Exploring Customer Preference for Mutual Funds

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ABSTRACT

With the impending liberalization of the financial market, India has emerged as a major investment destination, both in terms of size and choice, in the mutual fund industry. The Indian Financial sector has witnessed entry of various global players, who are trying to attract the Indian consumers with well –designed products and benefits. This paper surveys the relative importance of factors considered important in the selection of mutual funds by investors in Indian financial market. Using the technique of Factor Analysis this study identifies five factors which describes the consumer preferences and revealed that Past performance, Core product features; Expense ratio, Risk- Return tradeoff and Liquidity are the important factors while evaluating a mutual fund scheme. The result of this survey points out that a discrete product design along with features expected by investors will make the mutual fund schemes more attractive.

INTRODUCTION

The mutual fund industry in India has gone through various structural changes in past four decades.. The global investment management firms have brought the expertise gained internationally along with best international practices in terms of performance and investor services. Now Indian financial sector has transformed into a buyer's market, where customer has the choice to select from a variety of products, services and service providers. It is becoming increasingly difficult for service providers to judge the behavior of investors. Financial services, like other services are intangible, difficult to evaluate, and rest on experience and credence quality (Zeithaml, 1981; Zeithaml et al., 1985). Investors find it difficult to evaluate all possible products attributes while making a choice.. Their preference is guided by a set of "key attributes / factors" attached to the mutual fund scheme. Tracking these features for mutual fund products is the fundamental objective of the study.

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LITERATURE REVIEW

Selecting a mutual fund that is able to offer high returns with acceptable risks is a complex task.. The purpose of this literature survey is to identify the factors that previous research has found to be important in the performance of mutual funds. These factors are then used in the design of the questionnaire used for data collection. Beginning with Jensen (1969), numerous studies focus on fund performance and a manager's ability to outperform the market. Since the work by Ferris and Chance (1987), researchers have also considered impact of fund characteristics on expense ratios and vice-versa (Carhart, 1997).

Determinants of new asset flows to a fund have also been examined by the researchers and variety of determinants have been explored, including prior fund performance (e.g. Sirri and Tufano, 1998; Jain and Wu, 2000; Del Guercio and Tkac, 2002), rating systems such as Morningstar stars (e.g. Nanda et al., 2004; Del Guercio and Tkac, 2005), and the impact of advertising (Jain and Wu, 2000; Yankow et al., 2006). Past performance of mutual funds has been most used in the previous literature as it was found to be the simplest and most direct method to identify the performance of mutual fund but literature seems to find that there is only a slight positive relationship between previous performance and current returns (Blake et al., 1993; Bogle, 1992; Brown and Goetzman, 1995; Brown et al., 1992). Others seem to be more conclusive about the relationship (Grinblatt and Titman, 1992; Hendriccks et al., 1993).

It has also been explored that prior returns are the most important source of new money flows into mutual funds (Carhart, 1997; Gruber, 1996; Ippolito, 1992). Although previous returns do not guarantee future performance, a survey of 298 affluent investors was undertaken and it was explored that performance track record is considered to be one of the four most important criteria while selecting a mutual fund by the investors (Capon et al., 1994). On the question of why poorly performing funds still survive, Harless and Peterson (1998) explained that investors tend to choose funds based on previous performance but stick to these funds despite their poor returns.

Studies also focused on advertising as the deciding parameter by investors for choosing a mutual fund Korkeamaki, Puttonen and Smythe, T. (2007), examined the effect of advertising on mutual fund cash flows in the Finnish fund market. They found that neither past year's performance nor advertising alone is sufficient to produce increased cash flows. However, advertising together with past performance was found to be significantly affecting cash flows. Feuerborn, T. (2001) identified some of the misplaced marketing techniques of investment companies. He suggested that because the most valuable marketing tool for a new mutual fund is a strong performance record. Hence, many companies provide "illusions" of certain returns and consumers are often misdirected as the funds often revert to average returns after a couple of years.

The transaction costs involved in buying and selling of mutual funds also known as expense ratio has been considered by several studies. Blake et al. (1993), Carhart (1997), Elton et al. (1996) and Lilijeblom and Loflund (2000), for example, explain that there is an inverse relationship between the expense ratio and mutual fund performance. Ang et al. (1998) explored that cost increases when fund managers follow an active trading style, as they would require a large research team. Although we expect the cost of transactions to be a determining factor, its relative importance to other determining factors is an issue well worth considering.

It has also been highlighted that large mutual funds attract more investments. Shukla and Van Inweg (1995) explored that as larger funds are able to employ more research staff who is then able to provide more information that would lead to better portfolio selection. This relationship is supported by other studies (Chen et al., 1992; ang et al., 1998; Golec, 1996). Grinblatt and Titman (1989), however, found an inverse relationship between fund size and performance. A possible explanation for this finding is that the degree of performance pressure on the fund manager is so intense that investment style becomes aggressive resulting in frequent change in style and hence weaker performance.

SCOPE AND DESIGN OF THE STUDY

The study is explorative in nature and focuses basically on primary data about customer preference for Mutual funds in the Indore region of M.P., India.

The data has been collected through structured questionnaire survey. The study is based on non-probability, convenient sampling and 58 filled responses were obtained from customers (possessing mutual fund schemes), across Indore region. The opinion of 58 customers on 14 variables/reasons for preference of mutual funds (second column of Table-1) were measured on a five-point scale (Likert Scale) ranging from "1" (Least important) to "5" (most important) depending on the importance attached to each reason. These variables have been derived from various earlier studies conducted both in India and abroad. In India an investor takes into account various factors while deciding about buying of a mutual fund scheme. These ranges of factors begin with investor perception, the promised return and the attractiveness of the offer. So from informal discussions with mutual fund advisors and from references to earlier studies, all the relevant variables in the purchase of a mutual fund plan are included.

The data obtained for the study was analyzed by using "FACTOR ANALYSIS" for identification of the KEY FEATURES/ FACTORS preferred by the respondents in a mutual fund. Factor Analysis identifies common dimensions of factors from the observed variables that have a high correlation with the observed and seemingly unrelated variables but no correlation among the factors. Principle Component Analysis is the commonly used method for grouping the variables under few unrelated factors. A factor loading is the correlation between the original variable with the specified factor and is the key to understanding the nature of that particular factor.

In this study, Principal Component analysis has been used since the objective is to summarize most of the original information (variance) in a minimum number of factors for prediction purposes. Here the factors are extracted in such a way that factor axes are maintained at 90 degrees, meaning that each factor is independent of all other factors. A factor is a linear combination of original variables. Factors also represent the underlying dimensions that summarize in account for the original set of observed variables. An important concept in factor analysis is the rotation of factors. We have used Varimax Rotation to simplify the factor structure. Only the factors having latent roots (Eigen values) greater than 1(unity) are considered. An Eigen value is the column sum of squares for a

factor. It represents the amount of variance in data. The final step in factor analysis is naming the factors. This labeling is intuitively developed by the factor analyst based upon the appropriateness for representing the underlying dimensions of a particular factor.

OBJECTIVES

1. To explore the factors influencing investor's preference towards various mutual fund schemes.
2. To evaluate these factors in order of investors preference.
3. To offer suggestions for improving product features so that they can be useful to service providers.

FACTOR ANALYSIS AND DISCUSSIONS:

The 14 variables used for the factor analysis were coded using the five-point Likert Scale. Table 1 provides the varimax rotated factor loadings against the 14 variables measuring preference level for mutual fund products. This was obtained in 7 iterations through SPSS (Version 10). Factor analysis using Varimax rotation finds five derived factors, each having Eigen value greater than unity. In the rotated factor matrix, variables are grouped under their respective derived factors. Thus, the 14 variables (reasons for satisfaction / dissatisfaction) were then loaded on the five factors.

The Eigen values of all the five factors are 31.72, 12.99, 10.74, 8.15 and 7.25 respectively. The total variance accounted for by all the five factors was 70.85% which is quite reasonable, and this establishes the validity of the study. Naming the factors has been done on the basis of the size of factor loading of the variables. Greater a factor loading for a variable, greater are the chances of the factor being named after this specified variable. Table 2 depicts the variables under each of the five derived factors and all the five factors are explained below:

1. Past Performance: Investors perceive mutual funds as an investment vehicle that provides adequate returns to the holders of the instrument and they also do not indulge instrument holders in to difficult process/ formalities. It is measured by item 7, 6, 5 and 2. These items are "Mutual Fund is Hassle free investment"; "Long term investment in mutual fund gives higher returns", "Mutual fund gives regular income",

"Mutual fund gives guaranteed returns". Variable 7 is the strongest and explains 17.41 per cent variance and has a total factor load of 0.796.

2. Core Product features: It refers to all the features that identify the core components of a product along with its attractiveness and uniqueness. It is measured by items 8, 13, 12 and 14. These items are "Mutual fund plans are attractive", "Market Volatility or fluctuations highly affect the Net Asset Value of mutual fund", "Investment in Initial Public Offer is much better", "Are you satisfied with the asset allocation between equity and debt ratio in your mutual fund plan". Variable 8 is the strongest and explains 16.859 per cent variance and has a total factor load of 0.784.

3. Expense Ratio: The transaction costs involved in buying and selling of mutual funds are known as expense ratio and investors find it to be reasonable and transparent i.e. without any hidden charges. It is measured by items 11 and 9 and these items are "Mutual funds are low cost offerings"; "Mutual fund has transparency". Variable 11 is the strongest and explains 13.080 per cent variance and has a total factor load of 0.853.

4. Risk Return Trade off: It reflects quantification of return at a given level of risk. It is measured by item 3 and 4 and these items are "Mutual fund investment is risk free"; "Mutual fund investment is convenient". Variable 3 is the strongest and explains 13.032 per cent variance and has a total factor load of 0.852.

5. Liquidity: It reflects the amount of time in which the product could be sold and money can be recovered. It is measured by items 10 and 1.These items are "Mutual fund investments are liquid", "Mutual funds are better than stock /shares". Variable 10 is the strongest and explains 10.418 per cent variance and has a total factor load of 0.913.

Warther (1995); Chevalier and Ellison (1997); Blake et al. (1993); Bogle (1992); Brown and Goetzman (1995); Brown et al. (1992) and others suggest that funds with stronger past performance have higher flows. Ippolito (1992) demonstrated that the flow-performance relationship is asymmetric, investors tend to invest in funds with strong past performance and they withdraw funds at a much slower rate after poor

performance. Combined with Jain and Wu's (2000) evidence that recent high performing funds do not outperform in subsequent periods, this literature has led to claims of investor irrationality. Recent researchers have also focused attention on how ratings impact fund flows. Del Guercio and Tkac (2005) find that ratings upgrades to five stars lead to abnormally high flows. Similarly, Yankow et al. (2006) find that funds with higher ratings have significantly higher flows.

The analysis of how advertising impacts fund flows is also explored by few researchers. Sirri and Tufano (1998) test the idea that advertising reduces search costs for investors. Consistent with this hypothesis, they find that advertising does lead to significantly higher fund flows, a result corroborated by Jain and Wu (2000), who also find that funds that advertise have strong past performance. Yankow et al. (2006) consider the content of fund advertisements, specifically examining whether it mentions past performance or not. Differentiating their tests by distribution channels, they find that funds advertising performance in the direct-market channel attract increased cash flow, while investors in the broker-sold channel increase investment in funds whether they advertise performance or not.

While most studies focus attention on flows at the fund level, Nanda et al. (2004) examine flows at the fund family level. They analyze whether fund families having highly rated funds exhibit spillover effects, in terms of additional flows, to other funds in the family. Their results support this hypothesis. Additionally, they find that the spillover effect is most valuable for fund families having funds in fewer fund categories. Golec (1996) in fact suggests that investors should avoid funds with a high expense ratio. Elton et al. (1993) and Ippolito (1989) find evidence that funds with a lower transaction cost outperform those with higher fees. Nevertheless, Chen et al. (1992) finds a positive relationship between performance and expense ratio. Numerous studies considered risk return trade-off as a key factor for investment decision. (Karatepe and Gokgoz, 2006; Artikis, 2004; Artikis, 2003; Sorros, 2003) explained that rational investors desire to achieve an acceptable equilibrium among risk and return conditions.

CONCLUSION

This paper seeks to identify factors that are considered important while selecting a mutual fund by investors in an emerging market. This type of customer orientation is necessary in a market like India, where the market is turning competitive due to large number of players with varied financial musicale and expertise of reinvestment. The findings of this study may be useful to mutual funds that are already established in India, as well as for international management companies that are seeking to diversify into Indian markets. This study revealed that Past performance, Core product features, Expense ratio, Risk- Return tradeoff and Liquidity are the five most important factors in a mutual fund. Hence, investors prefer benefit for the cost given, flexible returns, additional facilities, proper performance delivery, service quality, and focus of the service provider besides the core product facilities offered. A prudent Product design, by adding the feature expected by investors that are spelt out in this research will make the Mutual fund scheme more attractive to investors.

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