

Jan Harkopf

Investment Criteria for Mutual Fund Selection



Anchor Academic Publishing

disseminate knowledge

Harkopf, Jan: Investment Criteria for Mutual Fund Selection, Hamburg, Anchor Academic Publishing 2016

Buch-ISBN: 978-3-96067-076-6

PDF-eBook-ISBN: 978-3-96067-576-1

Druck/Herstellung: Anchor Academic Publishing, Hamburg, 2016

Bibliografische Information der Deutschen Nationalbibliothek:

Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.d-nb.de> abrufbar.

Bibliographical Information of the German National Library:

The German National Library lists this publication in the German National Bibliography. Detailed bibliographic data can be found at: <http://dnb.d-nb.de>

All rights reserved. This publication may not be reproduced, stored in a retrieval system or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publishers.

Das Werk einschließlich aller seiner Teile ist urheberrechtlich geschützt. Jede Verwertung außerhalb der Grenzen des Urheberrechtsgesetzes ist ohne Zustimmung des Verlages unzulässig und strafbar. Dies gilt insbesondere für Vervielfältigungen, Übersetzungen, Mikroverfilmungen und die Einspeicherung und Bearbeitung in elektronischen Systemen.

Die Wiedergabe von Gebrauchsnamen, Handelsnamen, Warenbezeichnungen usw. in diesem Werk berechtigt auch ohne besondere Kennzeichnung nicht zu der Annahme, dass solche Namen im Sinne der Warenzeichen- und Markenschutz-Gesetzgebung als frei zu betrachten wären und daher von jedermann benutzt werden dürften.

Die Informationen in diesem Werk wurden mit Sorgfalt erarbeitet. Dennoch können Fehler nicht vollständig ausgeschlossen werden und die Diplomica Verlag GmbH, die Autoren oder Übersetzer übernehmen keine juristische Verantwortung oder irgendeine Haftung für evtl. verbliebene fehlerhafte Angaben und deren Folgen.

Alle Rechte vorbehalten

© Anchor Academic Publishing, Imprint der Diplomica Verlag GmbH
Hermannstal 119k, 22119 Hamburg
<http://www.diplomica-verlag.de>, Hamburg 2016
Printed in Germany

Contents

Abbreviations.....	III
Symbols.....	IV
Figures.....	V
1 Introduction.....	1
1.1 Investments in Mutual Funds	1
1.2 Remarks and Structure of the Study	3
2 Mutual Funds	4
2.1 Mutual Fund Basics	4
2.1.1 Overview and Economies	4
2.1.2 Advantages and Disadvantages of Mutual Funds	6
2.2 Mutual Fund Functionality.....	7
2.3 Mutual Fund Ratings.....	9
2.3.1 Basics of Mutual Fund Ratings	9
2.3.2 The Star Rating.....	9
3 Mutual Fund Performance	11
3.1 What is Important about Mutual Fund Performance	11
3.2 Active Investments	11
3.2.1 Why Using Active Strategies?	11
3.2.2 Skill in the Mutual Fund Industry.....	12
3.3 Persistence in Mutual Fund Performance and Mutual Fund Ratings	15
3.4 Mutual Fund Flows and Determinants.....	18
3.4.1 A Brief Overview	18
3.4.2 Mutual Fund Flows and Ratings.....	19
3.4.3 Investors and Mutual Fund Flows	20
4 Determinants and Mutual Fund Performance and (Potential) Problems.....	22
4.1 Why Decomposing Fund Performance	22
4.2 Mutual Fund Fees and Expenses	23
4.2.1 A Brief Overview	23
4.2.2 Multiple Share Classes and Fees	24
4.2.3 Corporate Elements and Fees	26
4.3 Board and Management Linked Parameters	27
4.3.1 A Brief Overview	27
4.3.2 Linkages between the Fund Board and the Management	28

4.3.3	The Structure of Fund Management	29
4.3.4	Mutual Fund Manager’s Characteristics	32
4.4	Exits in Mutual Funds	34
4.5	Bank Affiliation.....	36
4.5.1	A Brief Overview	36
4.5.2	Affiliation to Investment Banks	37
4.5.3	Credit Bank Affiliation and General Conflicts with Bank Affiliation	38
4.6	Corporate Elements and Performance	39
4.6.1	A Brief Overview	39
4.6.2	Morningstar Stewardship Rating	40
4.6.3	The Influence of Fund Governance on Mutual Fund Holdings	41
4.6.4	Linkages of the Morningstar Stewardship Rating to Mutual Fund Pattern.....	42
4.7	The Active Share of Mutual Funds.....	45
4.8	Incentives in Mutual Funds	49
4.8.1	A Brief Overview	49
4.8.2	Fees and the Manager Compensation Schemes	49
4.8.3	Holdings of Mutual Fund Managers and Board Members	51
4.8.4	Mutual Funds and Window Dressing	53
4.8.5	Return Transfers in Mutual Fund Families	54
4.8.6	Side-by-Side Management of Mutual Funds and Hedge Funds.....	55
4.8.7	A behavior perspective on Incentives	56
4.9	A Cross-sectional View on Hedge Funds	57
5	Mutual Fund Selection	59
5.1	What Investors Really Do? – Is Such a Behavior Rational?.....	59
5.2	Alternative Criteria in the Mutual Fund Selection	61
5.2.1	The Purpose and Functionality of Alternative Criteria.....	61
5.2.2	The Fee and Expense Ratio.....	61
5.2.3	The Active Share of Mutual fund Portfolios	62
5.2.4	Governance Linked Criteria.....	62
5.2.5	Selecting a Mutual Fund	63
6	Conclusion	64
7	References.....	66

Abbreviations

APM	Adverse price movement
AuM	Assets under management
BaFin	<i>(Bundesanstalt für Finanzdienstleistungsaufsicht)</i> Federal Financial Supervisory Authority
ETF	Exchange traded fund
IPO	Initial public offering
MBA	Master business administration
SAT	Scholastic assessment test
SEC	Security and Exchange Commission
SEO	Seasoned equity offerings
UK	United Kingdom
US	United States
USA	United States of America

Symbols

α_{fund}	(Alpha) Outperformance of mutual fund to the benchmark index
β_{fund}	(Beta) Mutual fund sensibility of co movement to the benchmark index
$\varepsilon_{fund,t}$	(Epsilon) Error term of regression
$R_{f,t}$	Return on a risk free security
$R_{fund,t}$	Return on a mutual fund
$R_{index,t}$	Return on a benchmark index
$w_{fund,i}$	Weights of asset i in the fund
$w_{index,i}$	Weights of asset i in the benchmark index

Figures

Illustration 1: Weights of the Morningstar rating.	10
Illustration 2: Different types of active and passive management.....	46

1 Introduction

1.1 Investments in Mutual Funds

The assets under management (AuM) invested in mutual funds worldwide amount to \$26.8 trillion at the end of 2012. Approximately 50% of these assets are invested in the United States (US), followed by Europe with 30%.¹ The importance of mutual funds for individual investors in general has increased in recent decades. This becomes apparent when looking at the increased share of households owning mutual funds within individual retirement plans and defined contribution plans. Younger households in the US tend also to participate stronger in mutual funds,² which implies that these retail investors are holding investments over longer periods and might even have larger invested stakes in mutual funds. I assume this pattern to apply to the European market, as well. In Germany, over 50% of assets in mutual funds are held by individual investors at the end of 2008. This number has decreased from around 70% in 2005.³ I further assume that this decrease is a consequence of the financial crisis, since individual investors are more likely to follow a general market climate than investing when markets are down.⁴

The main purpose of mutual fund investors is usually receiving a return which is above or at least close to the mutual fund's benchmark.⁵ Consequently investors want to identify and invest in those mutual funds which show these patterns in the future. Some mutual funds get much on attention since they generate extraordinary high performance; examples for these mutual funds are the Fidelity Magellan fund or the Schroder Ultra Fund. The last mentioned fund yields a performance of 107% annually in the time period of 1999 to 2001.⁶ But the question when looking at these mutual funds is: Is it possible to predict such performance before funds exhibit such outstanding performance? Recent studies outlined in foot note 7 below showed strong doubts whether this is possible, since mutual fund performance, at least in the short run, is rather a random walk than a result of managerial skill.⁷ Academics go even further while stating that active managed mutual funds on average underperform their

¹ Cf. ICI Factbook (2013) p. 25.

² Cf. ICI Factbook (2013) p.116.

³ Cf. Jank (2010) p. 8.

⁴ Cf. Celati (2004) p. 66.

⁵ Cf. Barras/Scaillet/Wermers (2010) p. 183.

⁶ Cf. Kosowski, et al. (2006) p. 2551.

⁷ Cf. Barras/Scaillet/Wermers (2010) p. 180; Fama/French (2010) p. 1916; Kosowski, et al. (2006) p. 2554.