GLOBAL RESEARCH ANALYSIS

ISSN No 2277 - 8160

Listed & Indexed with

ISSN Directory, Paris



Multi-Subject Journal

Volume : 1 | Issue : 1 | June 2012 | ₹ 250/-

GLOBAL RESEARCH ANALYSIS

ISSN No 2277 - 8160

GLOBAL RESEARCH ANALYSIS

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Volume : 1 | Issue : 1 | June 2012 • ISSN No 2277 - 8160

Research Paper | Management

Investors Perception for Mutual Fund Investment in 21st Century

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ABSTRACT

In the past decade, it is observed that Mutual Fund investors are getting more aware of the tax implications of their investments. Mutual funds are required by law to distribute their earnings yearly and these distributions result in taxable income to investors. The distributions are taxed either as ordinary income and/or capital gains based on the trading strategy of the fund manager, not the holding period of the investor. This creates significant taxable income, which can significantly reduce the net return earned by mutual fund investors.

Tax information is becoming more significant as the Securities and Exchange Board of India (SEBI) had made it mandatory to report the returns with taking taxes into consideration. This information allows investors to make more informed decisions on their mutual fund investment.

KEYWORDS: NAV, Tax-Managed Mutual Fund, SEBI

Introduction

The Investment Company Act of 1940 is the first act that specifically regulates the mutual fund industry. This Act regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. The Act requires disclosure upon initial issuance of shares and thereafter periodically. The focus is on disclosure to the public of information about the fund and its investment objectives, as well as on the company's structure and operations.

This paper deals strictly with open-end funds that can be easily bought and sold in an open market. These shares can be bought and sold at any time and the shareholder does not have to wait for a buyer. Open-end shares are sold back to the fund for their NAV and the mutual fund may have to sell some of its holdings to pay the shareholder. There are many choices available to open-end mutual funds that influence the risk and return of the fund. Funds can invest in stocks, bonds, and even money market funds.

Risk & Return Matrix of Investment:



Tax-Managed Funds

In the late 1990's some funds in the mutual fund industry organized tax-managed funds to help alleviate the high tax costs associated with holding mutual fund shares. The stated goal of the typical tax-managed fund is to decrease the tax costs to the shareholders thereby maintaining a high after-tax rate of return. Although these funds cannot totally alleviate the tax burden, they can decrease the burden it by decreasing the level of churning, holding growth as opposed to income stocks, and selling their holdings at losses or long-term gains before selling the shares of stock that were held only short-term. Another available option is to sell stocks with the highest cost basis first.

Development of Hypotheses

The hypotheses relates to that is testable via experimental analysis. An investor would not consider investing in tax efficient funds if the returns on these investments were well below the remainder of the mutual fund population. Without a suitable alternative, the tax situation surrounding mutual funds would have to be accepted.

H1: Investors would use the available after-tax return information to determine investments.

If tax efficient funds are found to have comparable after-tax returns to the overall population of funds, investors should be indifferent in choosing funds based on returns alone. An examination is necessary to determine whether investors look at tax efficiency in making their investment choices.

H2: Investors do not use the information pertaining to the distinction between capital gains and ordinary income to determine in which fund to invest.

Average returns are used in the comparison. Funds can have a bad year but over a time horizon of three or five years, it is expected that the average returns should be equivalent to the average returns of the fund populations.

Methodology

Empirical Test:

This involves the determination of how individuals make investment decisions. An experiment was performed. The students were given various data relating to mutual funds and asked to make investments into funds that they determined provided them with the highest net returns. The students were split into two main groups, one of which was given only pretax return information and one group that was given both the after-tax and pre-tax return information. The first group was given a variety of information about mutual funds which included five year averages of pre-tax returns, turnover rates, long-term capital gains paid, ordinary income paid and other miscellaneous information available on mutual funds such as Net Asset Values, fund strategy, loads and expenses, magazine rankings of funds performance and safety, and the current economic conditions.

Investors were given a hypothetical Rs. 10,00,000 to invest in one or two funds out of a choice of ten. The participants were also asked to rank the data used in their determination of the chosen fund. The sample size was 119 participants.

Analysis of Data

The participants ranked all the factors from one to twelve or thirteen (depending on which group they were in) with one being the most important factor utilized in their investment decisions and thirteen being the least important.

Testing Hypothesis 1, which states that "Investors would use the available after-tax return information to determine investments" was done two different ways. The actual investments that the study participants made will be analyzed along with their rankings of the information they claimed to be using in making their investment decisions.

Hypothesis 2 states that "Investors do not use the information pertaining to the distinction between capital gains and ordinary income to determine in which fund to invest." The breakdown among capital gains

and ordinary income was provided to the study participants under the heading "distribution information." They were then asked to rank how important "distribution information" was in their investment decisions. The test for this hypothesis is similar to the test for hypothesis 1 above. Instead of testing the differences in the means of the turnover rankings the test would be the differences in the means of the rankings of the distribution information.

The test statistic was computed for groups 1 & 3 and for groups 2 & 4. Groups 3 and 4 received the pre-tax return information and group 1 and 2 additionally received the after-tax return information. The values of the test statistics computed were then compared to the z score (due to the large sample size, the z score is used rather than the t value) for a one tailed test. The z score at a 5% confidence level is 1.645 and at a 1% confidence level is 2.33. The null would be rejected if the test statistic is greater than the z score. The test statistic for Mgroup 1 - Mgroup 3 was computed as 1.193602 and the test statistic for Mgroup 2 - Mgroup 4 was computed as .827187. Therefore the null cannot be rejected under either confidence level because the computed values are lower than the z scores. Therefore, pre-tax return rankings are not higher than after tax return rankings.

Conclusion and Discussion

The empirical results provided evidence that low turnover was found in funds that had high after-tax returns. The experimental results though found that investors did not utilize the turnover rate in their decision making process. In addition, distribution information that would be important to investors if they had not been given after-tax returns, were not found to be utilized by investors in their investment decisions.

Further analysis of investor's utilization of information pertaining to after-tax returns of various funds is important given the significance of both the tax-managed funds and the turnover ratios, as supported by the empirical analysis. The experimental portion of this paper examines the investor behavior in response to tax related information provided on various funds. In the past, investors had only been given pre-tax returns and after-tax returns had not been provided until a recent change in SEBI regulations. In addition, out of the possible thirteen rankings, pre-tax and aftertax returns were on average ranked third in importance (after risk preference and analysts forecasts). Therefore returns are important to investors in their decision making.

Discussion

The change in the laws requiring return disclosure made by mutual funds to include after-tax returns has brought the issue of taxes and net returns to the attention of the media and investors. The increased attention and after-tax return disclosures have led to the creation of a number of new tax-managed funds in the late 1990's and early 2000's. This study addresses the issues relating to the benefits of tax-managed funds and investors utilization of new after-tax return data being provided versus the data available prior to the new SEBI regulation requiring after-tax return disclosures.

Findings & Suggestions

The study provided evidence to support the theory that investors did not utilize raw data in investment decisions and rather relied on pre-calculated figures. The potential investors did not utilize the turnover and distribution information and rather relied on the after-tax return information in making their investment decisions. This finding can also be applied to the fee disclosures. Disclosure of various fees that need to be found, understood, and calculated by potential investors in order to make investment decisions would probably not be utilized by investors in their investment decisions. The clarity of a single, transparent, pre-calculated fee figure would be more beneficial to potential investors in their investment decisions.

Transparency in disclosure may not be sufficient in all situations and mutual fund management and policy makers may also need to focus on how well investors understand the various factors that comprise the mutual fund investment. The study did provide evidence that lower turnover resulted in higher after-tax returns, yet investors did not utilize turnover numbers in their investment decisions.

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