CHAPTER 1
INTRODUCTION

1.1 Background

Unit trust had received increasing attention from investing public recently, especially since the 1997 financial crisis. Since the end of 1999, RM6.7 billion had been invested in unit trust. Unit trust accounted for 9.74% of KLSE market capitalization as at December 2000 compared to 7% in 1996. Although the figure is not as high as developed countries, it is an encouraging signed. Investors have turned to unit trust as an alternative investment vehicle.

There is no doubt that the growth of the unit trust industry will bring great investment opportunities to Malaysia. However, in order to profit from the investment, investors must know how to evaluate the performance of unit trust funds. There are many ways to evaluate the performance of unit trust funds. The most important measure to an investor would be the actual returns he/she received at the end of the investing period.

In order to catch the attention of the investing public, Unit Trust Management Companies (UTMC) in Malaysia has been advertising their funds' returns and awards won by their funds. The advertisements are made to lure investors to invest in those funds. The awards include 5 stars rating from Micropal or best performing funds awarded from Lipper International. Nevertheless, do average investors in Malaysia receive the returns advertised by the management companies? To what extend the figures published by the 3rd party rating agencies like Micropal , Lipper or Normandy have any meaningful value to an average investors?

1.2 Types of Unit Trust Fund in Malaysia

Generally, unit trusts can be classified into two broad types:

a) Close-ended funds; and

b) Open-ended funds

1.2.1 Close-ended Fund

Number of units available for circulation is fixed at the time of launching or floatation on the stock exchange. Every transaction must go through a stockbroker. These funds' buying and selling prices fluctuate based on demand and supply of these investments. Property trust is the most common close-ended funds available in Malaysia. Property trust invest in highly illiquid such as real estate properties. Examples of close-ended funds in Malaysia are the Arab Malaysia First Property Fund and the First Malaysia Property Trust.

1.2.2 Open-ended Fund

Not listed on a stock exchange. All transactions are dealt directly with a fund manager. The fund manager's buy and sell prices of these funds is determined by the total net assets of the funds.

For the purpose of this study, the focus will only be on open-ended funds. Under this study open-ended funds are further categorised into growth funds, balanced funds, income funds, Islamic funds, small cap funds, state funds and index tracking funds.

1.2.3 Different Types of Open-ended Funds

Growth funds' objective is to maximize capital growth, by investing in companies with strong growth potential. This type of funds generally is more volatile than the other types of funds. However, over the long term this type of funds should generate higher returns as the risk level is higher.

Balanced funds are funds that hold a balanced portfolio between equities and fixed income instruments. The risk level and returns for balanced funds are lower as compared to growth funds. Balanced funds rate of return ranks between growth funds and income funds. This type of funds is suitable for investors who want to have some stability, growth and freedom from worry about market ups and downs.

The objective of income funds is to provide regular income with less emphasis on capital growth. The risk and returns for these funds will be lower than balanced funds. Income funds return is unlikely to be influenced by the movement of equities market. Income funds' return are influenced by the level of interest rate. Income funds are suitable for investors who require a regular income from their investment.

Islamic funds are funds that invest in accordance with Syariah principles, with investment in only "Halal" instruments only. Non-halal instruments include insurance, interest bearing investments and non-halal shares. Non-halal shares are shares of companies that engaged in non-halal activities for example gambling, insurance, alcohol, non-halal food products and etc.

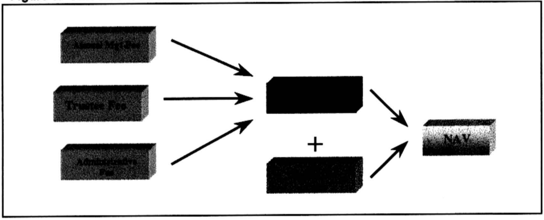
States funds are funds managed by State Authorities in Malaysia with the objective to develop their respective states. Small Cap funds are funds that invest in shares of companies with smaller paid up capital.

Index Tracking Funds are passively managed funds. The objective of these funds is to track the performance of an underlying indices such as the Kuala Lumpur Composite Index (KLCI) and Exchange Malaysia All Shares (EMAS) etc. and not to outperform such indices. The Management Expense Ratio (MER) of these funds is considerably lower than actively managed funds. In the U.S.A equity index funds generally have a 0.5% MER while in Canada, funds which track US S&P 500 index have MER of around 1.6%.

1.3 Fees

Fee is an important factor that will directly erode the returns generated by of a fund. In general, there are a few types of fees an investor pays when investing in unit trust. They are service charge (also known as front-end load or initial charge), redemption fee (back-end load or exit fee), annual management fee, trustee fee, transaction fee and other administrative fees. (Please refer to the appendix for individual fund's front-end load.)

Figure 1: Unit Trust Funds Fees Structure



Annual management fee, trustee fee and other administrative fees are items which form the Management Expense Ratio (MER). MER and transaction fee are included in the Net Asset Value (NAV) calculation. Therefore, all the fees except for loads (both front-end or back-end load) are not included in the calculation of performance returns.

It is important to know that unlike other developed countries, most of the funds in Malaysia still charges front-end load. The justification for service charge is to cover all costs in distributing funds to investors such as the prospectus printing costs, advertisements, commissions to agents and any other cost involved in the distribution of the funds. Most of the funds charge around 5% to 10% front-end load.

Most of the funds in Malaysia do not charge back-end fee. This fee can be a flat rate or a structured declining scale – where the longer investors keep their investment in the fund, the less fee the investors pay. Apex Tracker Fund is an example which charges declining scale back-end load while OSK-UOB Tracker fund charges flat back-end load.

Not many Malaysian investors are aware of such fees. From a survey done by Southern Unit Trust in 1999, 80% of the investors are not aware of the fees involved in investing in unit trust. Out of the 80% surveyed, 40% are not bothered with fees as long as the fund is able to generate higher returns, 60% would invest in the lower fees fund when the fees structure in made known to these investors. In United States, the SEC found that in 1996, more than 80% of investors did not know much about their funds' charges. The awareness of fees is also low in Canada. In a survey conducted in May 1997, 45% out of the 2000 participants did not even know they were charged fees. This figure is consistent with Southern Unit Trust's findings.

Prior to 1996, the maximum fee a fund can charge as front-end load is 10% of NAV. Unit Trust Management Company (UTMC) is required to publish only the buying (management's buying) and selling (management selling) price in 2 national newspapers, NAV price is not compulsory to be published. Therefore, the awareness of service fee is very lower. The information available to the investing public is the spread between the selling and buying price. The spread of a fund is not the service charge an investor pay.

For example, Fund ABC's NAV = 90 sen, Selling price = RM1.00, Buying price = 95 sen. The service charge is 10% on selling price and not 5% as per the spread indicated. Service charge is equal to Selling price minus NAV. Redemption fee would be the difference between the Buying price and the NAV. (All price are quoted as fund manager's buy and sell prices).

The Securities Commission 1997 Guideline lifted this ceiling price and allowed market forces to determine the quantum of the fee. Effective from 1997, UTMC must publish the value of funds' NAV in local newspapers. This requirement increases the level of transparency in the industry hence, marked the first step in increasing the awareness of load among the investing public.

However, Kang [2000] study showed most investors still focus on fund's performance and usually ignore the cost involved. General investing public in Malaysia are used to the idea of getting consistent good dividends from PNB's funds which make performance or more precisely the dividend and bonus declarations as their main considerations.

In Singapore, funds are charging between 3.0% and 5.5% as front-end load, while some are no load funds. While in Hong Kong, where front-end load ranges from 1.0% to as high as 7%. No load funds are also common in Hong Kong. As the industry becomes more developed the front-end load will reduce. This is mainly due to competition and awareness of general investing public.

1.4 The Objective Of This Study

Previous studies had shown that most unit trust outperformed benchmark Kuala Lumpur Composite Index. The returns calculated were "NAV Returns" and not "Actual Returns" average investors received by investing in unit trust. The Effective Cost of Investing had never been taken into consideration on the returns calculations.

The main objective of this study is to use a straightforward approach to evaluate the quantum of investment costs, and how these costs affect the performance of unit trust funds in Malaysia. Hence, whether actively managed unit trust funds in Malaysia after deducting investment costs, outperformed the benchmark Kuala Lumpur Composite Index.

This study will also try to determine whether the age of the funds will have an impact on the fund's performance. This finding will be beneficial to the industry to determine whether it is worth to take the risk in investing in newly launched funds that do not have any track record. The general impression is new funds would be able to generate better returns. Most investing public still associates newly launched fund with Initial Public Offer (IPO) of a company's shares. That is the reason why Unit Trust Management Company launched new funds to increase assets under their management. The competition objective is to gather as much asset as possible during the launching period. After the launch, the growth of the fund will be rather slow, unless the fund wins some awards or prizes.

Finally, the study will also try to determine whether Malaysian investors can benefit from chasing after the previous year's best performing fund, and whether there is persistence in performance. We will also see past performance is a good indicator of future performance. This finding is important for the investing public as they can decide whether to invest in yesterday's performer is a good strategy.

1.3 Significance of the Study

Unit trust is an important alternative investment vehicle for Malaysians. This study is specifically designed to evaluate the actual returns general investing public received as compared to the NAV returns publish by the rating company and media. The findings of this research would serve as a guide to investors on of whether it is better to invest directly in the equity market themselves by using a naïve buy-and-hold investment strategy or through the unit trusts that are managed by professional fund managers after deducting the transaction costs (load). This paper also serves to study the historical performance of the funds so that we can develop some investing rules for the investors and to identify those funds with the greatest likelihood of future success.

1.5 Limitation of the Study

This study assumed that bid (buying) price of a fund is equal to its NAV for all the 108 funds under study. This assumption might distort the result as not all funds peg their bid price to their NAV. Kang [1998] found that there were major shift in pricing policy. Before June 1997, only 38 funds peg their bid (manager's buying) price at NAV. However, as at end of November 1998, 72 out of 84 funds peg their bid price at NAV. In 1999, her study shows that, during the pre-crisis period (30 June 1997), UTMC sought to maximize profits with negative exit costs. The manager is effectively subsidizing the redemption. There are 5 funds that charge more than 10% entry cost in 1997, 11 funds in 1998 and 7 funds in 1999. Therefore, the result prior to 1996 may be distorted.

All the analysis under this study did not use the traditional performance measures like Sharpe, Treynor or Jensen Index, as this study is aimed to give general investing public in Malaysia a clearer view of the differences between the actual return they received and the published return. Therefore, the method used to calculate returns is based on Lipper's International method and the risk factors of the funds are not taken into account in calculating the returns.

1.5 Organisation of the Report

The report will consist of five chapters.

- Chapter 1 provides an introduction to the industry and the types of fees unit trust funds charge. This is followed by the objective of the research and limitation of the research.
- Chapter 2 will consist of the review of other findings and studies in the related area.
- Chapter 3 will cover the research methodology.
- Chapter 4 will provide the result of the findings and compare with other researches done earlier.
- Chapter 5 will be the conclusion and recommendation for future research.