



## Article

Evidence from purchases and redemptions in the Spanish equity fund market<sup>☆</sup>M<sup>a</sup> Isabel Cambón<sup>\*,1</sup>, Ramiro Losada<sup>1</sup>

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## ABSTRACT

The potential relationship between fund flows and performance is a remarkable topic in the mutual fund industry that has been explored by many empirical academic papers. In this work, it is shown that investors in Spanish equity funds respond to past good performance by increasing their (net) purchases, and to past poor performance by reducing their (net) purchases. However, the relationship between flows and performance appears to be non-linear. This non-linearity is different from the one observed in most of the previous research papers. These papers did not find any response to poor performance. Net purchases, purchases and redemptions are analysed separately and, as a new feature, the retail and wholesale markets of mutual funds are addressed. The comparison of the two markets reveals some interesting differences on the determinants of the financial decisions regarding purchasing or selling shares of equity funds. It was also found that investor sensitivity to poor performance is reduced in the case of more visible funds. This puzzling result, which originates in the retail segment, could be explained in terms of the market power of fund families.

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## 1. Introduction

The mutual fund industry is important in Spain in terms of the volume of assets under management and the number of investors who participate in the industry. At the end of 2012, according to the Spanish National Accounts, mutual funds represented 5.9% of total household wealth. According to the CNMV, in July 2013, the total assets of mutual funds under management amounted to 140,598 million euros and the number of investors totalled more than 4.7 million. Thus, one important area of research is related to the decision-making process that investors undertake when considering purchasing or selling fund shares. Hence, the aim of this paper is to shed light on the determinants of investors' financial decisions in the mutual fund industry in Spain. Throughout the paper, two main assumptions regarding investor behaviour are going to be the drivers of the analysis. Firstly, investors learn about managerial

ability from the performance of the fund. Secondly, investors face participation costs when they invest in mutual funds.

Numerous authors have investigated this issue empirically for the U.S. market. Regarding the first main assumption of this paper, the results of these studies suggest that both redemption and purchase decisions are influenced by prior performance. Earlier papers, such as Ippolito (1992), Gruber (1996), Sirri and Tufano (1998), Goetzman and Peles (1997), Chevallier and Ellison (1997) and Guercio and Tkac (2002), and more recent papers, such as Huang et al. (2007), Khorana and Servaes (2004), and Nanda et al. (2004) show a non-linear relationship between net purchases and performance of mutual funds. They found that investors made positive net purchases when a fund registered a good performance but they fail to react to poor performing funds as these funds only register low negative net purchases. These authors presented different explanations for the investors' failure to respond to poor performing funds. They argued that investors, especially unsophisticated investors, face frictions that prevent them from withdrawing their money from poor performing funds. Among those frictions, the authors mainly highlighted advice from brokers who discourage redemptions and the investors' aversion to realising losses.

Hence there is a well-documented asymmetric relationship between net subscriptions of mutual funds and past performance. In the literature, there are some studies describing this issue by means of theoretical models. The Berk and Green's (2004) seminal theoretical paper relates fund flows with past performance.

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In this paper, it is assumed that past performance is a good signal of the fund managers' abilities. So, investors can update their belief about the fund manager's abilities through Bayes' rule, while each time a fund's performance is known.<sup>2</sup> This paper also makes several assumptions with respect to investors' behaviour and fund markets that shape a frictionless environment. Thus, the authors prove that investors chase past performance. Whenever a fund has performed very well, it would receive positive net purchases and whenever a fund has performed poorly, it would show negative net purchases. In principle, the authors assert that poorly performing funds would register a large volume of redemptions and a very small volume of purchases. The opposite would arise for funds with a good performance. It is worth noting that this model fails to predict absence of reaction to medium and poorly performing funds as no participation costs are assumed.

Two subsequent papers, [Huang et al. \(2007\)](#) and [Dumitrescu and Gil-Bazo \(2013\)](#) presented extensions of the paper by [Berk and Green \(2004\)](#). [Huang et al. \(2007\)](#) incorporated frictions into the model with the intention of bringing results closer to the empirical evidence. They assume that investors enjoy different levels of information about mutual funds due to different skills to process information and the mutual fund families' effort to make their funds visible. They also assume that investors face monitoring and transaction costs. They showed that these new assumptions make investors to purchase a lower number of funds. This would be the reason why investors only concentrate their purchases in the best performing funds. They labelled this result as 'the winner-picking effect'. So, these authors provided a different explanation to why investors behave asymmetrically and investors' net subscriptions register an amount much lower in medium and poorly performing funds than the positive net purchases from the best performing funds. According to these authors, the asymmetry comes from investor overreaction to purchase instead of a lack of response to poor performance.

In the same vein, [Dumitrescu and Gil-Bazo \(2013\)](#) assume a mutual fund market where there are two types of investors: naïve (retail investors) and sophisticated (wholesale investors). Both types of investors face different searching costs that reflect their ability to find an adequate fund and they may also be financially constrained. In addition, part of the investors is incumbent whereas others may want to participate as new entrants. These potential investors have to pay a sunk cost if they want to invest in mutual funds. Under these assumptions, the authors also find a non-linear relationship between fund flows and performance. At the same time, they prove that due to these market frictions there are funds whose performances exhibit a higher persistence.

All these papers contribute to understanding investor behaviour when they decide to participate in the mutual fund market. However, they are concentrated in only explaining mutual fund net purchases. They do not further explore the possible information that may be separately embedded in purchases and redemptions, even though the decision to purchase a mutual fund potentially differs from the decision to withdraw money from a mutual fund. In order to close this gap, literature on the determinants of purchases and redemptions in the mutual fund industry has been developed. Although this literature is still relatively scarce ([Bergstresser and Poterba, 2002](#); [O'Neal, 2004](#); [Cashman et al., 2006](#); [Johnson, 2007](#); [Ivkovic and Weisbenner, 2009](#); [Jank and Wedow, 2010](#)), it offers interesting results on the determinants of mutual fund purchases and redemptions. Some of these papers, [Bergstresser and Poterba \(2002\)](#), [Johnson \(2007\)](#) and [Ivkovic and Weisbenner \(2009\)](#)

also failed to find a relationship between poor performance and redemptions.<sup>3</sup> However, the other three papers do obtain evidence that investors from the worst performing funds punish these funds by increasing redemptions. The major criticism of the former group of papers is that they examine non-random samples which may not be representative of the mutual fund universe.<sup>4</sup>

[Cashman et al. \(2006\)](#), one of the papers mentioned above, showed that mutual fund investors withdraw more from poorly performing funds, while they withdraw less from better performing funds. Although, there are responses to both the best and worst performing funds, the response is asymmetric. Redemptions increase more with poorly performing than they decrease in the case of the best performing funds. They also find that purchases respond to the worst and best performing funds. Previous research suggested that purchases were only sensitive to the best performing funds and not the worst performing funds. As for redemptions, purchase responses are asymmetric. The growth in purchases from the best performing funds is greater than from worst performing funds. [Jank and Wedow \(2010\)](#) found the same results as [Cashman et al. \(2006\)](#) regarding fund flows with one exception. They obtained evidence that redemptions increase with respect to performance for the best performing funds. In some of these funds, investors cash in their gains. This behaviour is known in the financial literature as the "disposition effect".

Regarding the importance of the second main assumption of this paper – the existence of participation costs in the mutual fund market – [Capon et al. \(1996\)](#) pointed out that it is inadequate to consider fund performance as the only explanatory variable for mutual fund investment decisions.<sup>5</sup> Several papers on this literature also analysed the role of participation costs in this type of market.<sup>6</sup> In principle, three measures are used to proxy participation costs: fund fees, the market share of fund families and the number of funds offered by the fund family. Authors found that fund families with a high market share are very often the ones which make their funds' characteristics more visible to investors. Somehow, their consumers are investors whose participation costs are lower. At the same time, these fund families are also usually the ones which charge higher fees and supply a higher number of funds to the market.

For example, [Sirri and Tufano \(1998\)](#) and [Huang et al. \(2007\)](#) showed the importance of taking participation costs into account into the analysis. They found evidence that participation costs lead to different net purchase levels. Given a level of performance, funds from the bigger families enjoy a much stronger net subscription response to performance than their rivals do. This issue was extended to purchases and redemptions by [Cashman et al. \(2006\)](#) and [Jank and Wedow \(2010\)](#). The former paper found no relationship between purchase flows and participation costs. Instead, the later paper showed that due to the higher visibility, funds from larger families exhibit higher purchases and redemptions.

<sup>3</sup> [Jank and Wedow \(2010\)](#) is the only paper mentioned in this paragraph which studies a dataset composed of mutual funds from outside the US market. These authors examine a database composed of mutual funds from the German market.

<sup>4</sup> [Bergstresser and Poterba \(2002\)](#) study the 200 largest mutual funds. [Johnson \(2007\)](#) studies fewer funds, all from a single no-load fund family. [Ivkovic and Weisbenner \(2009\)](#) only examine the trading behaviour of retail investors within a single discount brokerage.

<sup>5</sup> The importance of this assumption also appears in the 1990 Consumer Report survey of mutual fund investors published by the Bureau of Labor Statistics of the United States. Although performance was rated as the most important overall factor, several additional factors could be also relevant: amount of sales charge, management fees or type of fund family. These factors could be considered as proxies for participation costs in the mutual fund industry.

<sup>6</sup> [Sirri and Tufano \(1998\)](#), [Huang et al. \(2007\)](#), [Cashman et al. \(2006\)](#), [Guercio and Tkac \(2002\)](#), [Khorana and Servaes \(2004\)](#), [Nanda et al. \(2004\)](#), [Goetzman and Peles \(1997\)](#) and [Elton et al. \(2004\)](#).

<sup>2</sup> Bayes' rule links the degree of belief in a proposition (in this case, the manager's ability to pick assets which perform well for the funds under his management) before and after accounting for evidence (in this case, past performance).

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