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Out of sight, not out of mind: The evidence from Taiwan mutual funds[☆]

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ABSTRACT

This paper extends the current literatures on the relation between fund expenses and fund flows using data from Taiwan. Our findings for the Taiwan market differ from previous studies on the U.S. market. Specifically, we find no support for the notion of “out of sight, out of mind”. For Taiwan mutual funds, net flows and inflows are negatively related to operating expenses but not front-end loads. The discrepancy between our results and those reported for the U.S. market may be attributed to the fee structure in Taiwan, where operating expenses are much higher than front-end loads and seem to have a bigger impact on fund performance. The negative relation between net flows (inflows) and operating expenses is more pronounced for funds with high institutional investor participation and funds charging high operating expenses. However, investor types show no significant impact on the relations between front-end loads and various measures of fund flows.

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1. Introduction

The two major components of mutual fund expenses are front-end loads and operating expenses. Front-end loads are paid directly when a fund is purchased, and operating expenses are paid indirectly through reduced earning distributions by the fund. Although prior research has shown that mutual fund expenses affect fund returns (e.g. Livingston & O’Neal, 1998; Wilcox, 2003), few studies have examined the relative impact of front-end loads and operating expenses on mutual fund performance and, only recently, on net fund flows. Barber, Odean, and Zheng (2005) examined U.S. mutual funds and reported significant and negative relations between front-end loads and net fund flows but mixed results on the relation between operating expenses and net fund flows. Barber et al. (2005) suggested that investors are more sensitive to front-end loads than to operating expenses because of the conspicuous nature of front-end loads’ costs. Conversely, investors are less responsive to operating expenses because the costs are less salient and drawn over a longer time period. In contrast to Barber et al. (2005), Ivkovic and Weisbenner (2009) found a positive relation between fund flows and operating expenses. They attributed the positive relation to the marketing and signaling effects of operating expenses. In addition, they reported a negative relation between fund outflows and front-end loads.

We extend the current literatures on the relation between fund expenses and fund flows in several aspects. First, we revisit the relation between front-end loads/operating expenses and net fund flows using data from an emerging market, Taiwan. Several studies

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examine the fee structure of mutual funds internationally and find a significant variation across countries. However, none of these studies address the relation between fund flows and fund expenses. For example, [Khorana, Servaes, and Tufano \(2009\)](#) investigated factors that explain cross-country difference in fund fees, and [Ferreira and Ramos \(2009\)](#) provided international evidence on mutual fund industry competition and concentration. To enhance our understanding of the relation between mutual fund flows and fund expenses, we investigate whether the findings for the U.S. mutual funds market can be generalized to a market with a different fee structure. The Taiwan market is an important market in Asia and its fee structure is largely different from the U.S. fee structure. Namely, the difference between front-end loads and operating expenses is larger in Taiwan than in the United States. This variation allows us to examine whether the composition of mutual fees affects the fund flow–expense relation. In other words, we investigate whether the notion of “out of sight, out of mind” holds for Taiwan mutual funds.

Second, we disentangle the impact of mutual fund expenses on inflows (purchases) and outflows (sells) and examine whether the notion of “out of sight, out of mind” holds for both. [Ivkovic and Weisbenner \(2009\)](#) pointed out that aggregating inflows and outflows into net flows may cause a loss of important information and detailed insights. In addition, [Keswani and Stolin \(2008\)](#) showed that the smart money effect in the United Kingdom is caused by investors' buy decisions but not by sell decisions.¹ In general, sell decisions are not optimally made based on psychological or liquidity factors. Therefore, investors' responsiveness to mutual fund expenses may not be the same for buy and sell decisions.

Third, we consider the potential impact of investor types on the relation between mutual fund expenses and fund flows. Because institutional investors and individual investors are inherently different, the two investor types may respond differently to various components of fund expenses. For example, if institutional investors are more knowledgeable or smarter than individual investors, they may not eschew front-end loads despite their more salient nature, given that the negative impact of front-end loads on performance diminishes as the investment horizon increases. Moreover, because institutional investors tend to have a longer investment horizon than individual investors, they may be more prone to seeing the longer term cost benefits of front-end loads. Past studies on expense–fund flow relation do not distinguish between institutional and individual investors explicitly. Our Taiwan data allow us to fill this void in the literature by examining whether the degrees of participation by institutional investors affect the relation between fund flows and expenses.

Our findings for the Taiwan market differ from previous studies on the U.S. market. Specifically, we find no support for the notion of “out of sight, out of mind”. For Taiwan mutual funds, net inflows and inflows are negatively related to operating expenses but not front-end loads. Outflows are not significantly related to operating expenses when they are measured in absolute term rather than as a percentage of total net assets. The relation between front-end loads and fund flows is either insignificant or positive. Thus, we find that even though front-end loads are more salient than operating expenses, they are less of a concern to investors in Taiwan. The negative relation between operating expenses and fund flows is also inconsistent with [Ivkovic and Weisbenner's \(2009\)](#) finding using U.S. data that higher expenses either attract inflows through advertising or reflect better management quality. The discrepancy between our results and those reported for the U.S. market may be attributed to the fee structure in Taiwan, where operating expenses are much higher than front-end loads and seem to have a bigger impact on fund performance.

We find that investor types affect the relation between net flows (inflows) and operating expenses but not the relation between outflows and operating expenses. Specifically, the negative relation between inflows and operating expenses is more pronounced for funds with high institutional investor participation and funds with high operating expenses. However, investor types show no significant impact on the relations between front-end loads and various measures of fund flows.

The remainder of the paper is organized as follows. [Section 2](#) reviews some related research on mutual funds fees. [Section 3](#) outlines our hypotheses. [Section 4](#) presents the data and research method. [Section 5](#) reports and analyzes the empirical results, [Section 6](#) tests the robustness of our main results with respect to a different measure of fund flows and a different methodology, and [Section 7](#) provides our closing remarks.

2. Previous research

2.1. The effects of expenses on mutual fund flows

Relative to studies on the relation between fund fees and performance, only a few studies have examined the relation between fund fees and fund flows. [Sirri and Tufano \(1998\)](#) used data supplied by a private data vendor to examine net flows of U.S. equity mutual funds between December 1971 and December 1990. They found that consumers are fee sensitive. Funds with higher fees tend to grow slower than funds with lower fees.

[Barber et al. \(2005\)](#) used data from CRSP's mutual fund database for the period from 1970 to 1999 and trade data from 1991 to 1996 supplied by a nationwide discount broker to study the effects of expenses on equity fund flows. They decomposed total expenses into front-end loads and operating expenses and consistently found a negative relation between net flows and front-end loads. In contrast, they found no relation or a perverse positive relation between operating expenses and net flows. They concluded that investors learn by experience and that they learn more quickly about front-end loads than less salient operating expenses.

[Ivkovic and Weisbenner \(2009\)](#) examined the determinants of investor propensity to redeem fund shares and the determinants of fund flows. They found a strong relation between net flows and operating expenses. They showed that net fund flows, inflows, and outflows are all positively related to expense ratios, with more profound relations for inflows. The positive relation between inflows and expense ratios implies that larger expense ratios may reflect better management quality, which would induce higher demand.

¹ The smart money hypothesis states that investor money is smart enough to flow to funds that will outperform in the future; that is, investors can identify super mutual funds.

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