CHAPTER 2
LITERATURE REVIEW

2.3 Review Of Relevant Literature on fees – other countries

In other countries, many researches were carried out on the performance of mutual funds. The first person who conducted such studies is William Sharpe [1966]. His results showed that the average return of mutual funds is lower that the Dow Jones Industrial Index. Jesen [1968] also found that mutual funds were not able to outperform a "naïve buy and hold strategy". Besides that, Malkiel, the author of "Random Walk Down Wall Street" also found that mutual fund returns are negatively related to cost of investing. Malkiel [1995] concludes that most investors would be better off purchasing low expense funds.

The literature about performance of mutual funds is very extensive. Most studies use measures derived from the Capital Asset Pricing Model to determine the performance of a fund relative to a benchmark. Studies like Jensen [1968], Malkiel [1995], Sharp [1996], look at the deviation of the mutual funds' return from the security market line as the basis for their methodology.

To date, studies of mutual funds expenses are increasingly prevalent. Elton, Gruber, and Blake [1996] did consider the effect loads have on mutual fund performance. They found that funds that switch from no-load to load are typically underperformers. Kihn [1996] performed an analysis with loads and found that in general higher loads and distribution charges are correlated with higher levels of investor services offered (i.e., low initial purchases allowed, telephone switching, toll-free service number, etc.)

FundScope,[1997] (a mutual fund research company based in Toronto) conducted a study on 564 Canadian funds that have been on the market for 3

years or more and found that, everything else being equal, those funds with the lowest fees were most likely to outperform the market. On average, MERs for Canadian equity funds reduce the returns by 2.1% every year. FundScope also categorised funds into four different categories, equity, balanced, bond and money market, their study showed that in each of these categories, funds with higher than average MERs were likely to underperform the average. Conversely, lower MER funds perform better than the average.

Malhotra and McLeod [1997], did an empirical analysis of expenses incurred in funds. Their results showed that expense conscious investors should select older, larger, non-12b-1[1], Larger and more mature funds show lower expense ratios and no load funds, on average, had higher expense ratios than no-load funds.

Livingston and O'Neal [1998], in their study used the present value method to determine the quantum of distribution costs. They found that, distribution related fees have large effect on investor wealth and suggested that an investor should purchase the types of mutual funds that have the lowest present value of distribution costs.

Recently, in Wharton, Chalmers, Edelen and Kadlec [2000] did a study that cover trading costs. The trading costs that they focused on are spread costs and brokerage commissions. Their studies showed that trading cost are negatively related to fund returns.

[1] "12b-1" refers to a section of the SEC regulations that allows the management of a mutual fund to pay for various advertising expenditures from the assets of the mutual fund. The maximum amount allowed by SEC is 0.75% of total assets. But on average this fee does not exceed 0.25% of total assets, and many funds do not charge this fee. There is considerable controversy over these charges.

2.4 Review Of Relevant Literature on persistence performance – Other Countries

Grinblatt, Mark; Titman, Sheridan [1992], found that differences in performance between funds persist over time and that this persistence is consistent with the ability of fund managers to earn abnormal returns. Phelps and Detzel [1992] found that investing in yesterday's winning mutual funds is not a reliable strategy for being in tomorrow's winning mutual funds. The positive persistence disappears, when either the various dimensions of risk are more fully controlled or the different past period is examined.

Sirri and Tufano [1998] research showed that new cash flows from investors are related to past performance ratings. In fact, there is evidence in their research that high-rated funds experience cash inflows that are far greater in size than the cash outflows experienced by low-rated funds. Therefore, investors do believe that past good performance would repeat.

A recent study, reported in both Boston Globe and The Wall Street Journal, found that 97% of the money flowing into no-load equity funds between January and August 1995 were rated as 5 or 4 star funds by Morningstar. While funds with less than 3 stars suffered a net outflow of funds during the same period. As evidence of the importance of the Morningstar five-star rating service (where a five-star rating is the best and a one-star rating is the worst).

The heavy use of Morningstar ratings in mutual fund advertising suggests that mutual fund companies believe that investors care about Morningstar ratings. Indeed, in some cases, the only mention of return performance in the mutual fund advertisement is the Morningstar rating.

Studies done by Blake and Morey [2000], indicate findings that are robust across different samples, ages, and styles of funds, and performance measures. First, fund received low ratings from Morningstar generally indicate relatively poor future performance. Second, there is little statistical evidence

that Morningstar's highest rated funds outperform the next-to-highest and median-rated funds. Third, Morningstar ratings, at best, do only slightly better than the alternative predictors in forecasting future fund performance.

2.5 Review Of Relevant Literature – Malaysia

In Malaysia, Chua [1985], Tan [1995], Ong [2000] and Lee [2000] also conducted studies on unit trust (mutual fund) outperformance using the CAPM. Chua did a study in 1985 for a 10-year period from 1974 to 1984. His study showed that on average, the 12 unit trusts under his study provided better returns when compared to investments in risk-free assets and market portfolios.

Approximately 10 years later, Tan [1995] did an empirical study on 21 funds over a 10 year period from 1984 to 1993. In his research he found that, the unit trust performed worse that the market portfolio.

Last year, Ong [2000] did another study on 34 funds, he compared funds performance for the period before the 1997 financial crisis and post crisis. The results of his research showed that the unit trusts have been able to outperform the stock market before and during financial crisis. His studies also compared the returns on states funds and private funds; and whether fund size will affect the returns of that particular fund, however, did not touch on the age of the funds.

Lee [2000] in his study found that past performances of unit trusts in Malaysia are not consistent over time and therefore investors cannot rely on past performance as a guide for future performance. His findings also suggested that investors should choose funds, which are larger in size and exist longer in the market, as older and larger unit trusts are more secure and provide better risk-adjusted returns.

It would be interesting to find out the extend of predictability of past performance, especially those who awarded by Lipper Performance Award

Funds. Unfortunately, Morningstar did not rate the funds in Malaysia. It would be interesting to find out whether the result's would be consistence with those research done in US.

In Malaysia, the above studies did not take loads into considerations. Therefore, currently we cannot conclude whether a Malaysian investor would be better off investing in unit trust or holding market portfolio.