subscriptions to his fund *Eentragt Maakt Magt*. The fund invested in bonds issued by foreign governments and banks and in plantation loans in the West Indies. The fund was structured as a closed ended investment trust. The subscription was kept open till all the 2000 shares were placed. The initial success of *Eentrat Makt Magt* soon invited followers. In 1776, a vehicle named *Voordelig en Voorsigtig* was established by a consortium of banks. 40% of the portfolio was allocated to plantation loans. This fund had more freedom in framing investment policy.

The fortunes of the early mutual funds were closely linked to those of the plantations in the West Indies. When the Fourth English War started in 1780, shipments to the Dutch commission agents were affected. By the end of the century, the funds had disappeared from the records of the Amsterdam stock exchange. The *Concordia Res Parvae Crescent* was among the longest lived mutual funds to ever have existed.

Despite the poor performance of the first investment trust, there were also many success stories. During the 1780s and 1790s, there were more than 30 investment trusts that speculated on the future credit of the US. The Netherlands was one of the major financiers of the American revolution.

By the end of the 18th century, Hope & Co had become the principal banker, raising money in Holland for the Russian Czar. The bank issued both bonds and depository receipts. For a small fee, the firm would collect interest payments abroad and pass them on to the certificate holders when they presented the coupons. The depository receipts were freely tradable in bearer form in Amsterdam. The original inscriptions were carefully preserved in iron chests. Depository receipts helped do away with onerous registration requirements.

The first documented investment trust outside the Netherlands was the Foreign and Colonial Government Trust founded in 1868 in London. This trust too invested in foreign government bonds. By 1875, 18 trusts had been formed in London. During the 1890s, investment trusts were introduced in the US. Most of them were closed ended funds. The Massachusetts Investors trust became the first open-ended mutual fund in 1924. Open ended funds are the dominant model today.

To conclude, financiers in 18th century Netherlands introduced various innovations that are today the foundation for mortgage backed securities, pension funds, mutual funds and depository receipts. New claims and securities were constructed and existing financial instruments were repackaged. It appears that even those days, many concepts of modern finance were well understood. These include the notion of diversification, value investing, the importance of collateral, investor preference for positive skewness and agency conflicts. From these experiences of the past, we can draw useful lessons on what drives failure and success in financial innovation.