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EVALUATING FUND MANAGEMENT COMPANIES AND FUND MANAGERS : A STUDY OF MALAYSIAN UNIT TRUST COMPANIES

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Evaluating Fund Management Companies And Fund Managers : A Study Of Malaysian Unit Trust Companies

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ABSTRACT

This paper examines the performance of 33 Malaysian-domiciled equity unit trust funds under 10 different fund management companies covering a period of 15 ½ years from January 1983 to June 1998. Comparison of performance and ranking of unit trust funds are made based on the Adjusted Sharpe Index, the Adjusted Jensen Alpha and the Treynor Index. The effect of types of management companies and fund managers on the performance of unit trust funds is also examined using the Adjusted Sharpe Index. The research indicated that on average and over the long term, unit trust funds are not able to consistently outperform the market. The following conclusions were also made regarding the effect of types of management companies and fund managers on the performance of unit trust funds. Firstly, unit trust funds which are managed by fund managers external to the management companies concerned perform better. Secondly, unit trust funds managed by fund management companies with long serving principal investment officers perform better. Lastly, unit trust funds managed by fund management companies with foreign principal investment officers perform better.

1. INTRODUCTION

The study of investment performance has long sought to discover the most appropriate methods to measure performance and also factors behind investment success. There were many studies which have been conducted in the West on this topic while in Malaysia, serious researches started in the mid-1980's. Probably, the reason why researches on this topic gained momentum only recently in Malaysia was because of the difficulty in obtaining and inadequacy of publicly accessible data in the earlier years. Moreover, mass awareness of the industry in Malaysia was only created in 1981 with the launch of Amanah Saham Nasional (ASN) by the Government and the industry got its boost in the private sector after the 1993 'Superbull Run' of the Kuala Lumpur Stock Exchange (KLSE) with the sudden increase in the number of unit trust fund management companies.

Studies of unit trust funds performance in Malaysia has only been confined to cover short periods, normally 5 years, due to difficulty in obtaining data. Research with the longest known period coverage was 10 years, conducted by Tan H.C. (1995), covering the period of January 1984 to December 1993. Also, there has been no known studies on the effect of the type of fund management companies and fund managers, whether in the West or in Malaysia, on the performance of unit trust funds. This paper attempts to fill the abovementioned gaps.

This section serves as Chapter 1 which is the section on Introduction. Chapter 2 presents an overview of the unit trust industry in Malaysia. The main gist of this section is an introduction to unit trusts, a background of the industry's history in Malaysia, types of funds, industry structure and legal and regulatory framework. In Chapter 3, previous academic studies on investment performance measurement are reviewed. Thereafter, objectives of the research are stated and the hypotheses are presented. In Chapter 4, the reasons behind data selection, categorization and grouping are discussed. The methodologies used are explained in detail.

The results and analysis of the research are presented in Chapter 5. This entails the comparison of performance and the ranking of unit trust funds using the Adjusted Sharpe Index, the Adjusted Jensen Alpha and the Treynor Index. Lastly, the effect of types of companies and fund managers on unit trust funds performance are examined. Finally, the conclusions of the research paper are presented in Chapter 6.

2. BACKGROUND OF THE UNIT TRUST INDUSTRY IN MALAYSIA

2.1 Introduction To Unit Trusts

Unit trusts are a form of collective investment scheme that allows investors with similar investment objectives to pool their funds to be invested in a single portfolio of securities managed by professional fund managers. The funds are invested in a diversified portfolio of assets, such as equities and fixed income securities, with the primary aim of meeting the investment objectives of the unitholders, where different groups of unitholders have different risks and returns profile preferences. The cost of potentially higher returns is the higher risks that accompany the investment, and vice-versa. The risks and returns of unit trust investments have traditionally been benchmarked against those of fixed deposits, which provide stable returns with comparatively lower risks. In the short term, the certainty of investment returns of most unit trust schemes has been less than those offered by fixed deposits. However, in the medium to long term (ie. 5 - 20 years), unit trust investments has generally provided far better returns than fixed deposits at an acceptable level of risk.[1]

[1] As quoted in Section 1.1.2 page 3 of 'Understanding Malaysian Unit Trusts', The Federation of Malaysian Unit Trust Managers, Kuala Lumpur, Malaysia, June 1998.

Unitholders do not purchase the assets in the portfolio directly. Ownership of the fund is divided into units of entitlement. As the fund increases or decreases in value, the value of each unit increases or decreases accordingly. The return on investment for unitholders is usually in the form of dividends and capital appreciation, derived from the pool of assets supporting the unit trust scheme. Each unit is entitled to earn an equal amount of income, determined by the level of dividend and capital appreciation or depreciation in any one period.

Unit trust investors are typically small investors who neither have the time nor the inclination to hold portfolios of direct investments or shares. Rather, they prefer to invest in a secure, reputable investment vehicle. Unit trusts allow small investors to have easy access to a wide range of investments that they would not normally have.

In some countries, especially the USA, where unit trusts are very popular as an investment vehicle, the number and types of unit trust investment options available are almost endless. In Malaysia, the number and types of unit trust schemes are also developing quickly. These cater to the different investment needs and risk preferences of investors. The types of unit trust schemes are as follows :-

i) Listed trusts;

ii) Unlisted trusts;

iii) Equity unit trusts;

iv) Fixed-Income unit trusts;

v) Property trust funds;

vi) Islamic unit trust funds; and

vii) Balanced or diversified unit trust funds.

A detailed explanation of each of the above type of funds is presented in Appendix 1.

2.2 History

Malaysia has a young history in unit trusts compared to the West, specifically the USA. However, it was introduced to the concept relatively early compared to its Asian neighbours.

The first unit trust company in Malaysia, Malayan Unit Trust Ltd, was established some 4 decades ago in 1959. For the next 2 decades, the industry continued to grow gradually in its formative years. In 1981, the Government introduced Amanah Saham Nasional which created a mass awareness and excitement about the industry. In the meantime, the necessary infrastructure were being put into place to prepare the industry for further growth. The industry was put under the purview of the Securities Commission in 1993. After the unprecedented 'Super bull Run' on the Kuala Lumpur Stock Exchange, the industry took off in a big way

with new private unit trust fund management companies flooding the market.

The growth of the unit trust industry in Malaysia is categorized as follows :-

i) The Formative Years : 1959 - 1979;

ii) The Period From 1980 - 1990 ; and

iii) The Period From 1991 - 1997.

For a presentation of the chronological events on the development of the unit trust industry in Malaysia, please refer to Appendix 2.

2.3 Industry Structure

The structure of a unit trust scheme is presented in a diagram in Appendix 3.

The functions of parties in a unit trust scheme are as follows :-

i) Investors : invests in unit trusts to obtain income and capital growth

ii) Trustee : owns all of the assets of the trusts and also ensures the manager's compliance with the Trust Deed

iii) Manager : responsible for the day-to-day operations and management of the assets.

The relationship among the parties in a unit trust scheme is governed by a legal document called a Trust Deed, which is effectively the 'constitution' of the trust structure. This is a requirement of the Malaysian Companies Act 1965.

2.4 Legal And Regulatory Framework

The regulation of the unit trust industry in Malaysia is under the purview of the Securities Commission. The regulations and Acts of Parliament relevant to the unit trust industry are as follows :-

i) Securities Commission 1993;

ii) Securities Commission (Unit Trust Scheme) Regulation 1996;

iii) Securities Industry Act 1983;

iv) Companies Act 1965; and

v) Trustee Act 1949.

The regulatory framework is outlined in Appendix 4.

2.5 Guidelines On Unit Trust Funds

Guidelines On Unit Trust Funds was first issued in 1991 as a measure to protect the interests of investors. The latest revision issued by the Securities Commission on May 6, 1997 had the objective of encouraging

the growth of the industry as well as enhancing the safeguard features to protect the interests of investors.

The latest revision to the Guidelines On Unit Trust Funds is presented in Appendix 5.

2.6 Investment Safeguards

The investment policy that needs to be adhered by fund management companies as determined by the Guidelines On Unit Trust Funds are as follows :-

i) The value of a unit trust scheme's holding of the share capital of any single issuer should not exceed 10% of the scheme's net asset value;

ii) The value of the unit trust scheme's holding of the securities of, and the securities relating to, any group of companies should not exceed 20% of the scheme's net asset value, provided there are acceptable reasons for exceeding the limit agreed by the trustee and/or the Securities Commission;

iii) The unit trust scheme's holding of any class of securities of any single issuer must not exceed 10% of the securities issued;

iv) Investment by a unit trust scheme in 'non trustee stocks' must not exceed 50% of the scheme's net asset value;

v) The value of the scheme's holding of unlisted securities must not exceed 10% of the scheme's net asset value;

vi) The value of a unit trust scheme's participation in futures contracts must not exceed 10% of the scheme's net asset value and participation in any futures contract other than a futures option or an eligible exchange traded option must be for hedging purposes only; and

vii) No prescribed limit on investment in foreign securities is imposed but the investments must first be approved by the Securities Commission, Bank Negara Malaysia and other relevant authorities.

3. REVIEW OF LITERATURE AND OBJECTIVES OF RESEARCH

3.1 Review of Literature

3.1.1 Previous Academic Studies

Many studies have been conducted by researchers on the performance of unit trust funds (or mutual funds, as they are known in the USA). These studies were largely facilitated by the considerable progress made in three closely related areas – the theory of portfolio selection, the theory of the pricing of capital assets under conditions of risk and the general behaviour of stock market prices[2].

Traditionally, researchers have been conducting studies on unit trusts performance based on rate of returns per se without incorporating 'risk' in their measurements. Although the element of risk in unit trusts investments were widely known, there were no known quantitative measure which incorporated 'risk' in the measurement tool. However, over the period 1965 to 1968, Treynor, Sharpe and Jensen introduced performance measurement tools which addressed this. Jack L. Treynor (1965) pioneered a new dimension in the study of unit trust performance by

[2] As observed by Sharpe W.F. in his paper "Mutual Fund Performance", Journal Of Business Vol. 39 No. 1, January 1966.

suggesting a new measurement tool then - one that differs from virtually all those used previously by incorporating the volatility of a fund's return (which measures risk) in a simple yet meaningful manner. Treynor and Mazuy (1966) used the Treynor Index to measure the performance of 57 open-end mutual funds in the USA over the period 1953 to 1962. None of the funds could outperform the market portfolio (Dow Jones Industrial Average - DJIA). Treynor and Mazuy further concluded that the improvement in rate of return will be due to the fund manager's ability to identify underpriced industries and companies, rather than any ability to outguess turns in the level of the market as a whole.

William F. Sharpe (1966) examined the performance of 34 mutual funds in the USA over the period 1954 to 1963. He introduced the Sharpe Index as a risk-adjusted measurement tool of fund performance which is based on the Reward-to-Variability ratio (variability being measured by the standard deviation of the funds). On average, the funds did not outperform the DJIA with only 11 out of the 34 mutual funds performing better than the market portfolio. Sharpe also concluded that good performance was associated with low expense ratio and that the size of the funds per se is unimportant to predict future performance.

Michael C. Jensen (1968) studied the performance of 115 open-ended mutual funds in the USA over the period 1945 to 1964. He developed a risk adjusted performance measurement tool called the Jensen's Alpha for evaluating a portfolio manager's predictive ability of security prices. Risk was measured by a beta factor obtained by regressing the rates of return of each fund in the sample against the Standard & Poor's 500 Stock Composite Index (S&P 500) as the market portfolio. The evidence from his study indicated that on average, mutual funds were not able to predict security prices well enough to outperform a buy-the-market-and-hold policy. Also, there was little evidence that any individual fund was able to do significantly better than that were expected from mere random chance, even when the fund returns were measured gross of management expenses (that is assuming that fund managers' book-keeping, research and other administrative expenses, except brokerage commission, were obtained free). However, it is important to note that in the study, Jensen did not consider the question of diversification. Eugene Fama (1972) suggested somewhat finer breakdown of performance measure which was developed from available theoretical and empirical results on portfolio and asset pricing models. He suggested that the return on a portfolio could be subdivided into two parts : the return

from security selection (selectivity), which takes into account portfolio asset allocation policy and diversification, and the return from bearing risk (risk), which take into account timing ability of fund managers. However, Fama did not proceed to apply his model on actual data.

Kon and Jen (1979) conducted a study on 49 open-ended US mutual funds over the period January 1960 to December 1971. They used the Black Model (1972) and the Sharp-Lintner-Mossin Model to evaluate stock selectivity performance and the implications for the Efficient Market Hypothesis (EMH) when management is simultaneously engaged in market timing activities. The empirical evidence indicated that many of the funds in the sample significantly change their risk levels during the measurement interval. This behaviour also resulted in significantly different stock selectivity performance and portfolio diversification. The evidence on selectivity performance pertinent to the EMH is mixed. However, their conclusion was similar to previous studies in that mutual fund managers individually and on average are unable to consistently forecast the future prices on individual securities well enough to recover their research expenses, management fees and commission expenses.

Henriksson (1984) evaluated the performance of 116 open-ended US mutual funds using monthly data from February 1968 to June 1980 using both parametric and non-parametric tests for the evaluation of forecasting ability presented by Henriksson and Merton (1981). They found that mutual fund managers were not able to follow an investment strategy that successfully times the return on the market portfolio (which is a value-weighted portfolio of all stocks traded on the New York Stock Exchange).

Admati, Bhattacharya, Pfleiderer and Ross (1986) (hereinafter referred to as 'ABPR') discussed the conceptual and econometric problems associated with defining and measuring timing and selectivity. ABPR offered two modeling approaches which they referred to as the Portfolio Approach and the Factor Approach. Under the Portfolio Approach, timing information is restricted to be information about the returns on a pre-specified set of timing portfolios. Meanwhile, selectivity information is restricted to be information that is uninformative about the timing portfolio returns but informative about some other asset returns. Under the Factor Approach, timing information is information about the realizations of factors that affect the returns of many assets, without necessarily being confined to pre-specified timing portfolios. Meanwhile, selectivity information allows for

information to be any specific determinants of individual assets returns without restrictions. The evidence in the ABPR analysis suggested that even where timing and selectivity information are well-defined, they will be difficult to detect and distinguish.

Brinson, Hood and Beebower (1986) conducted a study on 91 large US pension over the period 1974 to 1983, using quarterly data, with the objective of determining return contributions asset allocation policy, market timing and security selection. They provided a simple framework based on a passive, benchmark portfolio representing the plan's long-term asset classes, weighted by their long-term allocations. Returns on this 'investment policy' portfolio are compared with the actual returns resulting from the combination of investment policy plus market timing (over or underweighting asset classes relative to the plan benchmark) and security selection (active selection within an asset class). Their conclusion was that although investment strategy (market timing and security selection) can result in significant returns, asset allocation policy (the selection of asset classes and their normal weights) provide the bulk of return to a portfolio.

An update of the Brinson, Hood and Beebower (1986) study was conducted by Brinson, Singer and Beebower (1991). Quarterly

data of 82 large US pension plan covering the period December 1977 to December 1987 was used. The results confirmed the findings of the earlier study. However, the update study extended the performance attribution framework to also account for actual and synthetic cash holdings within asset classes. The findings was that it was harder for managers to outperform equity benchmarks than bond and cash benchmarks; more plans had positive contributions from the bond and cash portions of their portfolios.

Moses, Cheyney and Veit (1987) introduced a new performance measure which generate one number to reflect the simultaneous effect of timing, diversification and selection on portfolio performance. The measure, ${}_{u}PM_{j}$, involved the construction of a Unique Asset-Weighted Benchmark Portfolio (UABP) for each mutual fund. It should be noted that constructing a unique, benchmark portfolio for each mutual fund is a deviation from the Capital Asset Pricing Model (CAPM). The UABP was constructed using the S&P 500 to represent a common stock portfolio, Moody's Corporate Bond Yield Averages to represent a bond portfolio and annualized holding-period yield on newly issued 90-day Treasury Bills to represent a cash and equivalent portfolio. The ${}_{u}PM_{j}$ was compared to the more traditional measures developed by Treynor, Sharpe and Jensen using annual data of 53