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New evidence on the impact of fees on mutual fund performance of two types of funds☆

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ABSTRACT

The impact of fees on mutual fund performance has received little research attention as is also the cases of performance differences of two classes of funds, one the common mutual funds and the other mutual funds with strict compliance with filters based on a number of binding restrictions as in Islamic mutual funds. After confirming the average returns over 20 years against the market benchmark of *equity* only funds, this paper reports significant reductions due to fees. The publicly reported performance of substantial returns to investors is whittled away to a small return once the different fees charged by funds are factored in. Another significant finding is that the evidence in prior research in support of market timing ability of funds disappears once the econometric problems of the methodology in prior research are addressed by using panel regression method. We believe that these two findings add new insights on the impact of different fees on returns to investors and further help to highlight the need to address methodological problems in mutual fund studies.
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1. Introduction

This paper addresses two policy-relevant research questions on fees and mutual fund managers' market timing ability. These issues have sprung to attention in recent years because of the investors' anxiety about reduced returns since the impact on investors' returns due to the 2007–2008 Global financial crises (GFC). Therefore, a carefully-constructed research is warranted, which prompted this paper to address the market-timing ability of mutual fund managers as the reason for charging fees and also to measure the fee-adjusted returns to investors. In recent years, mutual fund investors have begun, as have also the regulators, to raise objections to the fees charged by mutual fund industry despite the revelations of poor management skills of mutual funds[1]. The significantly worse fund performance relative to the markets during 2007–2011 reporting period after the GFC also prompted investors to monitor funds more closely. The regulators have taken the cue from disappointed investors and have begun to re-examine the role of different fees on what investors get as returns from the investment industry.

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[1] It can be shown very easily that a fund charging a fee of about 2% each year on the net asset value of a fund account will reduce the total returns to investors by about 10% over a 20-year period. This difference is significant value lost by the fund investors. Australia has passed new legislated restrictions from 2013 related to fees in superannuation funds.

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A related issue that comes to attention is the often-quoted evidence in finance literature that fund managers have unique market timing ability, so their professional service has value for which the fees are justifiable. However, the research literature on market timing is quite mixed. In the US, Henriksson (1984) adopts parametric and non-parametric tests on 116 mutual funds and finds there is no evidence that fund managers can perform successfully on market timing over the period 1968 to 1980. However, Lehmann and Modest (1987) evaluate 130 mutual funds (also in the US) based on time series regression model, and find significant abnormal market timing and selectivity performance abilities among some fund managers during the period January 1968 to December 1982. Moreover, Lee and Rahman (1990) denote evidence of positive selection abilities and superior market timing skill among fund managers at the individual funds level. Lee and Rahman detect selection ability and market timing ability of a mutual fund manager based on monthly returns over 87 months from January 1977 to March 1984 for a sample of 93 US mutual funds. They find that ten funds have both significant selection and timing skills. Four funds have significant selection skill with no timing skill while five funds have significant timing skill with no selection skill.

The methodology used in the papers evidencing fund managers' market timing ability has some serious econometric issues. Most of the studies used OLS methodology despite the data being a matrix relating to time series observations on selected mutual funds from the industry. Such a methodology, given what we know today of violations of assumptions of independent variables, stationarity of variables, equi- and serial correlation problem (see Bhatti, 2012), would render the evidence supporting market timing ability suspect. Thus, a second research problem we address in this paper is to adopt the latest methodology via panel data analysis that could remove some of the potential errors from the prior methods used to reveal market timing ability of fund managers. Finally, prior studies of mutual funds in the Kuala Lumpur stock market did not choose equity-only funds to measure their performance, and hence the use of stock market benchmark in such studies is an error. In this research only the equity funds of (i) Conventional mutual funds and (ii) Islamic mutual funds are matched so as to better compare like for like: The mutual funds under (ii) do not have non-equity securities.

This paper is organised as follows. Section 1 is an introduction while Section 2 introduces the reader to economy in which this study is done. The previous relevant literatures are discussed in Section 3. The methodology is expanded in Section 4 while the results are presented in Section 5. A summary follows in Section 6.

2. Background to the mutual funds studied

2.1. Ethics-filtered funds

Mutual funds have been around for several centuries. Socially responsible investment (SRI) mutual funds became popular in the 1960s and 1970s in the United States (US). However its growth was slow resulting in some 55 funds in the US managing assets worth US$ 12 billion. As of 2014, the market for socially responsible fund (SRF) has grown substantially: there are 493 funds managing a reported US$ 6.57 trillions. The growth has come from what were previously ordinary funds switching to rename themselves a SRFs by adopting some set of filters in the selection of the securities to be included in the managed funds. Obviously, the market operators have reacted to the investors' awareness of the importance of issues connected to (i) well-being of people, (ii) survival of the planet while curtailing greed for profits at the expense of people and planet. A new slogan has begun to be used PPP-friendly funds to mean friendliness to people, planet and profits.

At the core of this movement, the mutual fund firms are accepting is a set of filters as dictated by the constitution/rules of the funds. These filters have been named as: avoidance of exploitation of labour, prostitution, gambling, weapons of mass destruction, etc. These filters are required to select permissible investable securities so that a SRI fund would not invest investors' cash in securities issued by a weapon manufacturer, a prostitution company, etc.

Islamic mutual funds (IMFs) industry started around mid-1980s. Today, another class of "ethics-filter-based" mutual funds have grown across the world with filters based on faith and religious based funds. It has been a principal concern of these proponents of Islamic finance, which has similar concerns about people, planet and profits. For example, IMFs have filters (such as prostitution, gambling, dealing in intoxicants, dealing with exploitative interest charges, extremely risky securities resembling a gambling bet based short selling's) that are used to select permissible securities to be included in Islamic equity funds. Both the common type Conventional mutual funds (CMFs) and IMFs operate under similar trading conditions, although the design of the funds is based on different sets of regulations. This market has grown very large in Malaysia and that is the reason, this market was chosen for this study.

We are going to use a new term ethics-filtered mutual funds to describe the new phenomenon of requiring social concerns to be embedded as filters in the selection of securities to invest investors' wealth. This paper is about Islamic equity funds (IEFs) as ethics-filtered funds just as the SRIs are also ethics-filtered funds mostly in developed economies. There are no such funds in Malaysia.

There is a unique opportunity to examine the behaviour of such funds in an economy where ethics-filtered funds, the so-called religious funds, i.e. the IEFs operate side by side with the normal funds not subjected to special ethical concerns of the IEFs. Besides, the fees charged in this market are also high, given the fact that the mutual funds market is still developing rapidly. By examining two types of funds managed in the same environment would reveal results comparable to a controlled experiment, so this may provide very useful information about (i) Conventional equity funds (CEFs) and (ii) IEFs. Also, in the case of the Islamic funds, there is the policy relevant research question of whether an investor's choice to choose an ethics-filtered fund has a potential to lower returns. Hence this study aims to examine the comparative performance of two

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