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Do Mutual Funds Have Impact on Capital Market? (A case of Pakistan)

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ABSTRACT

The aim of conducting this research is to find out the impact of mutual funds, role of mutual funds on capital markets of Pakistan, Conventional Vs Islamic. In this paper we add several new perspectives to the growing body of empirical evidence on the investment performance of mutual funds. Risk-adjusted and unadjusted investment returns are not related to whether a fund is load or no-load, and asset size, expense ratios, and turnover rates are not related to investment performance. We find no reward for paying a load fee when investing in mutual funds. The majority of these research studies evaluate the performance of the funds according to classic measures, whereby different financial markets, in different countries for different periods of time serve as reference for evaluation. The ultimate conclusion of all of these studies is that there are no significant differences between the performance results of one type of funds and the other, on the other hand this study finds out the factors effecting the investment in mutual funds and measures the performance of mutual funds in capital markets through the models which are used worldwide to evaluate the performance, investment tendency in the area of mutual funds through portfolio (Risk-Return) Sharpe Measure and Treynor Measure. This research shows the relationship of Risk-Return characteristics either individual or institutional investor. The fact that more money is invested in active than passive funds despite the superior historical performance of the latter is "prima facie" evidence that most investors believe that some mutual fund managers have the ability to consistently beat the market. Explore the method of best point for investment through precise the risk and enhance the investment using some techniques which shows the favorable results for investments. Conduct this research we make the best point, which is much easier to take better decision for investment in capital market either sell or buy.

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Introduction

Many individual investors make their first entrance into the universe of "real money" investing capital via mutual fund. Mutual funds are the popular investment vehicles for both the small and large investor. The first mutual fund was founded in 1924 by the "Massachusetts Investors Trust" A mutual fund is an existing portfolio of assets into which someone may invest directly, which play a vital role in capital market. Mutual funds are technically called investment companies. Mutual fund is a professionally managed type of collective investment scheme that pools of capital from many investors and invests it in stock, bonds, short-term, long-term investment, capital market instruments etc. by the end of 1997 there were 9,400 mutual funds in the United States, with assets totaling \$4.49 trillion (including the close-end companies). This is a 25 percent increase since the end of 1996, which improve the investment which reflect in open market or capital market. These are continuously extend their implication so, from 1991 to 1997 in the U.S, the value of corporate equities held by mutual funds increased ten-fold, from \$309 billion in 1991 to \$4.49 trillion in 1997. In contrast, direct ownership of common stock increased only three-fold during the same period, from \$2.6 trillion to \$7.8 trillion. In 1991, 6.4 percent of common stocks were held indirectly through mutual funds; in 1999, that figure had grown to 18 percent. In 1999, nearly half of all U.S. households owned a mutual fund. Given the size and growing importance of mutual fund investors, it is important to gain a better understanding of their behavior. The mutual fund industry in Pakistan which was

introduced in 1962. National Investment Trust (NIT), launched in 1964, and Investment Corporation of Pakistan (ICP), a close-end fund launched in 1966.

ICP subsequently offered a series of closed-end mutual funds. Up to early 1990s, twenty six (26) closed-end ICP mutual funds had been floated by Investment Corporation of Pakistan. After considering the option of restructuring the corporation, government decided to wind up ICP in June, 2000. In 2002, the Government started Privatization of the Investment Corporation of Pakistan. 25 Out of 26 closed-end funds of ICP were split into two lots. There had been a competitive bidding for the privatization of funds. Management Right of Lot-A comprising 12 funds was acquired by ABAMCO Limited. Out of these 12, the first 9 funds were merged into a single closed-end fund and that was named as ABAMCO Capital Fund, except 4th ICP mutual fund as the certificate holders of the 4th ICP fund had not approved the scheme of arrangement of Amalgamation into ABAMCO capital fund in their extra ordinary general meeting held on December 20, 2003. The fund has therefore been reorganized as a separate closed end trust and named as ABAMCO Growth Fund. Rest of the three funds were merged into another single and named as ABAMCO Stock Market Fund. So far as the Lot-B is concerned, it comprised of 13 ICP funds, for all of these thirteen funds, the Management Right was acquired by PICIC Asset Management Company Limited.

All of these thirteen funds were merged into a single closed-end fund which was named as "PICIC Investment Fund".

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Later on the 26th fund of ICP (ICP-SEMF) was also acquired by PICIC Asset Management Company Limited. The certificate holders in extraordinary general meeting held on June 16, 2004 approved the reorganization of SEMF into a new closed-end scheme renamed as PICIC Growth Fund. The Securities and Exchange Commission of Pakistan subsequently authorized PGF on July 30, 2004.

In the last few years mutual fund industry has shown significant progress with reference to saving mobilization and important part of the overall financial markets. But still we are far behind the developed countries mutual fund industry. Growth in mutual funds worldwide is because of the overall growth in both the size and maturity of many foreign capital markets. These nations have increasingly used debt and equity securities rather than bank loans to finance economic expansion. The Pakistan economy can prosper because of the benefits of new investment opportunities arising from economic reform, privatization, lowered trade barriers and rapid economic growth.

Individuals throughout the world have the same basic needs that are education for their children, health, good living standard and comfortable retirement. In our country where people are religious minded, mostly they avoid bank schemes for investments, if they are provided an investment opportunity which suits the religion, we can mobilize savings from masses which may be laying an idle money at present. By doing so we would be able to improve the living standard of our countrymen through economic prosperity. This can be achieved through the introduction of different species of mutual funds and their performance. The success of this sector depends on the performance and the role of regulatory bodies. Excellent performance and stringent regulations will increase the popularity of mutual funds in Pakistan and also participate in capital markets in which they deals with millions.

Literature review

We argue that mutual fund investors use simple decision heuristics when selecting mutual funds to purchase or sell. (After presenting our empirical results, we discuss whether these heuristics affect investor welfare.) When purchasing funds, we posit that investors use a representativeness heuristic, where recent performance is deemed overly representative of a fund manager's true ability. When selling funds, this representativeness heuristic is more than offset by investors' reluctance to realize losses (the disposition effect).

In the early 1960s the investment community talked about risk, but there was no specific measure for that term. How investors quantify their risk about investment, the basic portfolio model was developed by Harry Markowitz (1952-1959). Markowitz showed the importance of portfolio management and to calculate the risk of portfolio (Systematic or Un-systematic). Ross (1976-1977) to develop the Arbitrage Pricing Theory, which is most beneficiaries to achieve the maximum return with lowest risk.

Carpenter, Michal D. & David E. (1981) discussed the trading volume and beta stability. Beta is the principle of risk in single investment as well as portfolio investment in mutual fund. H. Mendelson (1987) active performance of trading mechanism accomplishes the highest return of stocks.

Keith C. Brown & W.V. Harlow (1989) discussed the uncertainty for a rational investor; the best management of portfolio manger reduces the uncertainty through selection the active performance of funds. Bailey & Joseph Lin (1992) evaluate the diversification benefits and further diversify of portfolio to entrance the new investor in portfolio.

Martin J, Gruber & Edwin J. Elton (1993) evaluate the performance of bond mutual funds and discussed its importance in the real world of investment. If investors rely on a representativeness heuristic when selecting mutual funds, they will underestimate the tendency of fund performance to mean revert and thus anticipate better relative performance than is realized. The fact that more money is invested in active than passive funds despite the superior historical performance of the latter is "prima facie" evidence that most investors believe that some mutual fund managers have the ability to consistently beat the market. Surveys also reveal that investors rely heavily on past performance when evaluating their fund purchase decisions. Capon, Fitzsimons, and Prince (1996). The decision to sell a mutual fund is quite different from the decision to purchase a fund. Most investors hold few funds. In (1998), the average household held five mutual funds. Thus, unlike purchases where investors have thousands of funds to choose from; investors have only a handful of funds from which to choose when selling. Using the representativeness heuristic, investors would view poor fund performance as overly representative of a manager's skill and sell losing fund investments. However, this representativeness heuristic is partially offset by investors' desire to avoid the recognition of losses or loss aversion.

Brad M. Barber & Terrance Odean (2000) detail discussed about the performance of mutual funds return and to evaluate with other securities.

S. M. Aamir Shah & Syed Tahir Hijaz (2004) Pakistan mutual fund industry and also evaluates mutual fund performance using a survivorship bias controlled sample of funds.

Now, the main purpose of this research is to examine the risk-return characteristics of mutual funds, which impact on capital market in context of Pakistan. Risk-adjusted performance is evaluated using evaluation techniques, i.e., Sharpe measure & Treynor measure. We suspect that investors use both the investment frame and the agency frame. Which frame dominates in the buying or selling decisions of mutual fund investors is an empirical question, which we address in this research. We provide well-built evidence that it is the disposition effect, rather than the agency frame, that determines which funds investors buy or sell.

Objectives of the Study

- ❖ Precise the risk
- ❖ Enhance the investment
- ❖ Asset portfolio in funds perspective
- ❖ Buying & selling strategy, best point for investment

Research Methodology And Empirical Results

The Sample Mutual fund industry in Pakistan has witnessed significant change and growth in terms of private sector participation, divestment of public sector funds. At present we have selected 10 mutual funds 5 are conventional and 5 are Islamic which showed their best performance in couple of years especially after the global recession. We focus on both terms of mutual funds; open-ended as well as close-ended. As we are concerned with survivorship bias controlled data, we focus on those funds whose reflect the best possibility to investment for investor in open market with all respect of Risk-Return characteristics.

Sources of Data

Annual reports of all funds for the period from 2006 to 2010 have been used for data collection. For this purpose different sources have been used; Asset Management Companies of the funds, Stock exchanges, SECP and internet utilities. Data for

Treasury bills rate was collected from Statistical Bulletins of State Bank of Pakistan.

Variables

Variables picked for the investment tendency of mutual funds are net asset value, number of certificates/shares outstanding, earning per certificate and net asset value per certificate/share, monthly returns of KSE 100 index. Monthly Treasury bill rates, Return of fund were calculated dividing return per certificate. Net asset value per certificate was calculated by deducting total liabilities from total assets of the year or by taking shareholders equity. Return of a fund may also be calculated dividing net income after taxes of a fund by opening net assets of the fund for that year.

Methodology and Empirical Results

There are four models which are used worldwide for evaluate the investment tendency of mutual funds (1) Sharpe Measure (2) Treynor Measure (3) Jensen differential Measure (4) Fama French Measure. We have used first two measures excluding Jensen differential measure & Fama French Measure. The reason for not using Jensen differential measure, we calculate individual funds return and portfolio funds return excluding abnormal returns specifically in recession period because Jensen differential measure mainly use to calculate the abnormal return of a portfolio that is difference between the actual average return earned by a portfolio and the return that should have been earned by the portfolio given the market conditions and the risk of the portfolio, and not using for Fama French Model is that for this model we needed data on book to market ratio for all companies which we have selected listed at KSE which could not be made available.

The Sharpe Model

In 1960 William F. Sharpe started to work on portfolio theory as thesis project. He introduced the concept of risk free asset. Combing the risk free asset with the Markowitz efficient portfolio he introduced the capital market line as the efficient portfolio line. The model given by Sharpe, we can proceed further to use it for the determination of expected rate of return for a risky asset, which led to the development of CAPM capital asset pricing model. Through this model an investor can know what should be the required rate of return for a risky asset. The required rate of return has a great significance for the valuation of securities, by discounting its cash flows with the required rate of return.

In order to determine which portfolio offering the most favorable risk/return trade-off, we compute the ratio of the historical returns in excess of the risk-free rate to the standard deviation of the portfolio returns. The portfolio offering the highest reward/risk ratio then is the only risky portfolio in which investors will choose to invest. Using average returns of the portfolio uses Sharpe ratio to measure ex-post portfolio performance.

$$\text{Sharpe Ratio} = (R_p - R_f) / \delta p$$

R_p = the observed average fund return;

R_f = the average risk free return;

δp = the standard deviation of fund returns.

This model is used to measure the performance of a managed portfolio in respect of return per unit of risk. This ratio also measures the portfolio manager's ability on the basis of rate of return performance and diversification by taking into account total risk of the portfolio. Sharpe ratio results show the best performance of Islamic mutual funds specially Pak Intl.

The Treynor Model

Treynor introduced two types of risks. One risk is called Systematic risk which is associated with market and cannot be

diversified away. However, this type of risk can be calculated through "beta". Treynor says that portfolio expected return depend on its beta. The other type of risk which he separated from systematic risk is unsystematic risk. Unsystematic risk is specific to a company. The uncertainty attached with the specific company can be diversified away. Treynor model is used to measure the performance of a managed portfolio in respect of return per unit of risk (systemic risk). In this way the mutual fund

Provides the highest return per unit of risk (systemic risk) will be preferred as compared to the fund provides low return per unit of risk. Treynor ratio uses Beta as a risk measure hence considers the Systematic risk. This ratio also measures the portfolio manager's ability on the basis of rate of return performance and diversification by taking into account systemic risk of the portfolio. This ratio measures the historical performance of managed portfolio in terms of return per unit of risk (systemic risk).

$$\text{Treynor Ratio} = (R_p - R_f) / \beta$$

R_p = the observed average fund return;

R_f = the average risk free return;

β = coefficient as a measure of systematic risk / average portfolio beta

Treynor Ratio indicate that the portfolio offering the highest reward/risk (systemic risk) ratio will be the only risky portfolio in which investors will choose to invest. The assumption is that the portfolio manager has diversified away the diversifiable risk (unsystematic risk/company specific risk) and the matter of concern for the investor should be the systematic risk (non-diversifiable/market risk) only, instead of total risk.

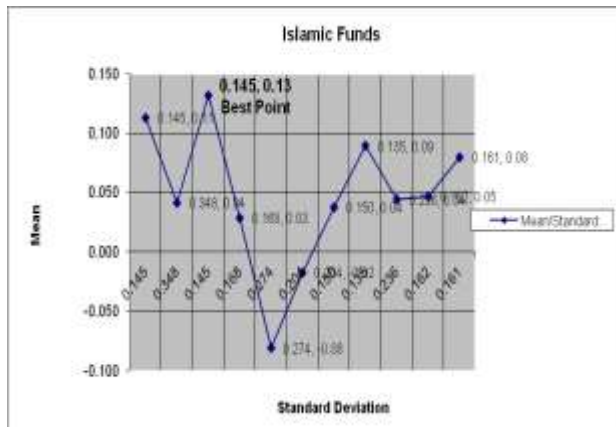
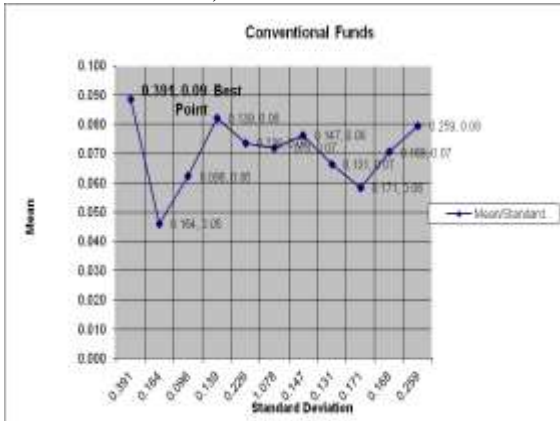
Conclusion

This paper provides an overview of the Pakistani mutual fund industry which play an essential role on capital markets and investigates the mutual funds risk adjusted investment tendency using mutual fund performance evaluation models. Survivorship bias controlled data funds are used for the evaluation of investment tendency on mutual funds. Mutual funds industry in Pakistan is still in growing phase. Overall results suggest that mutual funds in Pakistan are able to add more value either Conventional or Islamic. Islamic mutual funds perform better results as compare to conventional but still conventional funds continuously doing well to enhance their capital with sustainable returns. Our results show that the stated objectives of mutual funds do not necessarily distinguish the performance of the funds. Therefore, an investor using stated objectives may err in his selection decisions. Based on these results, even if he/she makes an initial decision that is congruent with his/her goals, the evidence shows that the performance of the fund may change over time. As a result, the performance of the fund may deviate from the original assessment to the point that it appears to perform like funds in other objective categories. This conclusion seems to be valid for both performance measures and for beta. The asset size of the funds does not seem to be a major factor in explaining the lack of consistency between performance and objectives. Whereas results also show some of the funds under perform, these funds are facing the diversification problem. Worldwide there had been a tremendous growth in this industry; this growth in mutual funds worldwide is because of the overall growth in both the size and maturity of many foreign capital markets, we are far behind. The need of an hour is to mobilize saving of the individual investors through the offering of variety of funds (with different investment objectives).

CONVENTIONAL FUNDS			
Average Portfolio Return =		0.0705	
Average Return of Risk Free Rate =		0.0925	
Average Portfolio Beta =		0.3143	
Treynor Measure =		-0.0699	
ISLAMIC FUNDS			
Average Portfolio Return =		0.0419	
Average Return of Risk Free Rate =		0.0975	
Average Portfolio Beta =		0.3900	
Treynor Measure =		-0.1425	
Islamic Funds is better performance than Conventional funds because the Treynor Ratio of Islamic Fund is higher than Conventional Treynor Ratio.			

The Sharp measure			
<u>Conventional</u>			
	Return	Risk free	SD
AKD	0.0895	0.09753525	0.380920992
FAYSAL	0.0872	0.09753525	0.179816025
PAK SMF	0.0816	0.09753525	0.294321229
PICIC	0.0642	0.09753525	0.086230974
ATLAS	0.0491	0.09753525	0.156001925
Rank The Sharp measure			
AKD	-0.02667		
PAK SMF	-0.13024		
FAYSAL	-0.12570		
ATLAS	-0.32134		
PICIC	-0.38752		
<u>Islamic</u>			
	Return	Risk free	SD
PAK INTL	0.1427	0.09753525	0.144679856
MBF	0.1224	0.09753525	0.144531418
MIF	0.0518	0.09753525	0.348120081
UCI	0.0341	0.09753525	0.167696670
UTP	-0.0909	0.09753525	0.273520646
Rank The Sharp measure			
PAK INTL	0.24581		
MBF	0.10439		
MIF	-0.14354		
UCI	-0.38630		
UTP	-0.56104		

The funds should also disclose the level of risk associated with return in their annual reports for the information of investors and prospective of investors. This will enable the investors to compare the level of return with the level of risk. The success of this sector depends upon the performance of funds industry and the role of regulatory bodies. Excellent performance and stringent regulations will increase the popularity of mutual funds in Pakistan. Graphical representation for best point (Conventional Vs Islamic)



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