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Are mutual fund investors in jail?

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Abstract

The absence of investor reaction to the poor performance of mutual funds is a widely reported phenomenon. This article investigates the role of load costs as an explanation for the phenomenon and concludes that back-end load fees are an obstacle to reaction. We found evidence consistent with the hypothesis that medium and long-term investors do not react to poor performances due to the fact that they are 'imprisoned' by back-end load fees.

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Notes

[1] Despite the fact that Portugal has had mutual funds since 1986, as of March 2001 there were only 261 mutual funds, managing a total NAV of 21 390 million euros. These mutual funds were managed by a total of 19 management companies. The Portuguese market is, therefore, substantially less complex than the US market, and the respective information costs are, consequently, considerably lower.

[2] As far as we know, Hungary is the only other country in the EU that publishes portfolios (and their value) each month, but not for all mutual fund categories. In the USA, for instance, there is only quarterly portfolio and demand information.

[3] 'Domestic equity funds' are funds that invest in stocks issued by Portuguese companies. APFIN is the Portuguese association of mutual fund management companies.

[4] The inclusion of foreign stocks would mean taking into consideration the systematic risk of other countries. The importance of local factors in the calculation of the price of the risk of each one of the return generating factors is documented by Serra (2000).

[5] The mean aggregate percentage of domestic stocks in the NAV managed by the samples' funds is 82.0%.

[6] We assume that the income distribution occurs on date t. Events, such as fund mergers, are handled using the follow the money approach (Gruber, 1996). Purchases (net of sales) made by fund of funds of the same financial group were deducted from the total flow, thereby ensuring that only capital flows originating from clients outside of the fund complex is considered.

[7] NCF is used by Ippolito (1992), Sirri and Tufano (1998) and Zheng (1999), among others.

[8] We use the PSIG Index (the Euronext general Index for Euronext Lisbon) as the market returns proxy.

[9] We use the LISBOR 3-month rate (an inter-bank money rate) as a proxy for the risk-free interest rate.

[10] The HML variable measures the book-to-market effect and corresponds to the return of a portfolio that is long in high book-to-market stocks and short in low book-to-market stocks; SMB measures the size effect, and corresponds to the return of a portfolio that is long in small caps and short in big caps; WML measures the momentum effect, and is the return of a portfolio long in stock winners and short in recent losers. Due to the reduced size of the Portuguese stock market, the small markets methodology of Alves and Mendes (2004) is used in the calculation of the HML, SMB and WML factors.

[11] Financial information disclosure service of Euronext Lisbon.

[12] This is the performance of one quarter (first Q) which is compared to the capital flows of the following quarter (second Q).

[13] The Chi-square test (with and without the Yates continuity correction), the cross-product ratio and the joint repetition test of Pesaran and Timmermann (1992) were also used, but results are not reported.

[14] Moreover, the literature reports that there is no persistence of long-term returns, expense ratios and turnovers (Droms and Walker, 2001).

[15] Added to which would be the possible payment of front-end fees for a new fund.

[16] In order to save space identical tables drafted for the different time horizons and different null hypotheses are not reproduced herein.

[17] This is the case of Alpha/NCF/CR24M: the value observed for WW*B (87) exceeds the expected value (84.5) and that for WL*B (87) is lower than the respective expected value (89.5).

[18] This is the case of Alpha/NCF/CR24M, where the WL*S observed value (117) surpasses the expected value (110) and that for WL*B (97) is lower than the expected value (104).

[19] Alpha/NCF/CR24M, once again, behaves according to the ‘entrenchment’ hypothesis.

[20] The hypothesis that demand is steered by liquidity concerns implies a relationship between the observed values and the expected values which is the opposite of the ‘entrenchment’ hypothesis. Under these circumstances, it would be expected that funds with lower fees are favoured (in terms of demand) in each performance category.

[21] In spite of the existence of fund families, the possibility to switch across different funds belonging to the same family at no (or negligible) costs is virtually inexistent. In fact, there were transaction costs in Portugal, and these dissuade mutual fund investors from transferring their money from one member of the family to another member. Additionally, inside each family, the domestic equity funds were managed independently from the other equity funds investing in foreign stocks. We must also note that, given the small size of the Portuguese stock market, there are no differences of style (vg, growth vs. value) between these funds. They are simply advertised as mutual funds that invest in Portuguese stocks. Thus, fund families and investment styles cannot be considered relevant explanatory variables.

[22] Sirri and Tufano (1998), for instance, assess the reputation of each fund and each fund complex using the lagged logarithm of the total amount of managed assets. The underlying idea is that the largest fund complexes have greater visibility and therefore investors will preferentially opt, minimizing the costs of obtaining information, for the larger funds and fund complexes. On the other hand, Zera and Madura (2001) report that bigger funds exhibit higher operational efficiency (lower expense percentages). The need to include both the size of each fund as well as the size of the management company is based on the fact that the largest companies usually possess more than one equity fund, so it is important to distinguish the reputation of the fund from the reputation of the company managing it.

[23] Caporale and Nikolaos (2004) evidence dynamic interactions between mutual fund flows and security returns in the Greek market, and found that momentum trading is the most plausible explanation for dynamic feedbacks.

[24] We report results for the NCF dummy variable, the CR3M and CR60M redemption periods, and performance measured by the alpha coefficient of the Carhart's (1997) model. Results for the other redemption periods, the CF and CR variables were very similar and are not reported. Likewise, we have included fund- and year-specific dummies and the results were essentially unchanged.

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