

A Slowdown in Mutual Funds: Causes and Challenges Ahead

Kwon, Min Kyeong*

Korea's mutual fund market has been suffering from a lingering slump. For the past decade, the net outflows from mutual funds excluding ETFs amounted to a total of KRW 57 trillion. The decline was most evident in equity funds, whose sales to retail investors dropped 73% from KRW 107 trillion at the end of 2009 to KRW 29 trillion at the end of November 2019. The primary causes behind the slump could be mutual funds' disappointing performance and the rigidity of the distribution channel. What's needed the most to help facilitate the market is self-help effort of asset management companies for enhancing investment management capabilities and investment returns. Such effort should go hand in hand with policy effort for igniting competition in the fund distribution market. More specifically, it's advisable to induce the entry of new players, e.g., distribution-only players with neither solicitation nor advising services; and distributors providing low-cost, automated advising services.

Korea's mutual fund market has slowed continuously. In terms of the net assets at year-end, the market grew only 15% from KRW 210 trillion in 2009 to KRW 242 trillion in 2019. This is evidently disappointing compared to private equity fund market that more than tripled from KRW 110 trillion to KRW 419 trillion during the same period.

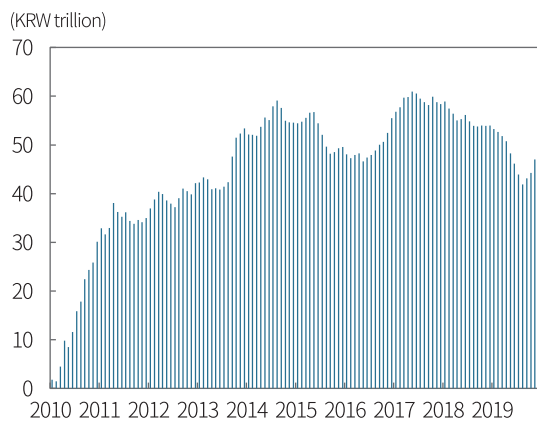
Setting aside the exchange-traded funds (ETFs), the situation seems even more drastic. Mutual funds' net assets at year-end excluding ETFs actually shrank from KRW 207 trillion

* 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.

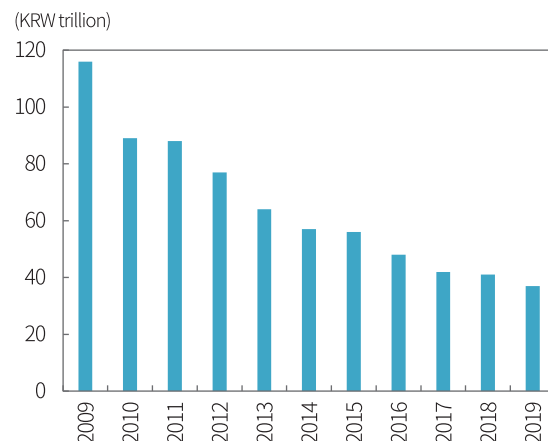
* Ph.D., Research Fellow, Fund & Pension Department, Tel: 82-2-3771-0681, E-mail: mkkwon@kcmi.re.kr

in 2009 to KRW 191 trillion in 2019.¹⁾ During the period, the net outflows from those funds amounted to KRW 57 trillion (excluding MMFs). Most of the outflows came from retail investors' redemptions of equity funds. The retail sales of equity funds dropped a whopping 73% from KRW 107 trillion at the end of 2009 to KRW 29 trillion in November 2019.²⁾

**Net Outflows from Mutual Funds
(Ex-ETFs, Cumulative)**



Retail Sales of Equity Mutual Funds



Note: 1) The chart on the left excludes MMFs.³⁾

2) The 2019 data on the right chart are year-to-date as of the end of November.

Source: Korea Financial Investment Association

What caused the mutual fund slowdown?

Mutual funds can be divided into two subtypes. First, mutual funds in a traditional sense are sold to investors via distribution channels such as banks and securities firms (traditional mutual funds, hereinafter). Second, other funds, so-called ETFs, are listed and traded on the exchange. In the past, most retail investors used to access a distribution channel to purchase mutual funds as categorized into the first subtype. More recently, however, retail investor tend to slant towards the second subtype, and increasingly trade ETFs on the stock exchange directly. What's observable in the aforementioned statistics is that the slowdown in the market is limited to traditional mutual funds.

1) On the contrary, the ETF net assets at year-end surged to KRW 51.7 trillion in 2019 from KRW 3.7 trillion in 2009.

2) The sales data for December 2019 were not released yet.

3) MMFs were excluded from the data because their high volatility in fund flows makes it hard to grasp the overall trend.

One of the primary causes behind the slowdown could be low investment returns. For the past decade, Korea's stock market has been so stagnant that investors commonly refer the Kospi to the "Boxpi", meaning that the index moves within a tight range. This is in stark contrast to the high returns in real estate, infrastructure, and other alternative assets. Given the characteristics of traditional mutual funds that invest heavily in equity but lightly in alternative investments, their underperforming returns during the period analyzed seem somewhat inevitable. Another problematic area is found in fund managers' investment management capabilities for selecting stocks and timing investment decisions. Because most traditional mutual funds are actively-managed funds, fund managers' discretion has a significant impact on investment performance. Indeed, abundant literature has documented that the average performance of actively-managed funds falls far short of the benchmark, and Korea is no exception to that. This could have made a substantial number of investors get disappointed and leave the market in the end.

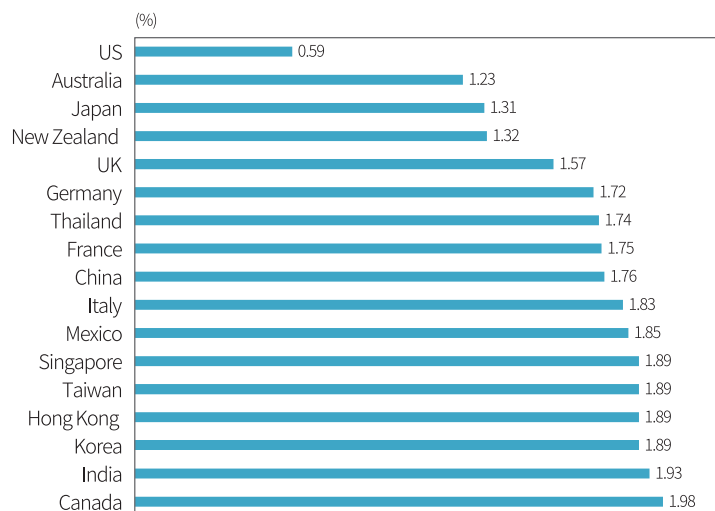
However, underperforming returns can't be the only reason behind the slowdown in the market. Another factor is the rigidity of Korea's fund distribution channel. Traditional mutual funds are mostly sold by banks and securities firms that receive sales fees in return. Because the levels of sales fees are strictly set by a fund's collective investment scheme regulation, every distributor is obligated to charge the equal fee for funds with the same type and class. In other words, the market structure hardly allows for fee competition among distributors.⁴⁾ Such a structure gives a competitive edge to large financial institutions already securing a wide customer base, while making small-to-medium players and new entrants struggle to attract customers.

Such rigidity in distribution is also related to the high sales fees in traditional mutual funds. Large-scale financial institutions with a dominant market position have a clear incentive to give strategic backing to high-fee funds. Hence, asset management firms would want to raise their funds' sales fees, so that they expect their funds to be sold more by large-scale distribution channels. This is how rigidity in distribution leads to higher costs for investors in traditional mutual funds. According to Morningstar (2019), the asset-weighted median value of the total

4) On top of sales fees, some funds also charge one-off sales loads. It's possible for a distributor to have discretion to adjust the sales loads with a certain range, which creates some room for price competition. However, given the one-off aspect of sales loads, their impact is limited compared to sales fees that are charged on an annual basis. According to Morningstar (2019), only 20% to 25% of mutual funds in Korea charge sales loads. Hence, it's hard to argue that price competition actually exists in Korea's fund distribution market.

expense ratio of equity funds available for sale in Korea stood at 1.89%, which is higher than major developed countries and the highest among Asian Region Funds Passport participants such as Australia, Japan, New Zealand, and Thailand.⁵⁾ Taking into account that sales fees account for the largest part in the total expenses of mutual funds, it's necessary to facilitate competition in the distribution market and thus bring down investors' overall cost burden.⁶⁾

Total Expense Ratio of Equity Funds



Note: The asset-weighted median value of funds available for sale in each country

Source: Morningstar (2019)

Future challenges

Mutual funds play a pivotal role in wealth accumulation and post-retirement income security for the public. Unlike private equity funds and discretionary investment services that come with a high threshold and limited access, mutual funds provide a low initial investment threshold and easy-to-access distribution channels, substantially lowering barriers for retail investors. In the past, the primary objectives for investing in mutual funds were asset accumulation. More recently, however, mutual funds have been widely used for securing post-retirement income security via personal and retirement pensions. This is why the government and the industry should work together for helping the mutual fund market break away from the long-held recession.

5) Morningstar, 2019, Global investor experience study: Fees and expenses.

6) On another front, distribution rigidity also adversely affects robo advisors and other investment advisory services. When the high expense levels are lowering expected returns on mutual funds, it's not easy for advisors to charge investors additional advisory fees.

For facilitating the mutual fund market, the asset management industry itself should exert utmost effort to improve investment returns. Rather than clinging to short-term performance, it's desirable to build customer confidence via higher long-term returns. The remuneration scheme for fund managers should be also designed in line with that direction. Also necessary are enhancing capabilities in terms of both overseas investments that are critical to supplementing low expected returns in the Korean market, as well as asset allocation that is essential to pension management.

On another front, policy effort is needed to intensify competition in the fund distribution market. What counts the most is to build a level playing field where new entrants and small-to-medium players can fairly compete with large players in the market. Also necessary is to facilitate the entry of new services that is either a distribution-only service with neither advising nor solicitation, or a distribution channel with low-cost, automated advising.⁷⁾ Toward that end, it'd better encourage asset managers to expand their direct distribution channels, or fintech firms to enter the market. What's worth considering in the long run is to induce price competition among distributors by giving distributors full discretion so that they can decide their own sales fees, instead of following the uniform fee structure set across fund classes and types.

7) Although there exist fund classes for no-solicitation, low-cost, online supermarket, direct sales, they are not popular yet.