**Research Journal of Social Sciences & Economics Review**
*Vol. 2, Issue 2, 2021 (April – June)*
*ISSN 2707-9023 (online), ISSN 2707-9015 (Print)*
*ISSN 2707-9015 (ISSN-L)*
**DOI:** https://doi.org/10.36902/rjsser-vol2-iss2-2021(61-67)

**RJSSER**
*Research Journal of Social Sciences & Economics Review*

# Determinants of Mutual Funds Performance: A Review Article

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## *Abstract*

*Mutual funds are a significant form of investment for the development and growth of Capital Markers. The paper surveys the existing literature that focuses on determining factors that have a role in mutual fund performance. The objective is to identify factors that affect the performance of mutual funds based on existing literature. It provides a review of the literature regarding mutual funds' performance. Different factors have been reviewed in the article which may contribute towards the return of mutual funds; some of the important factors are the size of the fund, Turnover, and Management Effectiveness. These factors have a greater contribution to the performance of Mutual Funds. These factors may be evaluated further individually or collectively in different financial markets of the world to analyze the further application of determinants in different markets.*

**Keywords:** Mutual Funds, Fund size, Fund Turnover, Fund Performance

## Introduction

Asset management is an emerging industry in Pakistan. Mutual Fund has a pivotal contribution towards capital market through channelizing the funds of low-income investors and circulating in the economy in the form of assets and investment in lucrative financial securities and assets. Mutual Funds invest capital of individuals and institutional investors in diversified financial securities. In essence, it pools resources from different investors and professionally invests these resources in different financial securities. Primarily, it invests the money and allocates resources in cash and equivalent securities, equity, and bond. As per the report of the Mutual Funds Association of Pakistan (MUFAP), funds of Total Net Assets worth Rs.772.69 Billion are being managed by Managers (MUFAP, 2020).

The enormous growth of the industry has developed the interest of academicians, financial managers, and economists to study this area of finance and the importance of mutual funds has led to a substantial interest to investigate the determinants of mutual funds' performance. This paper presents a review of the existing studies with a recommendation of future research areas. This paper also highlights determinants affecting the performance of mutual funds, keeping in view past important researches and recent literature. Primarily it will look at the factors that contribute towards increasing or decreasing the return of mutual funds.

The major findings of the paper are the identification of the determinants of Mutual fund Performance. These determinants include Fund Size, Expenses, persistence in Performance, fund Longevity, Management Effectiveness, and Style. There is the different opinion of different scholars regarding these factors; some scholars consider these factors important whereas others have concluded that some of the factors are not significant.

## Determinants of Mutual Funds Performance

### Fund Size

It has been the dilemma of investors and managers whether fund size affects performance. Existing research does not present ample evidence in identifying the relationship between Fund size and performance, so the relationship of fund size with mutual fund performance is reviewed in different categories of funds. The results are contradictory as most of the researchers have found a contrary relationship between the size of a fund and its performance and few have discovered a positive relationship.

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The effect of fund size on the performance of a mutual fund can be relevant for both scenarios. This is the reason that previous researches have showed mixed evidence regarding the return of the mutual fund and fund size. Due to economies of scale, the fixed expenses are distributed in large fund size and due to large trading volumes, this can decrease transaction cost and increase return. By contrast, Chen et al., (2004) found the return of funds diminish with lagged fund size owing to liquidity restraints.

The impact of fund size on performance may be accessed through evaluating the correlation of the fund's return with the assets of that fund. It has been observed in preceding researches that the operating efficiency of the funds is higher in the case of the funds which are of a smaller size. Chen et al., (2004) found that fund size spoils the performance of the mutual funds owing to liquidity and diseconomies. Similarly, Yan (2008) observed the same inverse association between fund size and mutual fund performance. He observed that inverse relation is found when investment is made in the less liquid portfolio and he considers liquidity as a prominent factor in large-size funds that erode performance. Similarly, Gorman (1991) concluded the same results and indicated that an economy of scale is drained by mutual funds and witness decreased returns (Becker & Vaughan, 2001). Soderlind et al., (2000) estimated the link between Mutual fund return and fund size in Sweden and found that smaller funds perform better than the larger funds in the category of equity.

Njuguna & Arnolds (2010) found that there is more efficiency in smaller funds as compared to larger funds. Fund Managers prudently invest meager financial resources which generates better results. The researchers also brought the view that financial efficiency not necessarily brings profitability.

According to Hedges (2004), small-size funds tend to generate better results than larger funds. For Indro et al., (1999), the funds ought to have the optimal size so adequate returns can be achieved to rationalize the receiving and trading information costs. Similarly, there exist diminishing marginal returns to some extent regarding the collection of information and trading and after that extent; return tends to be lower down as fund leads beyond optimal size. This view was supported by Tangjitprom (2014) who investigated the impact of the size of equity mutual fund on performance; this study was conducted in Thailand during 2006-2012 and concluded that there exists an optimal size of the fund. The performance tends to increase as the size of the fund augments, However as it grows larger and beyond optimal size, the performance declines due to diseconomies of scale and size deterioration. Ramasamy & Yeung (2003) studied determinants of fund selection and emphasized the size of fund as a more important determinant among past performance and costs of the transaction.

Dawe et al., (2014) analyzed the consistency of performance of mutual funds and concluded that the fund size tends to be an important variable that influences the performance of Mutual Fund because large size distributes the overall cost, and per-unit cost decreases due to economies of scale. Nyanamba (2015) concluded in his study that assets significantly affect the performance of mutual funds. Funds with heavy investments make the best use of them and are more likely to generate better returns. This return and performance have been credited to economies of scale.

The studies suggest that size directly does not impact mutual fund performance rather it has an influence on the expense ratio and that ratio contributes to the performance of the fund (Nazir & Nawaz, 2010)

**Expenses**

The Fund expense is one of the significant determinants of the performance. The observed evidence is incompatible. The growing share of low-cost index funds indicates that while investing in funds and making decisions, investors use this information. The researchers consider expense ratio as a key determinant of fund performance. On the other side, opposite views are brought by different researchers which consider the divergent influence of expense ratio and performance of the fund. Nazir & Nawaz, (2010) considered expenses as a positive influence on the fund return. They are of the view that expenses signify better management and efficient management of the fund has a positive impact on performance.

The studies on performance have provided a view that dynamically administered funds fall short of achieving sufficient returns to recover expenses. So, it can be concluded from the findings that there exists a negative association between the fund return and fund expenses. A study performed by Livingston & O'Neal (1998) on open-ended funds also highlighted particularly the importance of expenses for fund returns. A similar type of study by Elton et al, (1993) evaluated mutual funds return

on the equity side and concluded that expense ratio and expenses are negatively correlated. The transaction cost is incurred when fund Managers make adjustments in the portfolio allocation and according to Chen et al., (2000), the accelerating rate of fund turnover tends to be related to a general decline in trading costs over time.

Golec (1996) suggested that funds with higher fees and expenses should be avoided because they generate lower returns. Ippolito (1989) is of opinion that funds that have a minimum cost related to a transaction do better than the funds that charge a higher cost. Barber et al. suggest that investors have become aware of the costs of investing, and reluctant to pay up-front fees. Ennis (2005) recommended a model that illustrates the relation among few important variables i.e. Fund Managers' proficiency, expense ratio, and the possibility of investor success, and concluded that managers must be proficient in the skills and at the same time expenses should be minimized to generate better results.

The performance of the mutual fund is certainly affected by the expenses incurred on it and different researchers have found this in their studies. Elton et al., (1993) concluded in their studies that there exists a strong negative association between the expense ratios and returns.

**Fund Turnover**

The level of fund turnover signifies active or passive management policy pursued by management for accomplishing desired results. The active management pursues a higher turnover policy whereas lower turnover represents passive management policy. The literature has explained the performance of mutual funds and several factors have been identified as prospective determinants of mutual fund return. The factors include fund size, management fees, and expenses. Other variables that are found important include turnover ratio, flows, and returns. The turnover ratio is considered an important factor among all the possible determinants of mutual fund return.

The researches have been conducted to evaluate the correlation of Level of Fund Turnover and fund performance. The Empirical evidence in the case of mutual fund return and turnover is inconsistent. The higher turnover erodes mutual fund performance because bigger expenses are involved in the larger level of portfolio turnover and these expenses take off some percentage of fund return. Empirical research was done to investigate the US fund market and Carhart (1997) discovered an opposite affiliation among the turnover and returns. In contrary to this, Wermers et al., (2000) and Soderlind et al., (2000) found a positive association between turnover and fund returns, which means as fund turnover increases, returns of the fund will also improve. Glenn (2004) argues that there is the option of redemption in the open-ended funds and open-ended fund need to keep a certain sum of amount in cash or cash equivalent securities. These securities generate less or no return for the funds and these securities would have smaller portfolio investment as compared to close-ended funds. As a result, lower returns may be expected in open-ended mutual funds.

Turnover along with liquidity is a crucial factor affecting fund performance. The researchers have found a positive relationship among the two factors, Turnover and Fund Performance (Wermers, 2000). The negative relation was found by Afza & Rauf (2009).

Further studies on the flows of mutual funds proposed the existence of an asymmetric flow performance relationship. The study of these researches shows that higher returns and performance in a certain year or period is followed by a further rise in investment and inflows of assets in the succeeding time. The lower returns or substandard performance is not witnessed with a decline in asset outflows. The investor's behavior and his/her psychology also have an influential impact on the selection of funds and indecision of switching among the funds. (Goetzmann & Peles, 1997; Sirri & Tufano, 1998)

**Management Effectiveness and Style**

The permanence of management effectiveness is a significant concern for scholars. The funds are categorized differently as per the objective of Investment so the efficiency of managers and investment style may be a vital feature in the selection of Fund. Brown (1995) investigated yearly returns of mutual funds and concluded returns as consistent and interrelated over the years hence disparaging the efficient market hypothesis. Many empirical studies have found that investment style and management effectiveness contribute towards better results. The choice of Fund Managers to pursue certain preferences and investment approach over another may affect the structure of asset prices. This preference of following investment style and giving priority over others may be due to some behavioral and agency reasons.

Barber & Odean (2003) asserted that it is not portfolio selections that elucidate the declining performance but the cost and frequency of trading. Also, studies have shown that the funds, spending more on research and trade may be better identify underpriced stocks and therefore get rates with appropriately higher returns to counterweight higher charges.

The management style and preference of management for funds based on risk aversion and risk-taking also shape the future of Mutual Funds. The performance of funds depends upon the management style and risk-taking appetite. The funds having a clear objective, preference for risk, and consistency in policies perform better than funds having an inconsistent management style.

**Liquidity**

Different research papers have been analyzed to evaluate the impact of liquidity and it was identified that liquidity is one of the important variables in mutual fund performance. One of the research conducted in Kenya found that the fund performance is better which has illiquid assets.

According to research conducted by Foran & O'Sullivan (2014) in the United Kingdom regarding liquidity Risk and Performance, Funds are more focused on liquid stocks as they may be converted in cash and have low risk involved in liquid assets. The research also highlighted the important role of liquidity and risk towards the return of mutual funds. Funds taking less risk and having liquid assets are preferred among investors in different markets. Ferreira et al., (2012) evaluated performance and factors of mutual funds in twenty-seven countries over the time of 1997–2007 and found that the unfavorable scale effects in the USA are associated with liquidity restraints faced by funds that, by their style, have to invest in small and domestic stocks. The different results are witnessed in different countries.

**Persistence in performance**

Performance Persistence is also extensively talked about in the previous studies and literature to investigate whether particular performance will recur in the future. It is examining whether selecting a mutual fund based on past return has any connection or does it facilitates forecast future performance. Cuthberson et al., (2006) is of opinion that the notion of persistence is diverse to predictability in a way that is persistence, a positive relationship is observed whereas in predictability there are both positive and negative relationships.

Ample studies have been conducted on persistence in performance and a lot of them examined performance consistency in the mutual fund. Sharpe (1966) calculated the correlation coefficient through Reward-to-Variability ratios and found that correlation as 0.36. By analyzing this result, he concluded that Future return can be estimated through past performance.

According to Goetzmann & Ibbotson (1994) research which was based on a study of around 700 funds over the time of 1976-1988 concluded that past performance is determinant of mutual fund return. They are of the view that if fund performance has been outstanding in the current period then it is most likely to be repeated in the subsequent period. Hendricks et al. (1993) used time-average cross-section regression to investigate consistency; he observed returns of mutual funds for 12 years and found a positive correlation. In opposite to this view, Dahlquist et al., (2000) used the same approach in Sweden and found no evidence of consistency in performance. Blake & Timmermann (1998) used data throughout 1972-1995 and found evidence of persistence in performance among the best and worst-performing funds.

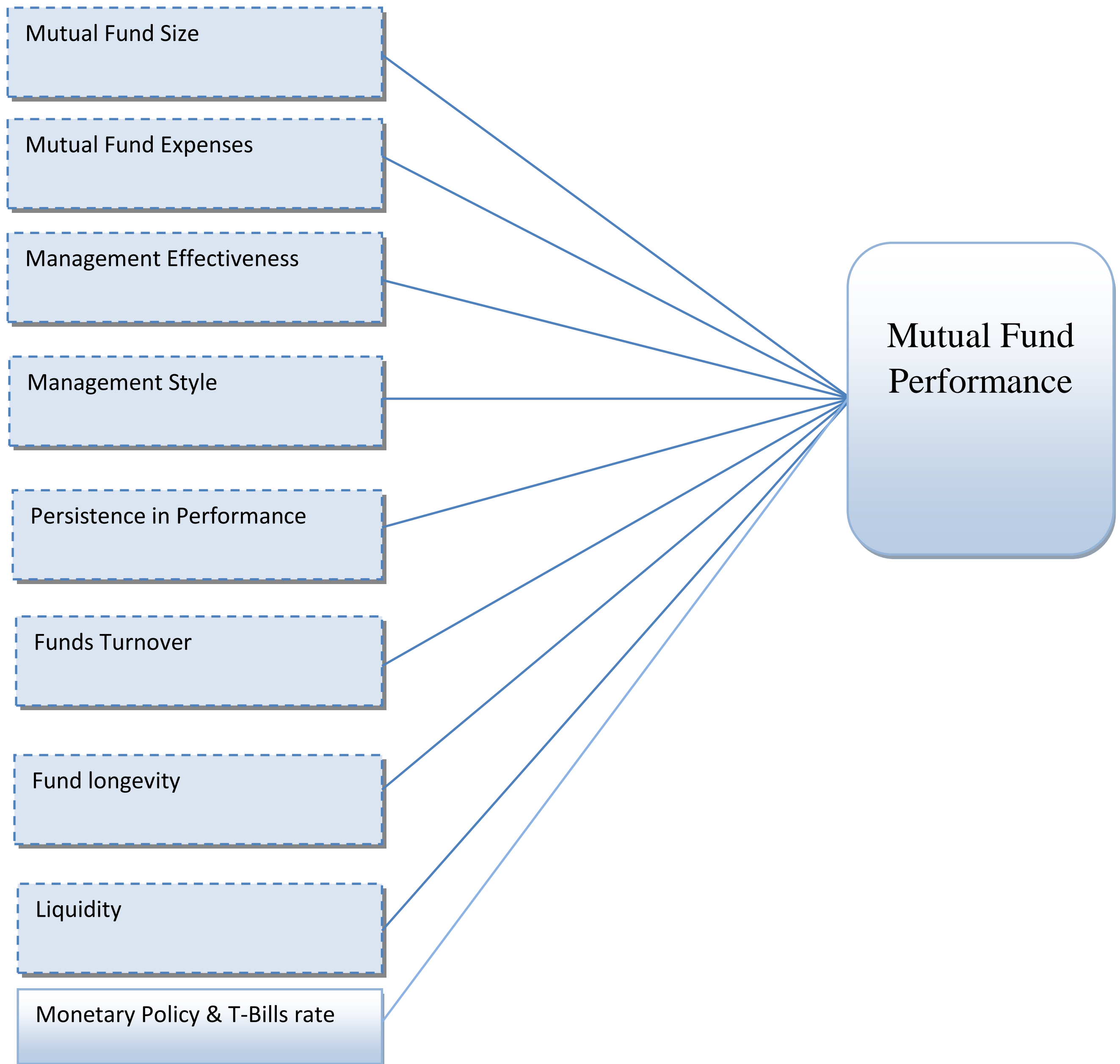
**Fund Longevity**

The performance of Mutual Fund and its relation with longevity has got little consideration by the researchers. At the start of a mutual fund, managers incur high costs on the advertisement to attract investors toward the fund and to augment investment in the fund. As advertisement is a fixed expense, it lowers down fund return in the initial years of investment. In contrast to this, it is urged that mutual fund managers of young funds tend to be more dynamic and energetic. This was later assured by Blake & Timmermann (1998) that the performance of funds is preeminent in the initial years of offering. Likewise, Otten & Bams (2002) found a negative relationship between performance and fund longevity in the research conducted by the European nations. Thus the effect of fund longevity on its performance can be in either form, positive or negative. The performance of newly issued mutual funds can be influenced by an investment learning period. They further added that there exists a relationship among

Fund size and age, smaller funds are mostly new ones and have minimum returns as compared to larger and older funds. Koedijk & Otten (2002) asserted that minimum performance and

lower returns are due to exposure of these smaller funds to higher market risk and volatility because managers tend to put funds in fewer securities.

**Proposed Determinants of Mutual Fund Performance**




**Conclusion and Further research**

The literature on the determinants of Mutual Fund performance is quite extensive, though arguably still limited. The literature helped in identifying different factors which have an impact on the results and outcome of Mutual Funds return. The size of the mutual fund and turnover of the fund along with management effectiveness can be regarded as important factors in predicting returns of the mutual funds. It is also certain that the returns of a mutual fund are affected by the expenses incurred on it and different researchers have found this in their studies. The expenses incurred on the mutual funds lower the return of funds so it is important to minimize the expense ratio. The investors can look at the expenses of the fund before investing in those mutual funds. Managers should manage current liabilities effectively to cope up with financial shortfall and maintain certain liquid assets, but these liquid assets should not be greater to minimize return because liquid assets tend to provide lower returns.

The factors reviewed under the article show the relationship of these determinants with the performance of Mutual funds. Among all these determinants, Fund Size, Funds expenses, and management effectiveness are widely discussed and considered significant variables in determining the return of Mutual Fund Performance. The study on these factors may further be conducted in Pakistan to have a greater idea of their application in the Pakistani Mutual Fund Market.

Different factors are also interrelated to each other, like Persistence in Performance and Management Effectiveness, similarly Funds turnover and Fund Size collectively can influence Fund Performance, and so future research may be conducted in which collective impact of these variables on Fund Performance may be evaluated in different markets.

Another important variable that has been not researched is the influence of monetary policy and Treasury bills rate over the results of Mutual Funds. It is observed in mutual funds that fund investment has been allocated in Treasury bills, but previous literature has not identified monetary policy rate as a significant indicator of mutual fund performance. The monetary rate in Pakistan has been uncertain and change over some time. This variable can be studied and the impact of change in monetary policy on mutual Fund performance can be researched initially in the Pakistan Mutual Funds industry. The income funds can be studied in the initial phase to determine the impact of changing rate on performance as most of the investment in income funds is allocated to treasury bills and marketable securities.

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