ANALYSIS ON FACTORS OF NEW FUND OFFERINGS IN MUTUAL FUNDS, CONSIDERING MARKET CONDITIONS AND INVESTOR RESPONSE

Mr. V. Siva Ramakrishna, Mr.Manmohan Tiwari, Ms. G. Hema Pratima
Department of MBA
Priyadarshini Institute of Science and Technology for Women Khammam

ABSTRACT

The study is based on a sample of 431 respondents chosen using convenience sampling to understand the mutual fund buying behaviour of the individual investors. The article identifies the various attrib- utes that investors consider important while investing in mutual fund. There are two underlying factors of importance that are extracted namely Credibility of the fund and Miscellaneous features of the fund. The relationship of these factors with demographic variables is ascertained. The article suggests recommendations for the mutual fund companies and suggestions for future research.

Keywords: Factor analysis, mutual funds, ANOVA, entry and exit load, past performance, tax benefits

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INTRODUCTION

Financial markets play a vital role in the economic development of a country. They facilitate the allocation of scarce resources by transferring them from savers to borrowers, thereby accelerating investment activities in the economy. One of the most popular financial investments is mutual funds, which pool the savings of a large number of

investors who share a common financial goal based on trust. The money thus collected is invested in capital market instruments such as shares, debentures and other securities. Investors get the number of units based on the amount invested and the net asset value of the units. The income earned is shared among the investors in proportion to the number of units held by them. A mutual fund is an investment that suits the needs of the common man. It is an indirect form of investment in the capital market that has the advantages of diversification, professional management, low-cost investment, liquidity and tax benefit. The primary objective is to provide better returns to the investor by minimizing the risk associated with capital markets. The most common features of mutual fund units are low unit cost. The first mutual fund in India was launched by the Unit Trust of India (UTI) in the mid-1960s, and since then, mutual funds have come a long way as an investment option.

The history of the mutual fund industry in India can be divided into four phases. The first phase (1964–1987) began with the establishment of the UTI in 1963. Set up by the Reserve Bank of India (RBI), the UTI also functioned under its regulatory and administrative control. The first scheme of the UTI was launched in 1964. At the end of 1988, the UTI had assets worth ` 670,000 million under its management. The second phase (1987–1993) saw the entry of the public sector, mutual funds set up by public sector banks, Life Insurance Corporation (LIC), as well as the General Insurance Corporation (GIC). At the end of 1993, the mutual fund industry had assets of ` 470,040 million under its management. During the third phase (1993–2003), the private sector funds entered the fray in 1993. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. At the end of January 2003, there were 33 mutual funds with total assets of ` 1,218,050 million. The fourth phase (since February 2003) began with the repeal of the UTI Act 1963 in February 2003. The UTI was bifurcated into two separate entities:

1. The specified undertaking of the UTI, with assets of ` 298,350 million under its

management as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes.

2. The UTI mutual fund, sponsored by the State Bank of India (SBI), Punjab National Bank (PNB), Bank of Baroda (BOB) and LIC. It is registered with the Securities and Exchange Board of India (SEBI) and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI, which had more than ` 76,000 million of assets under management in March 2000 and with the setting up of UTI mutual fund and with recent mergers taking place among different private sector funds, the industry has entered current phase of con-solidation and growth. At the end of March 2008, there were 33 mutual funds, which managed assets of ` 505,152 million.

There are now three types of mutual fund schemes:

1. By structure—open-ended schemes, close-ended schemes and interval schemes.
2. By investment objective—growth schemes, income schemes, balanced schemes and money market schemes.
3. By other features—tax saving schemes and special schemes (index schemes and sector specified schemes).

Mutual funds are designed to provide maximum benefit to the investors. The fund manager has a research team to achieve the objectives of the scheme. A mutual fund has the following advantages:

1. The investment is in a well-diversified portfolio of securities, irrespective of whether the amount invested is big or small.
2. As the investment is in a diversified portfolio of securities, the associated risk is less compared to merely investing in two or three securities. If some of the securities of the portfolio react negatively due to some economic or political factors, others will react positively. Thus, the overall effect of risk is much less in mutual fund compared to portfolios managed by individual

investors.

3. The funds are managed by fund managers who undertake a lot of research and have better investment management skills than individual investors.
4. Mutual funds are far more liquid than shares, as they can be redeemed easily and quickly.
5. By virtue of having large volume, mutual funds have lower transaction cost, the benefit of which is passed on to the investors.
6. As required by the regulator, mutual funds provide investors with updated information pertaining to the market and schemes, thereby providing transparency.
7. The interests of mutual fund investors are regulated, as all funds are registered with SEBI, which enforces complete transparency.
8. Mutual funds offer a lot of flexibility and convenience, as investors can easily switch schemes and their options.

However, mutual funds also have some disadvantages:

1. Investors do not have a say in the decision-making process of a fund manager, which may come in the way of achieving the investor's financial objectives. Moreover, information gathering is costly, and brokers or the agents often do not disclose all relevant information about the investment at the time of purchase.
2. Irrespective of the performance of the fund, investors have to pay investment management fees and fund distribution costs as a proportion of the value of investment as long as they hold the unit.
3. Mutual funds offer much less in return as compared to direct investment in the capital market.

Literature Review

As per Gupta (1993), investors perceive all types of mutual fund schemes as safe. However, they have a distinct liking for close-ended, pure equity and growth schemes. The research of Singh and Vanita (2002) also indicate that the investment in mutual funds is not perceived to be

risky, but the preference is for open-ended schemes. Mutual funds are ranked lower in comparison to investment in Public Provident Fund (PPF), National Savings Certificate (NSC) and LIC policies. According to them, an important reason for investment in mutual funds is saving of tax. Sikdar and Surjit (1996) also found tax savings to be an important reason for investment in mutual funds by salaried and self-employed people. However, Santhi and Gurunathan (2011) mention that the participation of Indian investors in tax saving mutual funds is comparatively less than other safer investment areas like insurance, postal deposit schemes and fixed deposits (FDs).

The relative importance of various factors like past performance of mutual funds, their size and cost of transaction are used by investors as criteria in investment in mutual funds. Past performance is given due consideration in the work of Bogle (1992), Ippolito (1992), Ramasamy and Young (2003), Sikdar and Singh (1996), Singh and Chander (2004) and Wilcox (2003). The size of the fund was found to be an important consideration in the work of Pollet and Wilson (2008) and Ramasamy and Young (2003).

Alexander et al. (1997) are of the view that investors are knowledgeable about cost, risk and returns associated with mutual funds. This is supported by Wilcox (2003), who found that educated investors demonstrate basic knowledge of finance in their investment decision. However, Mehry (2004) differs, stating that mutual fund investors are ignorant. Moreover, agents are only concerned about incentives and commissions they get by selling schemes rather than about the quality of products. They do not explain the risk factors to the investors associated with the fund. This view is supported by Feverborn (2001), who states that individual investors will continue to be misled by companies that sell new funds. These companies are not completely honest and transparent in their approach.

Barker and Odean (2001) are of the view that women are less confident in their investment decisions compared to men. Similar views are expressed by Sunden and Surette (1998), who they state that women are more

risk averse than men. Powell and Ansic (1997) are of the view that women are less able financial decision makers than men. A similar view is advocated by Oakley (2000), who states that women are less effective and competent than men in the area of financial investment. The result is that investors prefer to invest in funds managed by males. However, the findings of Stanley et al. (2003) are different. Comparing the performance and investment behaviour of female- and male-managed fixed income mutual funds, they found no significant difference in terms of performance, risk and other fund characteristics. However, they found net asset flow into funds managed by males to be higher, especially in the initial years of managing funds.

A number of studies have been conducted on the performance of mutual funds under varying conditions. The work of Badrinath and Gubellini (2012) examines the performance of mutual fund across the business cycle. This is done by disaggregating funds into different investment objectives to determine which funds show cyclical performance. The results indicate that both small-cap and mid-cap growth equity fund are able to contribute to performance, whereas value funds are not able to do so. Chang et al. (2012) compared the financial performance of green and traditional mutual funds. A total of 131 green mutual funds were compared with the traditional mutual funds in their respective Morning Star categories on various measures of performance. It was found that green mutual funds gave lower returns compared to traditional mutual funds in their respective Morning Star categories. The performance of green mutual funds has also been studied on a risk-adjusted basis. Trainor (2012), who examined the risk-adjusted performance of individual mutual funds that investors used to invest in this asset class, found that past performance did influence future performance and investors should invest in top performing funds with the lowest expense ratio. Arugaslan et al. (2008) evaluated the performance of 50 large US-based international equity funds using risk adjusted returns during 1994–2003. They used risk-adjusted performance M^2 to

evaluate equity funds. The results indicate that funds with the highest average returns may lose their attractiveness to investors once the degree of risk embedded into the funds is forced into the analysis. Further, some funds in which the average unadjusted returns do not stand out may look very attractive once their low risk is taken into performance. Research by Drachter et al. (2007) examines decision processes in general fund companies and their impact on fund performance. The results show that behaviour of managers depends heavily on the characteristics of the funds and that of the funds' company.

Some researchers have examined the behaviour of investors while investing in mutual funds. For example, Hou (2012) examined the return persistence and investors' timing ability of 200 domestic equity mutual funds in Taiwan between 1996 and 2009. It emerged that the funds that had performed well in the previous year continued to do so in the following year. However, investors' timing per- formance was negatively related to fund performance. Watson and Funck (2012) investigated the trading behaviour of short-term seller and found an increase in short selling with the level of cloudiness. They found a decrease in short selling three days prior to a cloudy day. Allen and Parwards (2006) examined mutual fund investors' response to merger of Australian mutual fund companies. Using regression analysis to find the impact of mergers on different types of parties in the merger, they found that mergers did not result in increased money flows. On the contrary, investors withdrew from target funds prior to and after the merger.

Objectives of the Present Study

The literature cited above does not discuss the investment behaviour of investors in mutual funds in the sense that no attempt is made to extract the important underlying factors of investment, their relative importance and their relationship with demographic variables. The present work takes care of these limitations. Specifically, the objectives of this study are the following:

1. To understand the mutual fund buying behaviour of individual investors.
2. To identify the various attributes which investors consider important while investing in mutual funds.
3. To extract the underlying factors of importance and their relative considerations for investors.
4. To examine whether these extracted factors vary with demographic variables.

Methodology

An exploratory research was conducted by reviewing the literature on the subject, followed by unstructured interviews with investors and investment consultants dealing with mutual funds. All this helped in identifying the variables on the subject. A structured questionnaire was prepared using these variables. Eleven attributes were identified that are considered important by investors while investing in a mutual fund. These were measured on a 5-point scale, where 1 = very unimportant, 2 = unimportant, 3 = neither important nor unimportant, 4 = important and 5 = very important. Besides the demographic questions, there were questions on investment behaviour. The survey instrument was pretested with 15 respondents and in the light of the feedback obtained, the questionnaire was revised. An online survey was conducted to obtain the responses. Some of the respondents were personally contacted to fill the questionnaire. A sample of 431 useable responses was obtained. It was found that for some of the questions, a blank was left by the respondents. Such questions were omitted from the analysis and the sample size was reduced accordingly.

A reliability test using Cronbach's alpha was conducted

on an importance of 11 attributes measured on interval scale. The value of Cronbach's alpha was found to be 0.781, which is quite high. A factor analysis was conducted on these items. The importance of factors was found by computing the average factor score for each factor. The factor scores are compared for each of the demographic variables using one-way ANOVA.

ransparency of the fund manager. This factor was named as 'credibility of the fund' and explained 27.942 per cent of the variations. The second contained the variables—entry and exit load, add-on provided by the mutual fund, lock-in period of closed ended funds and tax benefits available on mutual funds. This factor was named as 'miscellaneous features of the fund' and accounted for 17.314 per cent of the variations.

The average factor score for the two extracted factors was computed as 4.07 and 3.46 for the factors credibility of funds and miscellaneous features of fund, respectively. This shows that the credibility of fund is considered to be the most important factor while investing in a mutual fund.

As mentioned earlier, to determine whether the two factors vary across demographic variables such as age, sex, educational qualification, marital status, profession and income, a one-way ANOVA is performed with factor score as dependent variable and each of the demographic variables as factor. It is found that the credibility of the fund significantly varies with gender and profession (p value less than 0.05). This is significantly higher for male investors compared to female investors. The results are in line with the work of Barker and Odean (2001) and Powell and Ansic (1997), where they state that women are less able as decision makers. When it comes to profession, it is seen that businessmen are most concerned with the credibility of fund, followed by the public sector and the government employees. The self-employed are least bothered about it. Among the remaining demographic variables, there was no statistical difference. In case of the second factor, namely, miscellaneous features of the fund, it is found that

significant variations exist in case of age, educational qualification and marital status. As regards the second factor, that is, miscellaneous features of the fund, single persons attach significantly higher importance to it than married people. This is not surprising, as married people, because of increased family responsibilities, would have already invested elsewhere in miscellaneous features provided by the fund. This could perhaps be the reason for their lack of interest in this factor. Further, it is observed that graduates show more interest in the miscellaneous features than postgraduates. The interest of younger investors (aged less than 25) is the highest in this factor and it reduces with age. A plausible reason for this could be that with age, added responsibilities creep in and accordingly, they already invest in these features and do not wait for mutual funds to come up with these facilities.

Interpretation of Results and Recommendations

It has been found that past performance of the issuing company, tax-saving funds and growth funds with capital appreciation are the important considerations for investors in a mutual fund. It is surprising to know from our study that more than 54 per cent of investors want a capital appreciation and higher return along with tax savings and low risk. This shows that investors have very high expectations from the fund managers, whom they expect to generate a high return with minimum possible risk. This is contradictory to the famous theory in finance that 'high return is associated with high risk'. Since the mutual funds face under constant pressure to invest in securities that are likely to give much higher returns than the risk-free instruments. As the cost of capital to the investor is much less in risk-free investments, which is just the risk-free rate, the return from mutual fund is risk-free rate plus risk premium. Mutual fund companies would succeed if they are able to provide premium to the investors. Otherwise, it will be difficult for them to compete with the risk-free instruments. This is more the case with equity schemes and growth schemes. Our result is concurrent with many researchers who have conducted research in different

periods, which shows that past performance is an important factor for investment by the investors and majority of the investors themselves take investment decisions. Therefore, fund managers put all their efforts to generate high returns to have a stable record of performance and have competitive advantage. It may be worth noting that investment in mutual funds if redeemed after one year of investment is tax free. This aspect may be highlighted while advertising for mutual funds. The results indicate that two factors are considered important by investors while investing in mutual funds. These, in order of importance, are credibility of fund and miscellaneous features of fund. Since the results have indicated that the general public, business people and employees of public sector and government attach a lot of importance to the credibility of the fund, the credibility factor should be emphasized at the time of issuing mutual funds.

The second factor, namely, the miscellaneous features of the fund, is considered important by younger, unmarried people. This factor comprises of variables like entry and exit load, add-ons provided by the funds, lock-in period of the closed-ended funds and tax benefits available on mutual funds. All these variables are considered very important by most of investors with the exception of add-ons provided by the mutual funds which is considered important by slightly above 50 per cent respondents.

Limitations and Suggestions for Future Research

The main limitations of the study are that the sample is skewed towards respondents residing in metropolitan cities (Delhi, Mumbai, Kolkatta, Chennai and Banglore), with annual family income of more than ` 10 lakh, working in the private sector, in the age group 25–35 years, with postgraduate degree and above. It is seen that 88.5 per cent of respondents reside in metropolitan cities 45.7 per cent have income above ` 10 lakh, about 80 per cent work for the private sector, 65 per cent are in the age of 25–35 years and 72 per cent with postgraduate degrees. The sample could have been more representative. Further, it is known that mutual funds are

meant for small investors with meagre savings and low income. This is not the case in this study. Therefore, it may be difficult to generalize these results.

It is suggested that the study may be replicated with the majority of respondents from middle income and lower category belonging to Tier 1, Tier 2 and Tier 3 cities of India. Further, a considerable proportion of respondents should be from 50-plus age group, as mutual funds are perceived to be less risky, and older people tend to be risk averse. Further, the selection of respondents from various professions should be uniform.

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