

Performance Evaluation on Mutual Funds

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Abstract: Mutual fund investment has lot of changes in the recent past, and investors mentality and their expectation are changing in the present scenario. Investors preference towards return, risk varies often. The investor should compare the risks and returns before investing in a particular fund. For this, he should get the advice from experts and consultants and distributors of mutual fund schemes. The investors can invest in the mutual fund and can be to get more benefits.

Periodically checking up on how the mutual fund is doing is important, and there are lots of measures that the investor can use to perform the checking. A funds track record may be the single most important factor that an investor checks before opting for a mutual fund product. Hence evaluating funds is important before investing. But it is becoming increasingly important for investors to take note of other parameters too, while deciding between mutual funds. Of course, investors need to weigh the savings on expenses against the performance record before choosing a fund.

Over the past decades mutual funds have grown intensely in popularity and have experienced a considerable growth rate. Mutual funds are popular because they make it easy for small investors to invest their money in a diversified pool of securities. As the mutual fund industry has evolved over the years, there have arisen many questions about the nature of operations and characteristics of these funds. Thus the fund evaluation process helps the investors to know more about the funds and its performance.

I.INTRODUCTION

MUTUAL FUND INDUSTRY

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank. The history of mutual funds in India can be broadly divided into different phases: An Act of Parliament established Unit Trust of India (UTI) on 1963. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

CONCEPT OF MUTUAL FUND

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

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II. FUND CLASSIFICATION

Mutual funds now come in every possible size, shape, and color. Here are some of the general categories of mutual funds. They are bond funds, balanced funds, general equity funds etc.

BOND FUNDS

Bond mutual funds are pooled amounts of money invested in bonds. Bonds are IOUs, or debt, issued by companies or by governments. A purchaser of a bond is lending money to the issuer, and will usually collect some regular interest payments until the money is returned. Usually the amount of interest paid (the coupon) is fixed at a set percentage of the amount invested thus, bonds are called "fixed-income" investments.

BALANCED FUNDS

Balanced funds mix some stocks and some bonds. A typical balanced fund might contain about 50-65% stocks and hold the rest of shareholder's money in bonds. It is important to know the distribution of stocks to bonds in a specific balanced fund to understand the risks and rewards inherent in that fund.

GENERAL EQUITY (STOCK) FUNDS

Stock or equity mutual funds are pooled amounts of money that are invested in stocks. Stocks represent part ownership, or equity, in corporations, and the goal of stock ownership is to see the value of the companies increase over time. Stocks are often categorized by their market capitalization (or caps), and can be classified in three basic sizes: small, medium, and large. Many mutual funds invest primarily in companies of one of these sizes and are thus classified as large-cap, mid-cap or small-cap funds.

INTERNATIONAL/GLOBAL FUNDS

International funds invest in companies whose homes are beyond the fair shores of this great nation. Global funds invest in both U.S. and international-based companies. In general, international and global funds are more volatile than domestic funds.

SECTOR FUNDS

Sector funds invest in one particular sector of the economy: technology; financial, computers, the Internet, llamas. Sector funds can be extremely volatile, since the broad market will find certain sectors very attractive and very unattractive - often in rapid succession.

ADVANTAGES OF MUTUAL FUNDS

The advantages of investing in a Mutual Fund are:

- Professional Management
- Diversification
- Convenient Administration
- Return Potential
- Low Costs
- Liquidity

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- Transparency
- Flexibility
- Choice of schemes
- Tax benefits
- Well regulated

DISADVANTAGES OF MUTUAL FUNDS

- Portfolio construction – The portfolio cannot be constructed by the investors on their own. They are being constructed by the AMC's.
- Load Factor – The entry and the exit load charged cannot be determined by the investor. These are the major two limitations of mutual funds.

Prior to 1965 a mutual fund's performance was often rated by comparison to other funds' returns or by averaging returns over a number of periods. The shortcomings of such methods are briefly addressed by **Treynor** (1965) in "How to Rate Management of Investment Funds," a watershed work wherein the author presents a new way of viewing performance results.

In the modern portfolio theory, Treynor discusses both market influence on portfolio returns and investors' aversion to risk. The article has three parts: (1) a development of the characteristic line, which relates the expected return of a fund to the return of a suitable market average; (2) a development of the portfolio-possibility line, which relates the expected value of a portfolio containing a fund to the owner's risk preferences; and (3) a development of a measure for rating management performance using the graphical technique was developed.

Shortly thereafter, Sharpe (1966), in "Mutual Fund Performance," explains in a modern portfolio theory context that the expected return on an efficient portfolio, $E(R_p)$ and its associated risk (σ_p) are linearly related:

$$E(R_p) = R_F + \beta \sigma_p$$

wherein R_F is the risk-free rate and β is a risk premium. The optimal portfolio with the risky portfolio and a risk-free asset is the one with the greatest reward-to-variability ratio.

The author examines 34 open-end mutual funds (period 1954-1963) and finds considerable variability in the Sharpe ratio, ranging from 0.78 to 0.43. He provides two potential explanations for the results: (1) the cross-sectional variation is either random or due to high fund expenses, or (2) the difference is due to management skills.

Two years later Jensen (1968), in "The Performance of Mutual Funds in the Period 1945-1964," investigates the performance of mutual funds with a model that statistically measures a fund's performance relative to a benchmark.

$$R_p - R_f = \alpha + \beta (R_m - R_f) + E_i$$

where α is termed Jensen's alpha and the error term E_i is expected to be serially independent. A positive α indicates superior security price forecasting. A negative α indicates either poor security selection or the existence of high expenses.

Over the next half-decade, the papers of Carlson (1970) "Aggregate Performance of Mutual Funds, 1948-1967," and McDonald (1974) "Objectives and Performance of Mutual Funds, 1960-1969," address performance relative to fund type and fund objectives, respectively. Carlson shows that regressions of fund returns on the S&P

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index returns have a high unexplained variance which is significantly reduced when a mutual fund index (diversified, balanced, or income) is used as the market proxy. In a related vein, McDonald reports that more aggressive portfolios appear to outperform less aggressive ones. As a reward-to-variability ratio, the author uses mean excess return divided by standard deviation and finds that a majority of the estimated ratios fall below the ratio for the market index.

A later paper, "Mutual Fund Performance Evaluation: A Comparison of Benchmarks and Benchmark Comparisons," by **Lehmann and Modest** (1987), provides empirical evidence on whether the choice of alternative benchmarks effects the measurement of performance. Among the authors findings are results showing that the Jensen measures (α) are sensitive to the choice of APT benchmarks. The authors conclude that the choice of a benchmark portfolio is the first crucial step in measuring the performance of a mutual fund.

In contrast to earlier studies which examine the actual returns realized by mutual fund investors, **Grinblatt and Titman** (1989), in "Mutual Fund Performance: An Analysis of Quarterly Portfolio Holdings," employ both actual and gross portfolio returns in this study. The authors report that superior performance may exist among growth funds, aggressive growth funds, and smaller funds, but these funds have the highest expenses, thus eliminating abnormal investor returns. In a 1993 study these authors introduce a new measure of portfolio performance, the "Portfolio Change Measure" and conclude with essentially the same findings.

In a comprehensive study, "Returns from Investing in Equity Mutual Funds: 1971 to 1991," **Malkiel** (1995) employs all diversified equity mutual funds sold to the public for the period 1971-1991 to investigate performance, survivorship bias, expenses, and performance persistence. To consider performance he calculates the funds' alpha measure of excess performance using the CAPM model and finds the average alpha to be indistinguishable from zero. Using the Wilshire 5,000 Index as a benchmark, the author finds negative alphas with net returns and positive alphas with gross returns, but neither alpha to be significantly different from zero.

The author also finds no relationship between betas and total returns. The author concludes that the findings do not provide any reason to abandon the efficient market hypothesis.

In a study focusing on non-surviving funds **Lunde, Timmermann, and Blake** (1999), in "The Hazards of Mutual Fund Underperformance: A Cox Regression Analysis," investigate the relationship between funds' conditional probability of closure and their return performance. The authors explain that the process of fund attrition rates is important because: (1) survivorship bias is impacted by the funds' lives and their relative performance; (2) duration profiles of funds is important for understanding fund managers' incentive environments; and (3) termination processes may provide information about investor reaction to poor performance.

The paper measures the importance of various factors influencing the process and rate by which funds are terminated. After examining a data set of dead and surviving funds (973 and 1402, respectively), the authors present some reasons why funds are terminated: (1) not reaching critical mass in capitalization, (2) merging a poorly performing fund with a similar, more successful fund, and (3) merging or closing a poorly performing fund to improve family group performance overall. All of these are related to fund performance, which the authors use to explain fund deaths.

III.CONCLUSION

The prime aim of an investment is to earn profit. Hence for the investors the amount invested doesn't matter

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whereas the investment in good mutual funds contributes to a great extent for profit. Ultimately, it is important for an investor to study the risk and return involved in an investment, through which the investor can gain valuable information before investing in any mutual funds. The fund evaluation technique thus helps the investor to find the performance of selected securities in different manner. So the investor must aware of each techniques and finding the source of information which will help them to diversify the investment portfolio.

REFERENCES

S.NO	NAME OF THE BOOK	NAME OF THE AUTHOR	EDITION	PUBLICATION
1.	SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT	PUNITHAVATHY PANDIAN	2 nd EDITION 2005	VIKAS PUBLISHING HOUSE PVT LTD
2.	SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT	V.A.AVADHANI	8 th EDITION 2006	HIMALAYA PUBLISHING HOUSE
3.	SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT	DONALD E.FISHER AND RONALD J.JORDAN	2 nd EDITION 2000	PRENTICE HALL OF INDIA PVT LTD