

CHAPTER I

INTRODUCTION

A. Research Background

Mutual funds performance is one of the most commonly studied topics in investments area in the majority countries. This is because the availability of data and importance of mutual funds as vehicle for investment in the stock market. Mutual funds provide many benefits to their investors. Such benefits are as follow. They reduce the risk of investing in the stock market by diversification, mutual funds provide such as record keeping, providing market updates, suggestions on investment opportunities and so on. They provide professional management by experts in the stock market. Mutual funds also reduce transaction costs for investors in the sense that the only performance that investors need to see is of the fund and not the stocks or the assets held by the fund and can easily make decisions on that basis. By pooling of investment funds, they allow small investors to hold a diversified portfolio. The fund portfolio is also professionally managed and monitored by professionals in the market who have both experience and information for profitable security selection. The benefits of mutual funds mentioned above are consistent with the ones also identified by Sipra (2006).

The important thing that the investors need to note down and pay attention is that the past performance does not always guarantee future performance.

Return is not the whole matter in investment. Instead choosing the fund that offer great return, investors need to create a good diversification and efficient performance on recent date that will give a better result than only return in the future dates. Mutual Funds provide an investment opportunity to individual investors which are professionally managed. Mutual funds cater to the needs of especially those investors who do not have much understanding of the financial markets, providing them with an opportunity to hold the diversified portfolios thus minimizing the overall risk of their investment.

Mutual funds are getting much popularity around the world. This is because mutual funds today have assets under management worth not millions or billions but trillions of dollars. Mutual funds have been in existing for a long time, U.S being the pioneer in mutual funds industry where the growth of mutual funds started after the World War II when the mutual funds had assets worth \$1.2 billion which then reached \$6 trillion by 2002 (Mahoney, 2004). In Indonesia, the *reksa dana* has been traded since 1995 as the *Undang-undang No. 8 tahun 1995* was published. As the way for easier investment process was created, the progress of development of the mutual fund went rapidly till 1997.

The capital market plays a very important role as an efficient tool of cashflow from the investors which have more capital to the company which is in need of money. The capital market is a place where the mutual funds are being sold along with the others type of investment such as stocks, bonds, unit link, etc.

Without capital market, the efficiency to direct access to the capital will be decreased. When the exchange market is successful in managing the capital market, the efficiency rate and value of capital will be effected for they can be intermediated by lower financial instution under the capital market.

By observing the overall Mutual Funds Industry clearly highlights that there has been a phenomenal growth in the Industry; both in terms of assets under management and the number of funds (Shah and Hijazi, 2005). Asebedo and Grable (2004) identified as an important factor influencing mutual funds' performance. They argue that fund managers control all sorts of decision making related to investment by the fund, therefore their style influences the fund to a great deal. Fund managers also control the diversification and turnover of fund's assets which again influence fund performance (Malhotra and Mcleod, 1997 and Fredman, 1999).

Before deciding to invest in mutual funds, it's always been better to understand what are the risks that the mutual funds have in general so that the investors will not be surprised when the uncertainty happens in the market. Some of the general risks are:

1. Reinvestment risk is the risk that faced by the investor for the interest risk which is received from the reinvestment.
2. Equity risk is the risk that one's investments will depreciate because of stock market dynamics causing one to lose money. The measure of risk used in

the equity markets is typically the standard deviation of a security's price over a number of periods. The standard deviation will delineate the normal fluctuations one can expect in that particular security above and below the mean, or average. However, since most investors would not consider fluctuations above the average return as "risk", some economists prefer other means of measuring it.

3. Interest rate risk is the risk (variability in value) borne by an interest-bearing asset, such as a loan or a bond, due to variability of interest rates. In general, as rates rise, the price of a fixed rate bond will fall, and vice versa.
4. Currency risk is a form of financial risk that arises from the potential change in the exchange rate of one currency in relation to another. Investors or businesses face an exchange rate risk when they have assets or operations across national borders or if they have loans or borrowings in a foreign currency.
5. Commodity risk refers to the uncertainties of future market values and of the size of the future income, caused by the fluctuation in the prices of commodities. These commodities may be grains, metals, gas, electricity etc.
6. Inflation risk is the risk that faced by investors for the increase of inflation rate. It will affect the purchasing power of the buyer for the money they have. Higher the inflation lower the purchasing power.
7. Default risk where the investors do not receive the payment from the issuers where they can't afford to pay the duty.

The theory of modern portfolio was first started by Harry Markowitz at year 1952 (Portfolio Selection in Journal of Finance Volume 7/1 1952). In this modern portfolio theory the investor evaluate the portfolio based on the expected return and risk of a portfolio using the systematic curve. This curve will lead the investor in choosing which one has a high and low return and high and low risk. This type of curve was famous as being used by Sharpe, Treynor, and Jensen. Three of them used the risk-adjusted method in calculation the risk and return of market.

Several methods of calculating the average rate of return on mutual funds has been widely used, some of which are the arithmetic method, the method of weighing the time, method of weighing the dollar. Rate of return is usually reported as an annual average. Therefore requires the existence annual subperiode rate of return. Some of the methods used are the Treynor index, Sharpe index, Jensen index. The three tools are calculated using different assumptions, but has almost the same conclusion because both take into account the risk factors of an investment (Manurung, 2008).

The actions done for giving information and clear understanding related to the mutual fund are highly important in order to attract the investors to put their money in the mutual fund. The researches related to the topic of mutual fund which can give a positive return and low risk are to be declared to the

investors, so that the investors know and understand the performance of certain mutual fund (Manurung, 2006).

Sharpe (1965) used the Capital Asset Pricing Model (CAPM) to compare the risk-adjusted of the mutual fund against the market portfolio. It showed up that returns earned by the investor are less than the operation cost. Levy (1972) argues that the Sharpe Ratio cannot be interpreted independently of the investment horizon. Therefore, practical implementation of the Sharpe Ratio using short (monthly, quarterly, annual) return intervals to evaluate portfolios or make asset-allocation decisions will be biased for long-term investors and may lead to suboptimal results. Lo (2002) said that in building blocks of the Sharpe Ratio are unknown quantities that must be estimated statistically and are subject to estimation error.

Treynor index, which was founded by Jack Treynor (1965), is commonly used to measure mutual fund performance. This measurement assumes that the mutual fund, as the object of study, is well diversified, therefore this index only takes the systematic risk (β) into account. The Treynor index can be calculated by dividing the net of mutual fund's return minus the risk-free rate with the market risk of that mutual fund.

Jensen index, however, measures the performance of mutual fund based upon the Capital Asset Pricing Model (CAPM), which calculate the excess return on

a portfolio over time. This index also measures the investment manager's ability to increase the funds' return above the market's return by using active strategy. In another word, this index can measure of how best the mutual fund can "beat the market". Additionally, any mutual fund with a consistently positive excess return (adjusted for risk) will have a positive alpha, vice versa.

According to Keng (2000) unlike the traditional risk-return diagram, the snail trail method not only shows results relative to the median or average fund manager, but is a robust tool for comparing fund managers' performance.

According to Mangiring (2009) the research related to the mutual fund performance has not found a fix answer about the market. Maleaki (2001) had written in his thesis that the mutual fund can perform better that the market index as the use of active strategy and passive strategy depend on the calculation of raw performance.

As a form of investment, the mutual fund always has the performance or return. The performance or return can be obtained through calculating the return and the risk it possesses. And the performance of a mutual fund is fully based on the investment manager's policy in managing its investment. On another words, the performance of mutual fund is the frontlook of the investment manager's performance.

The success of an investment manager is related to the performance in how high is the return rate, as the returns is an indicator how much capital that are given back to the investors for their investment decision. One of the main indicator in valuing the performance of the mutual fund is by seeing the net asset value (NAV) which is reported at daily basis. This is calculated by the value of investment and holding capital, after deducted to the operational costs and debts.

Alongside fund manager's style, his experience also plays an important role in the overall performance. Experienced fund managers would definitely have more knowledge and knowhow of the market and how to react in certain situations as compared to young managers. Markese (2000) indicated that mutual funds with new and inexperienced managers should be avoided as there is no surety of their performance. Added to that Golec (1996) concluded from his study that the funds exhibiting good performance are usually the ones managed by experienced managers.

In an efficient market mutual fund managers cannot beat the market and any superior performance is simply luck and does not persist. But recent studies (Elton, Gruber and Blake, 1996; Goetzmann and Ibbotson, 1994; Hendricks, Patel and Zeckhauser, 1993) found that past performance of mutual funds can predict future performance. These new findings cast doubts on the efficient market hypothesis and rekindle investors' hope of earning abnormal returns by

plowing through historic performance records. Brennan said that to improve the understanding of capital markets we must learn how individual investors acquire and process information when making investment decisions, and not to assume that individual investors have the same technical knowledge as trained economists. He also believes that the press is the primary source of information for many investors and suggests a “reverse business school survey on leading financial publications” to assess the quality and value of such information.

If mutual fund performance is predictable, using the rankings may help investors select funds that will continue to outperform in the future. On the other hand, if performance does not persist, rankings based on past returns have no value (Brennan, 1995). There are so many researches that have been done by many economists and other writers, and the methods that were used to measure the performance of the mutual fund are; Treynor Index, Sharpe Index, Jensen Index, and Snail trail method. The first three methods are mostly being used globally and yet the last one, Snail Trail, is probably the newest method that is being used today.

This reserach is written as to give a new point of view for the performance appraisal for the equity mutual fund in Indonesia. There will not be any comparative analysis from the result of this study to the other results using other methods, therefore this is highly different from the other study. This study is limited only based on the active Indonesia Equity Mutual Fund which

is announced by the *Bapepam LK* for the period of January 2006 until December 2010. The level of return will be measured by net asset value (NAV) or *nilai aktiva bersih (NAB)* data, which are collected on daily basis. The data will be used to calculate the return and the risk. As a new method, snail-trail method will give new information to the market about the ranking of mutual funds and can be used as the comparative value to the current available information for the investors in their investment decision.

This study doesn't examine the other than equity mutual fund because the equity mutual fund gains the most interest from the investors as it gives the probability of high return where at the same time it has high risk too. In Indonesia, at the year of 2006 according to the data from Bapepam for December 2006 (Bapepam, 2006) total fund collected from the mutual fund is Rp 52.28 billion and 16% or Rp 8.36 billion was the equity mutual fund. And for the year of 2011, the equity mutual fund was collected for 36.27% or Rp54.88 billion from total Rp151.33 billion fund raised up to May 2011 (Bisnis, 2011). Even though this type of mutual fund has greater risk than the deposit, for the long term this investment is hoped to have a higher value of investment.

1. Problem Statement

Based on the descriptions above and explanations on the background, the writer formulates the following issues:

The Performance Evaluation of Indonesia Equity Mutual Fund Using the Snail-Trail Method (Period 2006 to 2010)

2. Scope of the Problem

In order to limit the scope of the discussion on the issue and to obtain a clearer direction for the writer in discussing this problem so the writer has set limit on the following issues:

- a. This research will only be conducted on the Equity Mutual Fund in Indonesia which is considered active according to the BAPEPAM for the year 2006 - 2010.
- b. A financial ratio measured in this study is the net asset value (NAV) or *nilai aktiva bersih (NAB)*, Risk, and Return of Investment.
- c. This research will only be conducted to evaluate the performance of the Indonesia Equity Mutual Fund without comparing the result with the other risk-adjusted method results.

3. The Originality of Writing

This research is carried out based on the previous researchers that have been done before. Basically, this research is replication research based on the previous research with the title "*Unit Trust Performance Measurement; the Snail Trail Approach*" performed by Tan Yen Keng. This research published in 2000 by universiti Putra Malaysia Press. Some research related to this topic is also used to broaden the sources and to deepen knowledge of

the empirical results related to the impact of investor sentiment on the excess returns.

B. Objective and Benefit of the Research

1. Objective of the Research

As described above, that the study is intended to examine the value of the Performance Evaluation on net asset value (NAV) or *nilai aktiva bersih* (*NAB*) using the snail-trail method for the equity mutual funds which are listed in Bapepam (www.bapepam.go.id). It is presented to the thesis titled “THE PERFORMANCE EVALUATION OF INDONESIA EQUITY MUTUAL FUND USING THE SNAIL-TRAIL METHOD (Period 2006 to 2010)”

2. Benefit of the Research

This research hopefully will be able to bring benefits toward:

a. The writer

Add an experience in the case of making scientific report and enhance more knowledge about capital market especially increase understanding about mutual fund, performance evaluation, and the methods. This study is important to make a better understanding and more information about the investment decision.

b. The reader and investor

This research is expected to provide a broader knowledge of the community who involved in the financial business world, for potential investors in the national mutual fund market. This research expected to provide a broader knowledge about the performance evaluation of the equity-fund using the snail-trail method. This research can be used as an additional information when they want to make investment decision related with capital market especially in the case of right issue and in the case of choosing well-performing portfolios.

c. The Development of the theory

This research can be a reference in order to support subsequent writers, especially in relation to the study mutual fund appraisal and sensitivity analysis.

C. Research Report Outline

The writing is divided into five chapters, which are:

Chapter I Introduction

This chapter will discuss the introduction about the research. The introduction consists of research background, problem statement, scope of the research, objective and benefit of the research, and research report outline.

Chapter II Theoretical Background and Previous Research

This chapter contains the related theoretical background and previous research.

Chapter III Research Methodology

This chapter describes the population and sample used in this research, data and data gathering, variable and variable measurement, and method of analysis.

Chapter IV Data Analysis

This chapter provides and presents the data analysis and discusses the result obtained in this study.

Chapter V Conclusion, Limitation of the research, and Suggestion for further research.

This chapter consists of conclusion, limitation of the research, and suggestion for further research.