FACTORS THAT AFFECT MUTUAL FUND PERFORMANCE - A STUDY OF THE REGISTERED FUND MANAGERS IN KENYA

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ABSTRACT

The mutual fund industry has developed, rapidly over the past 20 years; this can be attributed to the various advantages associated with mutual fund as opposed to other investment vehicles. Survival of the fund is solely determined by its performance in the market; this is determined by growth of fund investments and amount of periodic returns to investors for growth and value funds respectively. Kenyan fund market is still at its nascent and of late it has not been performing as well as compared to other developed fund markets in the world. Despite this, little research has been carried out to determine the reasons for poor performance and especially in studying the fundamentals that determine the fund performance. The purpose of the research was to study the fundamentals that predict mutual fund performance in Kenya. The essentials studied in the research included; Investment styles, behavioral patterns and managerial capabilities. The research findings will be of utmost importance to the fund managers, investors, government and also academic fraternity. The study involved all the registered fund managers in Kenya which according to RBA stands at 16. The research design was descriptive and the researcher employed census method of study where 2 questionnaires were issued to each registered fund manager; one to investment manager and the other to fund administrator. 27 questionnaires out of 32 questionnaires issued were duly completed and returned. The data collected was first subjected to descriptive statistics including frequencies, percentages, means and standard deviations. Inferential statistics was also used in the study; in this case, Pearson's moment correlation coefficient was used to determine the magnitude of relationship between variables. The research established a positive relationship between fund performance and investment style and managerial The researcher found a negative relationship between fund performance and behavioral patterns. The research recommends that the various fund regulators comes up with the necessary policies and laws to regulate the industry and also training of fund managers and investors on the funds best practice to improve performance.

KEY WORDS: Mutual fund, investment style, behavioral characteristics, mutual fund performance

1.1.1 INTRODUCTION

The regular global economic melt down has led to almost half of the worlds population to live on less than two dollars a day and about 535 million working people, surviving on less than a dollar a day. With this, there is common consensus that there is need to reach the poorest of poor by encouraging them to pool their resources and cooperate out of poverty (ICA, 2009). The changing economic conditions make investor come up with new alternatives to their investment. These alternatives consist of a mixture of numerous investment vehicles which are mainly formed by various types of mutual funds (Melih, 2010). Investopedia (2012) describes a mutual fund as a company that brings together a group of people and invests their money in stocks, bonds, and other securities. Each investor owns shares, which represent a portion of the holdings of the fund. There is a wide array of benefits associated with investing in mutual funds. This comprises; Simplicity of investment, diversification, benefits of economies of scale, lower transaction costs, lower commission costs, divisibility, liquidity, professional management among others. (www.commerceandindustry.co.ke).

According to Fund Managers Association (2012), the mutual fund investors rely on fund managers who they entrust in investment of their pooled resources. The terms Fund Manager, Investment Manager, Asset Manager, Wealth Manager and Portfolio Manager are used interchangeably. These refer to the person(s) responsible for implementing a fund investment strategy and managing its portfolio trading activities. Fund managers are paid a fee for their work which typically is a percentage of the fund's average assets under management. Fund Managers thus offer important professional input and direction in creating value for investors and any portfolio of investments often pension funds, mutual funds or insurance funds in accordance with stated goals of the funds. To perform, the Fund Manager primarily liaises with the custodian of the Fund. The Fund Managers would not hold client assets in their name but rather these are registered and controlled by an independent third party i.e. the custodian Bank. According to retirement benefits Authority (RBA), there are 16 registered fund Managers.

USA is the world leader in the mutual fund industry with asset base approximating $11.6 trillion under management by the end of year 2011. Total net assets decreased $199 billion from year-end 2010, as gains in bond and hybrid fund assets were more than offset by declines in equity and money market fund assets. Demand for mutual funds remained weak in 2011, with net withdrawals from all types of mutual funds amounting to $100 billion. The mutual fund industry in Africa is among the lowest in the world accounting for 13% when combined with Asia pacific. (ICI, 2012).The mutual fund performance is one of the most addressed topics in fund literature. This comes with recognition that various characteristics affect fund performance either positively or negatively (Melih, 2010) .The investigation of performance has evolved from the examination of benchmarking and modeling issues to analyses of other factors that may impact performance. Most research has documented investment styles which include the size dimension and fundamental attributes of that holding as affecting fund performance. Other factors affecting fund performance include fund characteristics and behavioral patterns, managerial abilities and persistence of return patterns (Oliver, 2009)

Fund performance is measured in terms of capital growth and periodical returns for growth and value funds respectively. The survival of the fund is solely determined by its performance in the market, that is, persistent increase in capital for growth funds and constant returns for value funds. This performance mainly depends on the investment managers' ability to outperform the market through choosing appropriate investment style. This requires stock picking and market timing abilities of the fund managers (Melih, 2010)

1.1.2 Background of the Kenya Mutual Funds

According to Kenya's blue print vision 2030, the key goal in the area of financial services is to raise savings and investment rates from 17 % to 30 % of gross domestic product (GDP). This is through: increase in bank deposits, reducing population without access to financial services from 85% to 70 % and raising stock market capitalization from 50% to 90% of GDP (GoK, 2013). Mutual funds being financial instruments are without doubt one of the key instruments to play pivotal role in support of this noble vision.

In Kenya like any other country in the world, an increasing number of investors are relying on mutual funds as investment and retirement vehicles (Melih 2010). According to the retirement Benefits Authority website, there are 16 registered fund managers in Kenya. in the year 2010, fund managers association of Kenya was set up as a self regulatory initiative. Eligibility to the association was spelt out in its Memorandum and Articles of Association. The main objective of FMA is to make representations to Government on various matters including Legislation, regulation, policy and taxation which affect the business and professional interest of members. Thus, FMA may make representations to Government ministries, statutory bodies such as the Retirement Benefits Authority (RBA) and the Capital Markets Authority (CMA), Stock Exchanges and international institutions on matters affecting business or professional interests of members.The mutual fund market is greatly unexploited in Kenya and research on their performance is greatly deficient. Further, Melih (2010) observes that the current literature on fund markets, though growing, is still not sufficient. It is against this background that the research will be undertaken with a sole objective of studying each of the determinants of fund performance and how they may impact the growth of Kenyan fund market and comparing the findings with other global mutual fund market.

1.1.3 Investment Styles Along with Mutual Fund Performance

One of the most interesting developments in the field of assets management during the past few decades is how investment styles and their characteristics are defined and what role they play in the determination of future returns (Melih, 2010). The outstanding features of investment styles includes; the market cap of typical fund holding (size dimension) and the fundamental attributes of that holding (value-growth dimension). The fund manager's selection of a particular style has an impact on the fund performance. The magnitude of this performance is greatly dependent on this selection process which can contain either a style-consistent or a style-drift manner. (Brown, 2009). According to Melih (2010), many studies in the academic literature pay particular attention to style investing along with mutual fund performance. Investment styles may be classified into three distinct categories, namely style characteristics, style diversification and style consistency, and style performance.

1.1.4 Behavioral Patterns and mutual fund performance

This behavioral patterns includes excessive trading, liquidity and valuation motivated trading, overconfidence, diversification, disproportional buying and selling, the tendency to sell winning stocks earlier and holding on to loser stocks over a longer period. Hence, it also brings momentum and contrarian strategies, noise trading and herding behaviors into focus. Importantly, this category is further classified into 4 distinct segments. We begin the review of this category with the studies investigating herding behaviors and excessive trading patterns first.

1.1.5 Herding Behaviors and Excessive Trading Patterns

Herding behaviors refers to the individuals mimicking the actions of a larger group without planned direction. On the other hand, excessive trading can simply be defined as excessive buying and selling of stocks. Hong, Kubik and Stein (2005) examined the impact of word of mouth diffusion of opinions on trading behaviours of mutual funds and present some evidence on Local Investor Relations (LIR). It further lays stress on career concern-type herding behaviours. Running OLS regressions, the findings indicate that fund managers located in the same city are involved in word of mouth communication with others by exchanging ideas regarding the stocks in which they invest. There is a negative correlation between managerial incentives and the choice to invest in bubble stocks (Dass, Massa and Patgiri 2008). High- incentive funds with low levels of bubble stock. Hong et al. (2005), Dass, Massa and Patgiri (2008), in another study, also build on this strand of the literature by bringing herding behaviours of the fund managers into focus and by examining the fund performance and managerial incentives On the basis of the findings

As in Dass et al. (2008) and Hong et al. (2005), Beaumont, Daele, Frijns, Lehnert and Muller (2008) also examine the effects of herding behaviours in a relatively similar concept. They focus on the ways investor sentiment influences the returns and volatility on preferred indices and point out the salient effects of noise trading on financial markets.

Additionally, Niessen and Ruenzi's study (2009) is a major step forward in this strand of the literature. It displays the relationship between excessive trading and fund performance, and underlines the impact of fund managers' characteristics on funds' success. It also brings gender discrimination and stereotyping into focus. Apart from employing Carhart, and Fama and French multifactor models, this study develops a new measure called "Appraisal Ratio" to assess fund performance. Carhart (1997), Switzer and Huang (2007) and Mazumder et al. (2008) all document that excessive trading may dilute returns and impose additional costs.

1.2 Problem Statement

Despite the documented benefits associated with investing in mutual funds, the mutual fund industry in Kenya is not fully developed. According to FMA (2014), the mutual fund performance in Kenya as measured by periodical returns of the funds and capital growth of investors funds is low as compared to mutual funds in other parts of the world. The mutual funds are not as common as other investment securities including equity securities, government securities and corporate securities among others (FMA, 2014) this is despite the advantages associated with mutual funds as compared to other securities. In fact, Africa combined with Asia pacific mutual fund market account for only 13% of the world mutual fund market. This is far much lower compared to USA alone, accounting for 49 percent of the $23.8 trillion in mutual fund assets. Various research studies have documented various determinants as affecting the mutual fund performance. For example ,the works of brown et al (2009), Rawkoski and Wang (2009), Duan Hu and Mclean (2008) and Cohen et al (2008) document investment style, fund characteristic, managerial capabilities and persistency of returns respectively, as affecting mutual fund performance. There exists research gap in all this studies since the researchers only identified the factors, but the direction and the magnitude of the relationship between this factors and mutual fund performance was not identified. The researchers also considered a single factor in each case without considering the combined effect of these factors on mutual fund performance. Most research also applied sampling techniques which do not give accurate findings as compared to census as a method of study which the researcher used in this study. Little attempts have been carried out to determine the characteristics of these fundamentals in Kenya and hence the reasons for poor performance of mutual industry in Kenya.

1.3 Purpose of the study

The overall objective of the study was to investigate the factors that determine mutual fund performance, specifically the study sought to; (a) to determine the effect of investment style on mutual fund performance. (b) To determine the effect of behavioral patterns of fund investors on mutual fund performance in Kenya. (c) To establish the effect of managerial capabilities of mutual fund managers on mutual fund performance.

1.4 Study design

1.4.1 Research Design

The researcher adopted a descriptive survey design. A descriptive survey research study was preferred since it has the dimension of investigating possible relationships between two or more variables (Mugenda and Mugenda, 2003). The descriptive survey design is ideal since it is concerned with making accurate assessment of the inference, distribution and relationship of the phenomenon (Edwards, 2006)

1.4.2 Target population and sampling

The population of interest in this study was all the registered fund managers in Kenya. According to the Retirement Benefits Authority of Kenya (RBA), there were 16 registered fund managers.

1.4.3 Data Collection and instrumentation

Two questionnaires were issued to all registered fund managers in Kenya; one to investment manager and the other to the fund administrator. The questionnaire contained both open ended and close ended questions. The questionnaires were chosen because of their simplicity of administration and high reliability. . The instruments were pre-tested for their reliability with a sample of 2 registered fund managers; in each fund 2 questionnaires were issued making a total of 4. 2 registered fund managers was chosen for pre-test because according to Mugenda and Mugenda (2003), a sample for pre-test should not be very large and normally the pre-test sample should be between 1% and 10% of the target population. Consistency of reliability alpha coefficient was then used to test the reliability whereby a coefficient of 0.70 or more was acceptable as advocated by Fraenkel & Wallen (2009). A high alpha coefficient (0.7 and above) implies that the items correlate highly among themselves, that is, there is consistency among the items in measuring the concept of interest (Fraenkel &Wallen, 2009). The sample for pre-test was also used to test data validity. The validation of the instrument was aimed at ensuring the instrument was measuring what they were intended to measure (Kathuri & Pals, 2007).

1.4.4 Data Analysis

Data analysis was carried out using the Statistical Package for Social Sciences (SPSS).The data collected was subjected to descriptive statistics thus frequency distribution and measures of central tendency was used. Inferential statistics was also used to determine the relationship between variables.

1.5 Research findings

Table 1.0 summary of regression coefficients

Model	Unstandardized coefficients		Standardized Coefficients	t	Sig.
	B	Std error	beta		
Constant	.227	.114		3.985	.000
Investment styles	.643	.298	.350	1.386	.005
Behavioral patterns	-.543	.080	-.381	-1.033	.013
Managerial capabilities	.809	.343	.363	1.462	.033

Using the values of the coefficients from the regression table above, the established regression equations takes the form of:

Fund performance= $0.227+0.643X_1-0.543X_2+0.809X_3$

Where X_1 :investment style

X_2 :behavioral patterns

X_3 :is managerial capabilities

This can be interpreted to mean, in absence of the various fundamentals of fund performance, the fund performance will change by a magnitude of 0.227. The results further indicate that there is a positive correlation between fund performance and investment style adopted; a unit change in investment style will result in 64.3% change in fund performance. Similarly, the research established a positive relationship between fund performance and managerial capabilities. This means that a unit change in managerial capabilities 80.9% change in fund performance. The research further established that there is a negative correlation between the fund performance and behavioral characteristics meaning, a unit increase in behavioral characteristic will lead to a reduction in fund performance of 43.6%. The results also show that all the variables are significant as the p-values are less than 0.05 ($p \leq 0.05$)

Investment styles and fund performance

The study established that the performance of mutual fund highly depends on the investment style employed by fund managers. This is shown by positive Pearson coefficient of correlation of 0.643. Most fund managers invest in blend of funds. The average value of fund was found to be 50 million and above and most investors often dispose off their investments. In assessing the performance of the funds, most fund managers combine benchmarking and industry performance to determine the performance of their fund. In investing the investors' wealth, the fund managers purchase and sell a diversified portfolio as shown by a high percentage of 66.7% of fund managers who invest in diversified portfolio. The investors frequently purchase and sell their securities. A high number of fund managers, 62.9% were found to use brokers in purchasing and selling securities. This contradicts a study by Carhart (1997) who found that actively traded funds outperform other funds in the market.

Behavioral Patterns and fund performance

In line with Glode (2009), the researcher found a negative correlation relationship between behavioral patterns displayed by investors and fund performance. This is shown by a negative correlation between behavioral patterns and fund performance of -0.543. The study also established that the investors often portray overconfidence, excessive trading, buying attention grabbing stocks, selling winning stocks earlier and sell losing stock, all this affects the fund performance negatively. This is in line with Alexander et al (2008) who found a negative relationship between behavioral patterns and fund performance.

Managerial capabilities and fund performance

The researcher established that there is high positive correlation between managerial capabilities and fund performance. This is shown by positive correlation of 0.809. 74% were found to employ active strategies in fund investment while most fund managers were found to have market timing and stock picking abilities as shown by a high of 62.9%. Most fund managers consider education as opposed to experience a key determinant of fund performance.

Discussion and recommendation of the study

In the light of the research findings, the study established a positive relationship between investment style and fund performance. The study recommends that, the Kenyan fund managers be trained on the best investment styles including, the size of fund to hold, type of funds to invest in, frequency of change of investment style, methods of assessing performance among other investment style characteristics.

The study also established a positive relationship between fund characteristics and fund performance. Most characteristics in Kenyan were found to favor fund performance. However, regulation of fund industry was found to be greatly lacking as one of the fund characteristic. It is recommended that the various regulators of fund industry come up with the necessary regulations to control the fund market and hence fund improving performance.

The behavioral characteristics were found to have negative relationship with fund performance. This factor has been found to be prevalent in Kenya. Behaviors such as overconfidence, buying attention grabbing stocks, selling winning stocks earlier and losing stock late were found to be prevalent. The research therefore recommends that fund investors and managers be trained on the best practices to avoid such negative behaviors.

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APPENDIX 1

Registered Fund Managers in Kenya

1) African Alliance Kenya Investment Bank Limited
2) Amana Capital Limited
3) Apollo Asset Management Company Limited
4) British-American Asset Managers Limited
5) CO-OP Trust Investment Services Limited
6) Dry Associates Limited
7) Genesis Kenya Investment Management Limited
8) ICEA Asset Management Limited
9) Jubilee Financial Services Limited
10) Kenindia Asset Management Company Limited
11) Madison Asset Management Services Limited
12) Old Mutual Asset Managers (Kenya) Limited
13) Pinebridge Investment East Africa Company Limited
14) Sanlam Investment Management Kenya Limited
15) Stanbic Investment Management Services (EA) Limited
16) Zimele Asset Management Company Limited

Source: Retirement Benefits Authority