

2. Properties of the mutual fund industry

Instead of starting with the quantitative empirical part right away, the following three chapters (chapters 2 to 4) will create context by delivering a useful and logically structured top-down information framework on the (for this thesis) most relevant key-aspects of mutual fund investing.

Due to the top-down approach of the “information framework” (comprising chapters 2 to 4) this first part (chapter 2) is designed to provide condensed insights into the market structure of today’s mutual fund industry, without neglecting its past development as well potential future prospects (e.g. anticipated impacts of ongoing ETF-innovation and propagation). Even though some aspects might be valid for the global mutual fund industry also, the author puts strong emphasis on highlighting the situation for the European mutual fund industry (which will also be part of the quantitative empirical parts of chapters 5 to 7). Chapter 3 will then discuss how investors could (objectively) assess, compare and classify mutual funds and their (out-) performance, whereas chapter 4 will discuss how investors actually incorporate such measurement methods in their investment process.

2.1. Properties of mutual funds

Before directly going into the details of the key-properties of present-day mutual fund industries, it is beneficial to shortly recap the main purpose of the concept itself (“mutual funds”) and to assess its justification for existence.

2.1.1. Purpose and benefits of mutual funds

One of the main ideas of the concept of mutual funds is to offer investors the advantage of accessing the benefits of a (usually) broadly diversified as well professionally managed portfolio at clearly reduced entry barriers. Thus by exploiting the concept of mutual funds also smaller investors have the possibility to easily diversify their capital across virtually any desired market, region or asset class.³⁵

As it was already stated in the previous paragraph, mutual funds are managed professionally. Hence via employing mutual funds investors can in a sense “out-source” all or at least some parts of their personal asset allocation and portfolio

³⁵ HSBC (2005) pp. 52-54.

management decisions against a specific fee (management fee). So in contrast to direct participants of the respective underlying market (e.g. global equity market in case of global equity funds), mutual fund investors not necessarily need to permanently follow and react to new market information and movements as the fund management team takes care of such tasks.³⁶

2.1.2. Active versus passive mutual funds

Although mutual funds can be classified in innumerable different ways, one rather foundational way of classification is the distinction between actively and passively managed mutual funds. This separative factor is highly essential as it usually acts as a strong explanatory factor for both performance objectives and fee structures of mutual funds.³⁷

Depending on the respective asset class, passively managed mutual funds aim to track a certain market (e.g. by trying to mirror a certain index) whereas actively managed mutual funds usually communicate the objective of “beating” a certain market (respectively index). Another major difference between actively and passively managed funds is their fee/cost structure. Since passively managed funds simply need to track the performance of a certain target index (e.g. via constantly rebalancing the respective index holdings)³⁸, management of such funds usually involves considerably lower overhead-costs which should generally also lead to comparably lower management fees. Active funds, however, tend to run extensive research networks in order to achieve the information necessary for outperforming a certain benchmark. Needless to say such fund management structures can produce significantly higher running costs and therefore leads to comparably higher management fees.³⁹

Within the quantitative empirical part of this thesis only actively managed mutual funds will become part of the researched sample (see chapter 5 “Methodology & definitions”).

³⁶ HSBC (2005) pp. 19-20.

³⁷ SEC (2007) online.

³⁸ FINRA (2013) online.

³⁹ Edwin et al. (2009) pp. 703-704.

2.1.3. Open-ended versus closed-end funds

Another relatively foundational and (for the aims of this thesis) highly relevant way of separating investment funds is to distinguish between open-end and closed-end funds.

Closed-end funds are investment companies that issue a specified amount of shares to investors in the course of their initial public offering (IPO). After an IPO of a closed-end fund has taken place, the fund management company is usually neither willing to accept the issuance of new shares (which would directly lead to an increasing fund volume) nor the direct redemption of existing outstanding shares (which would directly lead to a decreasing fund volume). However, just as with ordinary equities, investors have the possibility to constantly trade shares on a secondary market.⁴⁰

An open-end fund is the term for a set-up type of an investment company that is actually employed by most of those funds that are being commonly referred to as “mutual funds”. In contrast to closed-end funds, open-end funds are explicitly willing to respond to changes in demand from new or existing investors by standing ready to issue or buy-back shares at virtually any time. Thus fund volume of open-end funds is not just dependent on a fund’s portfolio performance (positive performance increasing the Net Asset Value (NAV)⁴¹ and vice versa) but can also constantly be heavily affected by fund inflows and outflows as investors have the hypothetical possibility of pulling as much money in or out of the fund as they wish to do.⁴²

Since closed-end funds are not willing (or able⁴³) to let their fund volume be exposed to investor in- and outflows, only open-end funds will become part of the quantitative research part of this thesis (see chapters 5 to 7).

⁴⁰ Reilly (1994) p. 880.

⁴¹ NAV equals the price of one unit (share) of a fund.

⁴² Reilly (1994) p. 884.

⁴³ Closed-end funds might be invested in illiquid “niche-strategies”.

2.1.4. Justification for existence

Chapter 2.1.1. already briefly stated the most evident benefits of the concept of mutual funds that can now be summarized as (i) enabling investors to achieve a diversified portfolio already with small capital amounts and (ii) offering a relatively cheap and easily accessible way to professional portfolio management.⁴⁴ Although over the past decades the benefits of mutual fund investments have clearly been extensively exploited by investors around the globe (see subsequent chapter 2.2 “Market development and competition” for details), today’s mutual fund industry, and more specifically, actively managed mutual funds are far away from possessing an undisputed or not interchangeable function in global financial markets. The reasons for the currently highly questioned usefulness⁴⁵ as well as future of the (active) mutual fund industry can also be segmented into two (strongly interrelated) areas that are now being simplified as endogenous and exogenous factors:

- (i) Endogenous factors: As chapter 3.2. will discuss and present in more detail, actively managed funds, on average, fail to beat their target market (benchmark) on a long-term perspective and thus only depict strongly limited persistence in performance.
- (ii) Exogenous factors: Continuously increasing financial innovation in form of exchange traded funds (ETFs) has become a serious factor within the global fund industry.⁴⁶ Whereas some 20 years ago⁴⁷ investors would have only had the realistic⁴⁸ possibility to access a broadly diversified market or index by buying a suitable mutual fund (passive or active), they can now easily access a multitude of indices and markets by purchasing passive ETF-structures at considerably lower costs.

Combining both factors, the currently challenging situation for the (active) fund management becomes even more undeniable: A not very convincing average performance of actively managed funds in conjunction with comparably high man-

⁴⁴ HSBC (2005) pp. 19-20.

⁴⁵ Edwin et al. (2009) pp. 703-704.

⁴⁶ Reuters (2009) online.

⁴⁷ In 1993 State Street Global Advisors have launched the first ETF (passive ETF on the S&P 500).

⁴⁸ It is highly unlikely that a (smaller) investor seeks to follow a larger index (e.g. S&P 500) by directly acquiring all underlying index-constituents.

agement fees of active funds can potentially tempt investors to switch to competing cheaper products (e.g. ETFs or ordinary passive, index-funds).

2.2. Market development and competition

The following subchapter starts off by discussing the market size development of both the global and European mutual fund industry by presenting condensed empirical data taken from acknowledged industry sources (Investment Company Institute (ICI) in case of global market developments, European Fund and Asset Management Association (EFAMA) and Lipper for Investment Management (LIM) in case of the European market). This is followed by a structured evaluation of the current level of competitiveness within the European mutual fund industry.

2.2.1. Market size and development: Global

The Investment Company Institute (ICI) is primarily known for its function as the “national association of U.S. investment companies (including mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts (UITs)”⁴⁹ and is therefore focused on publishing US-market related statistics. However, ICI also releases quarterly statistics on the global mutual fund industry on behalf of the International Investment Fund Association (IIFA).

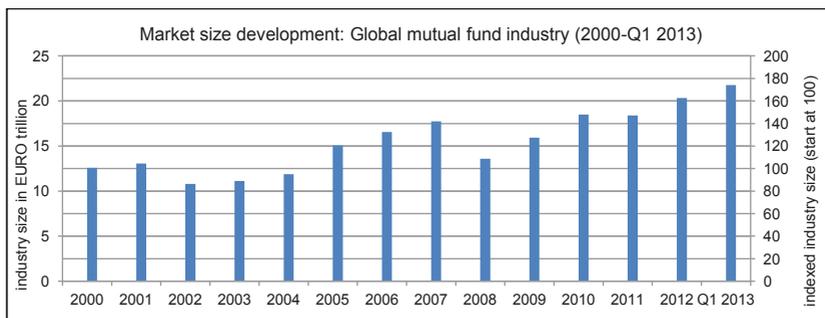


Illustration 1: Market size development: Global mutual fund industry (2000 – Q1 2013)

Just as the previous chart depicts, time series of historical data on worldwide market size provided by ICI are currently being available from the end of the year 2000 up to the end of the first quarter of 2013.⁵⁰

⁴⁹ ICI a, (n.a.) online.

⁵⁰ ICI b, (n.a.) online.

According to the latest quarterly data compiled by the ICI, the global⁵¹ mutual fund industry amounted to an all-time-high of €21.75 trillion at the end of March 2013 (Q1 2013). When compared with the first available industry size data of end of 2000 (€12.60 trillion) the global mutual fund industry has grown by 72.60 % during that period (in nominal terms). However, industry growth within that period has been anything but monotonously increasing. Illustration 1 clearly reveals that most of the industry growth has been achieved within the recent four to five years, since the devastating effects of the financial crisis of 2008 almost caused the industry size to reach an all-time low (€13.60 trillion industry size by the end of 2008).

Although the above data is supposed to display the picture of a global mutual fund industry, a simple analysis (breakdown of the industry's total assets by domicile country) demonstrates the current level of geographical concentration. Based on ICI global market volume of Q1 2013 (€21.75 trillion) not less than 75.05 % of worldwide mutual fund assets can be attributed to the top-5 domiciles (in descending order: United States, Luxembourg, Australia, France and Ireland), with the US alone already accounting for 49.09 % of the industry.⁵²

When analyzing the latest available industry size (Q1 2013) on basis of types of funds (or "asset classes"), the picture is as follows: 41.34 % of all industry assets can be allocated to equity funds, followed by bond funds (25.92 %), money market funds (16.73 %) and balanced/mixed funds with 11.76 % of market share.⁵³ According to ICI the remaining delta of 4.26 % can be allotted to "other" fund types as well unclassified funds.⁵⁴

While the global data samples provided by ICI would actually allow for a multitude of further testing and evaluations, those opportunities are not exploited until the subsequent sub-chapter, which will explicitly highlight and analyze the current as well as past development of European mutual fund market.

⁵¹ ICI consolidates data from national mutual fund associations of 45 different countries.

⁵² ICI a, (2013) online.

⁵³ ICI b, (2013) online.

⁵⁴ ICI b, (2013) online.

2.2.2. Market size and development: Europe

A detailed and thorough analysis of the market framework of the European mutual fund industry is of particular interest for this thesis, as the quantitative empirical part (chapters 5 to 7) is strongly focusing on funds being domiciled within Europe. Moreover since the majority of comparable research (for more information please see chapter 1.2.) has been carried out for the US-American fund market, this sub-chapter will strongly concentrate on carving out characteristics that are unique to the European mutual fund industry.

Official statistics on the European mutual fund market and its size are published by the European Fund and Asset Management Association (EFAMA) on a monthly basis.⁵⁵ EFAMA can be considered as the European equivalent of IIFA and therefore acts as a cross-border representative association for 26 full-member countries and one observing country (Malta)⁵⁶, leading to a total sample of 27 European fund domiciles that are covered in EFAMA statistics. The following chart shows the historical market size development of the European mutual fund industry.

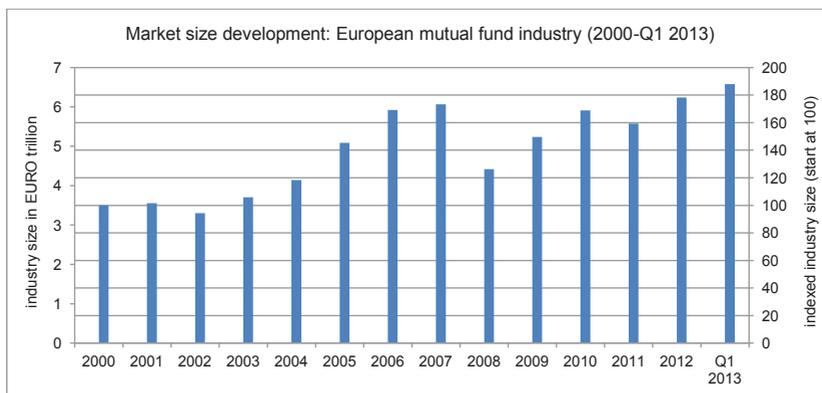


Illustration 2: Market size development: European mutual fund industry (2000 – Q1 2013)

For reasons of convenience⁵⁷ and consistency, the processed industry figures (Illustration 2) for the European market have also been taken from the comprehensive global mutual fund industry statistics provided by ICI. However, since

⁵⁵ EFAMA a, (2013) online.

⁵⁶ EFAMA b, (2013) online.

⁵⁷ EFAMA only publishes PDF-statistics; ICI also offers convenient xls-files.

EFAMA does not cover the Russian market in its statistics⁵⁸, this constituent has been removed from the European data sample in order to achieve homogeneity with EFAMA methodology (which is essential for further analyses).

Based on ICI data, the European domicile currently controls assets in the amount of € 6.6 trillion (as per Q1 2013). This means that, within the presented observation period (End 2000 until Q1 2013), the European mutual fund market has been able to almost double its industry volume (+ 88.14 % in nominal terms). However, it is not entirely meaningful to contrast this figure with the global growth figure presented in chapter 2.2.1. as it is largely biased by European data (as per Q1 2013 Europe had a 30 % share in the global mutual fund market).⁵⁹ Thus, in order to enable a more significant comparison, the subsequent chart compares the size development of both the European market and the adjusted “global (ex. Europe)” industry. For the sake of enhancing comparability, both industry sizes start at an indexed value of 100 in t=0 (2000).

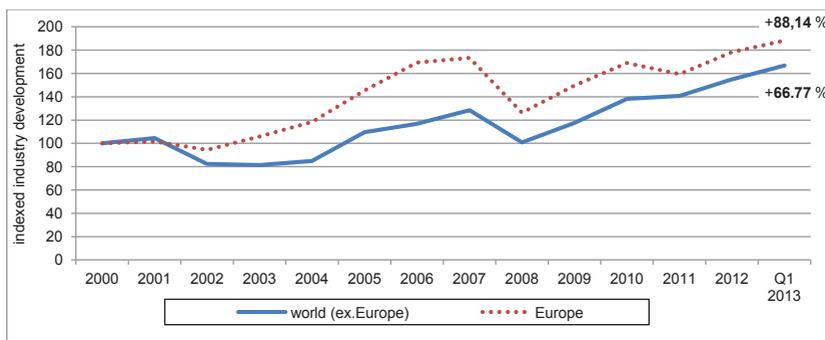


Illustration 3: Industry growth comparison: Europe versus Global (ex. Europe)

In addition to an obvious correlation between both samples (correlation coefficient close to 0.9), the above chart also discloses the outperformance, the European market has been able to achieve relative to the remaining global industry in terms of total growth rate within the observation period (88.15 % in the case of Europe versus +66.77 % in the case of the remaining global industry).

⁵⁸ EFAMA c, (2013) p. 9.

⁵⁹ ICI b, (2013) online.

Similar to the global market, also the European mutual fund industry can be characterized by exhibiting significant levels of geographical concentration. As per Q1 2013 a cumulated market share of 66.19 % could be attributed to the Top-3 domiciles (in descending order: Luxembourg, France and Ireland). The subsequent Lorenz curve visualizes the current level of geographical concentration.

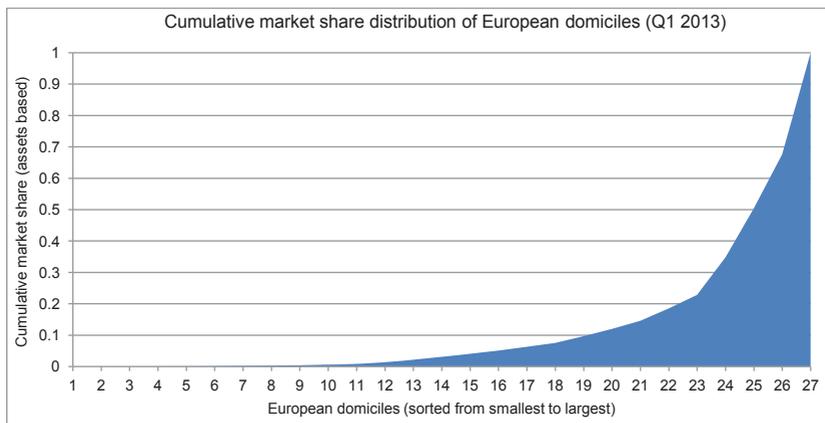


Illustration 4: Cumulative market share distribution of European domiciles (Q1 2013).

The above chart clearly demonstrates that the European fund industry is far from being equally distributed over all 27 domiciles. This is supported by the results of a Gini index calculation, which based on the data of Q1 2013, produces a Gini coefficient of 0.7678. Gini coefficients can potentially range from 0 (total equality) up to 1 (total inequality). In order to test this coefficient for consistency and to be able to research developments as well as trends in the underlying distribution, the author has additionally performed Gini calculations for historical points in time (2006 – Q1 2013).

The results of the historical Gini coefficient calculations are plotted in Illustration 5. It is observable that the level of inequality (Gini coefficient) remains relatively stable within the observed period (bandwidth of Gini coefficients ranging from 0.7251 in 2006 up to 0.7678 in Q1 2013). The highest annual change in inequality can be observed for the year 2008 with a relative increase in the Gini coefficient of +3.81 % (Gini 2007: 0.7291, Gini 2008: 0.7570) thus indicating that the financial crisis of

2008 generally fortified the geographical concentration within the European fund industry.

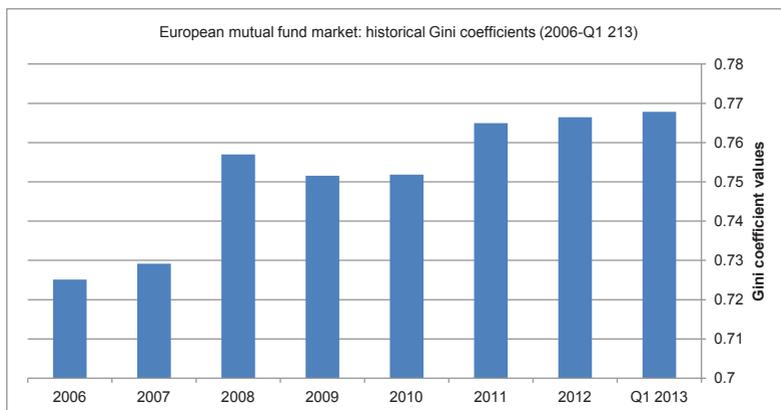


Illustration 5: European mutual fund market: historical Gini coefficients (2006-Q1 2013)

In respect to the top European domiciles, it has to be mentioned that the current no. 1 (Luxembourg) as well as no. 3 (Ireland) play a very specific role within the European (or even global) mutual fund industry. Both fund domiciles were able to significantly attract fund management companies over the past (see illustration 6), which is primarily a result of their relatively low levels of taxation (“tax havens”) in connection with their capability to easily host “cross-border” UCITS fund structures. Once a UCITS (“Undertakings for Collective Investment in Transferable”) structure is domiciled in an EU member country, the fund can easily be distributed across the remaining EU by applying the “passport” regulation.⁶⁰ Thus it can be argued that funds domiciled in Luxembourg or Ireland are typically not aiming to reach domestic investors but to simply exploit the above stated regulatory benefits.⁶¹

The subsequent chart highlights the increasing popularity of choosing European tax havens (Ireland and Luxembourg) as the fund domicile of choice. In order to enhance comparability, all industry sizes once again start at an indexed value of 100.

⁶⁰ SEI (2013) online.

⁶¹ CACEIS (2011) pp. 22-26.



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