

## Key Features of Domestic Equity Funds' Sales Pattern and its Implications

Kim, Jongmin\*

This article investigates the pattern of fund flows and post-sale fund performance of domestic equity retail funds from 2009 to 2017. Results show that investors tend to invest more in the affiliated funds as well as the funds with higher past inflows or strong performance. For the actively managed funds, the higher sales fee a fund imposes, the larger new investments in the fund. However, its post-sale performance has significantly deteriorated, which is also pronounced in the affiliated funds with large inflows or the funds with high sales fees. These findings imply that a sharp decline in domestic equity funds' sales since 2009 is related to not only the poor performance but also conflicts of interest inherent in the process of fund sales between investors and distributors. Hence, restoring investor confidence calls for the regulator's efforts to improve institutional arrangements to align the interests of fund managers and distributors with those of investors in addition to the fund management industry's efforts to enhance the investment capacity.

Publicly offered funds or retail funds are the most popular indirect investment vehicle that investors without professional knowledge of finance can opt for when they want to invest in risky assets such as stocks. Accordingly, the proportion of publicly offered funds held by individuals is relatively high, compared with other financial investment products. As at the end of 2017, individual investors accounted for nearly 80% of the sales amount of domestic equity funds. Information asymmetry between investors and fund distributors, however, is as

\* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

\* Ph.D., Senior Research Fellow, Fund & Pension Department, Tel: 82-2-3771-0822, E-mail: jongminkim@kcmi.re.kr

high as the proportion of individual investors, which puts investors at high risk of mis-selling or conflicts of interest when they purchase funds. For example, fund distributors are likely to recommend funds with high sales fees or loads or their affiliated funds to investors. They could also induce investors to redeem their existing investment and buy new funds to maximize their revenue. As a result, investors may earn lower-than-expected investment returns or incur losses, which is the case in many empirical studies on the conflicts of interest between investors and fund distributors. In this regard, this article analyzes the pattern of fund flows and post-sale performance up to 3 years of the domestic equity funds offered to the public over the counter in each fund distribution channel such as banks and securities companies.<sup>1)</sup> The analysis is based on the Korea Financial Investment Association (KOFIA)'s data on monthly fund sales and Korea Fund Ratings (KFR)'s data on monthly fund evaluation from 2009 to 2017.

### Key characteristics of fund flows

The sales amount of domestic equity funds targeted to retail investors offered at the counter of fund distributors stood at KRW 20.4 trillion as at the end of 2017, down more than 50% from KRW 52.2 trillion in 2009. When we look at this number with the data aggregated by the investor type, most of the decline in the sales amount can be explained by the fact that individual investors pulled back on equity fund investments.<sup>2)</sup> In other words, individuals' fund investments have been cut more than in half during the analysis period.

Figure 1 shows the pattern of fund outflows in connection with stock market conditions. From 2009 to 2017, the domestic equity retail funds experienced outflows mainly for three periods. The first period was between 2009 and 2010 when the stock market enjoyed a rally. During this period, net fund outflows stood at about KRW 17.0 trillion in the bull market. The second period ran from 2012 through 2016 when the stock market continued to move sideways. This period can be characterized by temporary net fund inflows in the bear market and then massive fund outflows in the bull market. In the second period, net fund outflows reached about

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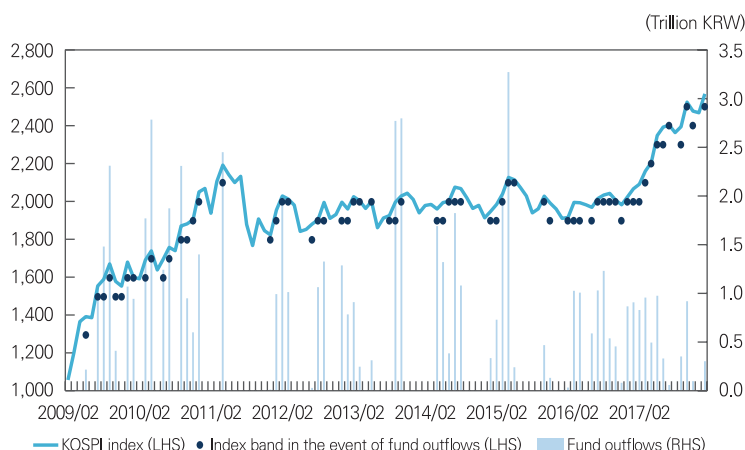
1) I mainly focus on the domestic equity funds sold to the public over the counter because it is not possible to identify whether investors are actually individual investors in the dataset. So, funds like online funds, pension funds, institutional funds, and other class funds linked to other financial investment products such as Wrap and ELS/DLS are excluded in the analysis.

2) According to the aggregate data from KOFIA, the amount of domestic equity funds sold to individual investors only has declined KRW 40 trillion from KRW 61 trillion at the end of 2009 to KRW 21 trillion at the end of 2017. Considering that a decrease in the sales amount of domestic equity funds as a whole totaled KRW 39 trillion over the same period, such decline can be attributed primarily to individuals' fund outflows. The same is true for the publicly placed foreign equity funds.



KRW 24.6 trillion. The third period was the year of 2017 when the KOSPI index went up as in the first period. During this period, net outflows from domestic equity funds totaled KRW 5.3 trillion.

**Figure 1. KOSPI index and fund outflows**



Source: KOFIA

I conducted an analysis on the determinants of fund flows in order to better capture the pattern of fund flows using monthly net inflows (unit: KRW 100 million) as a dependent variable. Key results are as follows. First of all, the funds with high inflows or strong performance over the past one year, and the affiliated funds tend to have larger net inflows. In particular, monthly average inflows into the affiliated funds were estimated to be KRW 460 million to KRW 560 million per fund greater than the inflows into the non-affiliated funds. For the actively managed funds, the parameter measuring the change of net inflows per unit change in sales fee was estimated to be 1.66 - 1.68, which implies a positive relation between sales fees and net inflows. In other words, the higher sales fee a fund imposes, the larger new investments in the fund. As such, variables reflecting distributors' economic incentives such as affiliation and sales fee are found to significantly affect the investors' capital flows for the domestic equity funds.<sup>3)</sup> In the meantime, monthly average net inflows into the affiliated funds have shrunk about KRW 1.7 trillion per fund since sales limits on the affiliated funds were set from April 2013 to reduce the excessive dependency of fund sales on the affiliated funds.

3) Both affiliation and sales fees are also found to have a statistically significant impact on the fund outflows, even when examining the net outflows.

### Key features of fund performance

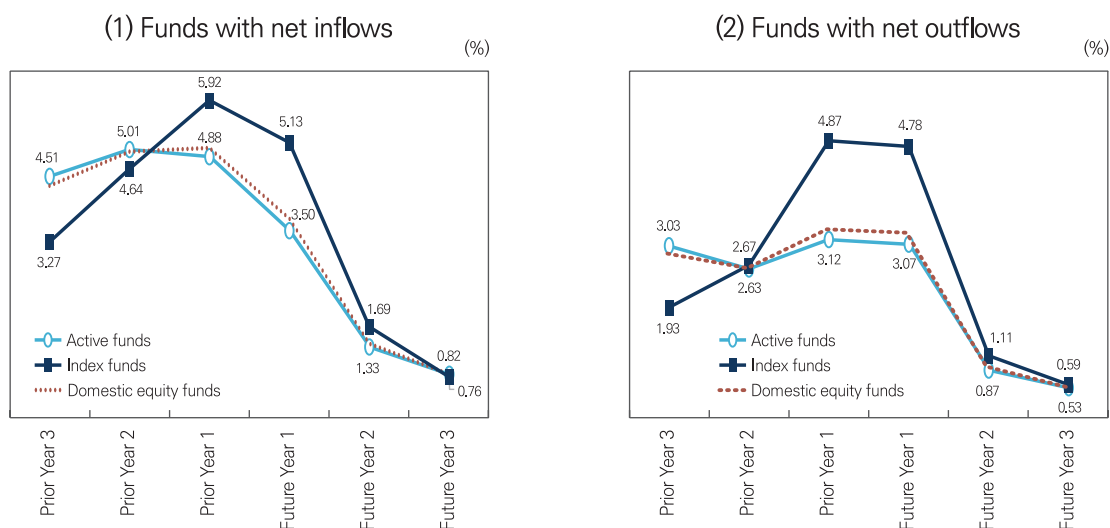
Figure 2 depicts the trend of annual rate of returns of publicly offered domestic equity funds from an investor's perspective. For the actively managed funds with net inflows, annual average rate of fund returns that investors could observe right before their investments, i.e., pre-inflows annual average returns range from 4.51% to 5.01%. However, annual average returns after their investments are 3.50% in Future Year 1, 1.33% in Future Year 2, and 0.82% in Future Year 3, which means post-inflows performance has deteriorated considerably. If this analysis is confined only to the funds with net outflows, the funds tend to experience outflows when their previous annual average returns are between 2.63% and 3.12%. Following the net outflows, the fund returns fall further.

Taking these into account, investors seemed to expect annual average rate of return of 4% to 5% when investing in the actively managed funds. But the actual rate of return that they earned was 2%p to 3%p lower than expected, leading to the redemption of the funds. The same trend is also found in index funds albeit in slightly varying degree. This pattern of rates of return before and after fund investments indicates that disappointing fund performance was the main reason for the decline in the fund sales amount.

The worsening performance of the funds can be observed as well even when taking into account distributor-related variables like affiliation and sales fees. In this case, I used before-TER excess return to control for the performance variation arising from the different fee structures and estimated the effects of these variables on the post-sale performance. Key findings are provided below. First, the parameter measuring the performance change per unit change in sales fee is estimated to be -0.68 in Future Year 1, -2.24 in Future Year 2, and -1.66 in Future Year 3. This implies that if other conditions remain the same, annual average excess return after net inflows becomes approximately 0.06%p to 0.11%p lower when a fund charges sales fees 10 bp higher than others. That is, the higher sales fee a fund imposes, the lower the future performance. In addition, annual average excess return for the affiliated funds remain 0.19%p to 0.35%p lower than those for the non-affiliated funds over three years after the fund sales, which is statistically significant. Taken all together, fund distributors sold the funds with high sales fees or the affiliated funds for the benefit of themselves, not investors, and losses were incurred by investors as a result.



**Figure 2. Trend of annual rate of returns – investors’ viewpoint**



Note: Fund returns (%) represent geometric average returns of the funds in each fund category shown above, which are calculated and annualized using the average rate of returns per period on investments.

Source: KFR, KOFIA

### Implications

This article has looked at investment flows and key characteristics of post-sale performance for publicly offered domestic equity funds from 2009 to 2017. Results show that their post-sale performance has significantly deteriorated, which is more pronounced in the affiliated funds with large inflows or the funds with higher sales fees. These results suggest that the sharp decline of domestic equity funds’ sales since 2009 is related to not only the poor performance but also conflicts of interest inherent in the process of fund sales between investors and distributors.

Hence, restoring investor confidence requires the fund management industry’s efforts to enhance the investment capacity and the financial regulator’s efforts to improve institutional arrangements to align the interests of fund managers and distributors with those of investors. To that end, it is necessary to reduce the costs associated with fund sales that investors should pay by expanding open-ended platforms, alongside the regulatory efforts for tighter monitoring to address the conflicts of interest and prevent the mis-selling of the funds. Furthermore, the validity of information that investors use at the time of investment should be enhanced. For instance, it is necessary to express fees and commissions in amount units that investors easily understand, and provide investors with forward-looking fund ratings assigned by external rating institutions



based on their independent views such as Morningstar's Analyst Rating.<sup>4)</sup> More essential is improving the intended function of publicly placed funds as a wealth management tool to individual investors by invigorating investment advisory services, expanding platforms for wealth management, and strengthening the links between publicly offered funds and pension products.

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4) Morningstar Analyst Ratings refer to the ratings assigned by Morningstar analysts based on their quantitative and qualitative forward-looking analyses of five core factors that are critical to a fund's future performance: People, Process, Parent, Price, and Performance. In September 2011, Morningstar started to assign the ratings on a five point scale with Gold, Silver, Bronze, Neutral, and Negative to distinguish them from the existing star ratings.