CHAPTER III

THEORETICAL BACKGROUND AND HYPOTHESIS

3.1. Theoretical Background

3.1.1. Investment Theory

The term investing can cover a wide range of activities. It often refers to investing money in certificates of deposits, bonds, common stocks, or mutual funds. More knowledgeable investors would include other "paper" assets, such as warrants, puts and calls, futures contracts, and convertible securities, as well as tangible assets, such as gold, building, real estate, and collectibles (Jones, 1998: 2). Any assets – tangible or intangible – that have the potential to provide a periodic return and/or to increase in value called investment (Winger, Frasca and Ralph, 1995: 10). Investment is also defined as current commitment of money or other resources in the expectation of reaping future benefits (Bodie, Kane, Marcus, 1998:2).

Investment has a broad meaning. The different perspective and point of view results in different concept in defining the term of investment. In macroeconomics perspective, macroeconomists use the term of investment to mean additions to the stock of productive assets like capital goods in the form of equipment, structures, or inventories. The action that PT. Indofood Tbk. builds a new factory or when Mr. Udin builds a new house represents investment. Many people speak of

"investing" when buying a piece of land, an old security, or any title to property. In economics, these purchases involve financial transactions or portfolio changes, because what one person is buying, someone else is selling. There is investment only when real capital is created (Samuelson and Nordhaus, 1995: 433). This concept has limited concept of investment, which distinguishes between investing in real assets and financial assets.

The material of wealth of a society is ultimately determined by the productive capacity of its economy, that is, the goods and services its members can create. This capacity is a function of the real assets of the economy: the land, buildings, machines, and knowledge that can be used to produce goods and services. In contrast to such real assets are financial assets, such as stocks and bonds. Such securities are no more than sheets of paper (or entries in a computer) and do not contribute directly to the productive capacity of the economy. Instead, these assets are the means by which individuals in well-developed economies hold their claims on real assets. Financial assets are claims on the income generated by real assets (or claims on income from the government). We cannot own our own auto plant; but we can still buy shares in Astra Internasional Tbk. and thereby, share in the income derived from the production of automobiles. While real assets generate net income to the economy, financial assets simply define the allocation of income or wealth among investors. Individuals can

choose between consuming their wealth today or investing for the future. If they choose to invest, they may place their wealth in financial assets by purchasing various securities. When investors buy these securities from companies, the firms use the money to pay for real assets such as plant, equipment, technology, or inventory. Therefore investors' returns on securities ultimately come from the income produced by the real assets that were financed by the issuance of those securities (Bodie, Kane, Marcus, 1998:2).

Investment term in this thesis deals with the investment in intangible assets or financial assets especially in mutual fund. Even though this thesis discusses investment in financial sector, the framework still concerns on macroeconomics perspective in terms of analyzing the factors that affect the growth of mutual fund.

Why do people invest? Actually it is a basic question. Stated in the simplest terms, investors wish to earn a return on their money. Cash has an opportunity cost: by holding cash, we forego the opportunity to earn a return on the cash. Furthermore, in an inflationary environment, the purchasing power of cash diminishes, with high rates of inflation bringing a relatively rapid decline in purchasing power. Bernard J. Winger (1995:7) has concluded some of more important investment objectives, they are: *First*, meeting liquidity needs; an asset is said to have liquidity when it can be converted to cash quickly with no loss in value. Practically everyone

needs some degree of liquidity. Everyone needs it to fulfill irregular receipts of income and payment of expenses. Everyone also likes to have it in the case of an emergency. Therefore, some investments must be those that provide adequate liquidity. *Second,* saving for a large expenditure. In many cases, people save and invest to accumulate sufficient funds for future expenditure, such as a car or house. Liquidity plays a less important role in these situations; particularly of the expenditure will not take place for a long time. *Third;* planning retirement. Retirement planning is the most critical investment objective. It is important because it influences the style and quality of the investment. Few people want to retire from an existence that is substantially inferior to the retirement they enjoyed during their working years. *Fourth,* speculating. Those investors who are fortunate enough to have satisfied tangible investment goals can then invest in more speculative ventures if they wish. Investors at this stage have adequate funds to afford losses if investments perform poorly.

Investors buy, hold, and sell financial assets to earn returns on them. Within the spectrum of financial assets, why do some people buy common stocks instead of safely depositing their money in an insured savings account or a government bond with a guaranteed minimum return? The answer is that they are trying to earn returns larger than those available from such safer (and lower yielding) assets.

They know they are taking a greater risk of losing some of their money by buying common stocks, but they expect to earn a greater return.

In investment it is critical to distinguish between an expected return (the anticipated return for some future period) and a realized return (the actual return over some past period). Investors invest for the future – for the return they expect to earn – but when the investing period is over, they are left with their realized returns. What investors actually earn from their holdings may return out to be more or less than what they expected to earn when they initiated the investment. This point is the essence of the investments process: investors must always consider the risk involved in investing.

Investors would like their returns to be as large as possible; however this objective is subject to constraints, primarily risk. The investment decision therefore must always be considered in terms of both risk and return. The two are inseparable.

There are different types, and therefore different definitions, of risk. Risk is defined here as the chance that the actual return on an investment will be different from its expected return (risk involves chances, or probabilities) (Jones 1998: 10). In general terms, risk refers to the possibility of loss. There are two concepts of risks used in

portfolio theory: systematic and unsystematic risk[1] (Gup, 1992: 367-368).

Do investors dislike risk? In economics in general, and investments in particular, the standard assumption is that investors are rational. Rational investors prefer certainty to uncertainty. Investors apparently dislike risk, but more precisely, investors are said to be risk averse. A risk-averse investor is one who will not assume risk simply for its own sake and will not incur any given level of risk unless there is an expectation of adequate compensation for having done so. It should be noted carefully that it is not irrational to assume risk, even very large risk, as long as one expects to be compensated for it. In fact, investors cannot reasonably expect to earn larger returns without assuming larger risks.

Investors deal with risk by choosing (implicitly or explicitly) the amount of risk they are willing to incur. Some investors choose to incur high level of risk with the expectation of high levels of return. Other investors are unwilling to assume much risk, and they should not expect to earn large return.

[1] Systematic risk can be attributed to a common source, such as changing economic conditions, and affects all stocks in the same manner. Systematic risks cannot be eliminated by diversification because all stocks are affected in much the same manner. Nevertheless, an investor can increase or decrease the average systematic risk of a portfolio by altering the proportions of stocks held. Meanwhile unsystematic risk can be attributed to unique events, such as a flood, fire, or labor strike that can affect an individual company. This risk can be eliminated by diversification because the effect of such events on the price of one company's stock should have no relationship to other companies' stock prices. Collectively, systematic risk plus unsystematic risk equals total risk.

Dealing with risk, mutual fund can minimize the investment risk in which the portfolio investment is spread by fund manager professionally. It is an advantage for investors who invest their money in mutual fund.

3.1.2. Portfolio Theory

Jones (1998: 3) defined portfolio as securities held by investor taken as unit. It is any combination of assets held at the same time. All assets an individual owns should be considered parts of his portfolio. These would include typical investment assets such as stocks, bonds, mutual fund shares, direct business interests, and personal assets such as home, automobiles, jewelry, and other important items (Winger, Frasca and Ralph, 1995: 568).

Most people realize intuitively that holding one or even several investments is risky. Many still do it, recognizing the risks but hoping their luck will be favorable. Some of the risks these investors take could be avoided by more thoughtful investment selection. The key is to design an effective portfolio. To do this, the portfolio must be constructed properly to begin with, monitored closely over time, and modified as circumstances might warrant.

In designing an investment portfolio, an important first step is setting goals. Goals establish priorities and indicate tolerable risk levels. Another portfolio activity is forecasting the investment environment. Forecasting by default implies the investor has no

preconceived ideas about the future prices, which contrasts with making specific forecasts. Assets are selected to conform to investor goals. There would be sufficient diversification to eliminate random risk and to take advantage of poorly correlated returns among broad investment groups, such as stocks, bonds, and tangibles. After the portfolio is constructed, it must be monitored in three steps: (1) estimate performance in advance of the investment period, (2) measure performance after the period is over, and (3) evaluate performance. Evaluation can be in absolute sense or relative to performances of other investments or market indicators (Winger, Frasca and Ralph, 1995: 590).

Investment in mutual fund, however, covers the purposes of portfolio and is easily accessible to small investors. The mutual fund pools the resources of many investors and purchases a wide variety of financial market securities on their behalf.

3.1.3. Investment in Capital Market and Money Market

3.1.3.1. Investment in Capital Market

Capital market is a market where long term financial assets and financial liabilities like stocks, warrant, rights, convertible bonds, and bonds are bought and sold. It is a market in which financial assets having a maturity of more than one year are bought and sold (Colander, 1998: 232). Capital market is designed to finance long term investments

by business, governments, and households. Trading of funds in the capital market makes possible the construction of factories, highways, schools, and homes. Financial investments in the capital market original maturities of more than one year and range in size from small loans to multimillion dollar credits

Capital market trading occurs in either the primary market or the secondary market. The primary market is where new issues of stocks and bonds are introduced. Investment funds, corporations, and individual investors can all purchase securities offered in the primary market. This market transfers savings to borrowers who want to invest (buy real assets). We can think of a primary market transaction as one where the issuer of the security actually receives the proceeds of the sale. When firms sell securities for the very first time, the issue is an IPO (Initial Public Offering). The capital markets also have well-developed secondary markets. A secondary market is where the sale of previously issued securities takes place, and it is important because most investors plan to sell long-term bonds before they reach maturity and eventually to sell their holdings of stock as well. In other words secondary market is the market in which previously issued financial

assets can be bought and sold. A secondary market transfers existing financial assets from one investor to another.

People who invest their money in capital market will earn some advantages, they are; dividend, capital gain and having vote right in shareholders meeting.

3.1.3.2. Investment in Money Market

Money market is a sub sector of the fixed-income market. It consists of very short-term debt securities that usually are highly marketable. Many of these securities trade in large denominations, and so are out of the reach of individual investors (Bodie, Kane and Marcus, 2002: 28). It is an alternative market for financial institutions and companies to get short-term debts. Actors who involved in money market are: banks, insurance and fund companies, companies that issues commercial paper, government institution like Bank Indonesia that issues Bank Indonesia Certificates and individual investors who have extra fund in order to earn profit from the discount system.

Securities that are traded in money market are Bank Indonesia Certificates, Surat Berharga Pasar Uang (SBPU), Commercial Paper, Promissory Notes, Call Money, Repurchase Agreement, Banker's Acceptance, Treasury Bills (Darmadji and Fakhruddin, 2001: 1).

3.1.4. Mutual Fund Framework

Basically mutual fund is a type of financial service organization that receives money from its shareholders and then invests those funds on their behalf in a diversified portfolio of securities (Gitman and Joehnk, 1996: 442). It is a coordinating institution to pool fund from society (investor society) to be invested on securities portfolio by a fund manager (Capital Market Act article no 1 verse 27). There are three elements involved in mutual fund, they are the existence of fund from investors, the invested funds in securities and managed by a fund manager (Darmadji and Fakhruddin, 2001: 145). Mutual fund is also defined as an alternative investment chosen by people who pool their money to buy stocks, bonds, and other securities selected by professional managers who work for an investment company (Kapoor, Dlabay, Hughes, 1996: 499).

Mutual fund investors come from all walks of life and all income levels. They range from highly experienced investors who all share a common view: each has decided, for one reason or another, to turn over at least a part of his or her investment management activities to professionals. Mutual funds are popular because they offer not only a variety of interesting investment opportunities but also a wide array of services that many investors find appealing. Indeed, the mutual funds are available today to meet just about investors need. Individuals who invest in mutual funds are considered shareholders of the fund. In

the analysis, however, an investment in a mutual fund really represents an ownership position in a professionally managed portfolio of securities. When one buys shares in a mutual fund, he or she becomes a part owner of a portfolio of securities.

The mutual fund concept is based on the simple idea of turning the problems of security selection and portfolio management over to professional money managers. In essence, a mutual fund combines the investment capital of many people who have similar investment goals, and it invests the funds for those individuals in a wide variety of securities. In an abstract sense, we can think of mutual fund as the *financial product* that is sold to the public by an investment company. That is, the investment company builds and manages a portfolio of securities and then sells ownerships interests – shares of stock – in that portfolio through a vehicle known as a mutual fund (Gitman and Joehnk, 1996: 443).

3.1.4.1. Advantages of Mutual Fund

Mutual fund has more advantages compared to other investment vehicles. Investors are able to get the following advantages when they invest their fund in mutual fund:

a. Professional Management.

Investment portfolio of mutual fund managed by a fund manager who has a skill and specification in fund management. The role of fund manager is very important

to manage fund of individual investor who have limited time and skill to be involved directly on his investment process, in terms of analyzing and watching the market directly and regularly.

b. Diversification.

One of advantages of investing in mutual fund is diversification; the spreading of risk over a variety of companies, industries, securities, or other forms of investments whose returns are affected differently by changing economic and financial market conditions (Gup, 1992: 51). It is the process of combining assets for the purpose of reduction risk done through portfolio management by fund manager. A fund manager creates a portfolio with its own return and risk characteristics. The important quality of a portfolio is that it can reduce investment risk without necessarily reducing expected return (Winger, Frasca and Ralph, 1995: 111). The management portfolio in mutual fund can minimize the risks; because of the pooled funds from investors are invested and spread in various securities. The diversification in the same time will spread and diversify the risks that can not be done by buying one single securities by an investor.

c. Easiness.

The easiness to invest in capital market is offered by mutual fund with lower fund. It is reflected in the first investment value in which many investment companies set their competitive and low price for its unit of mutual fund products.

Besides, many investment companies market their mutual fund products through its branches and agents in order to get closer to the investors. Even some of them cooperate with banks to support the marketing and promotion of their mutual fund products.

Another facility is reinvestment plan; investors can reinvest the profit when they are willing to. Most investment companies have provisions for automatic reinvestment of dividends and capital gains. Generally, the dividends from investment income are reinvested at the offering price, which may include a sales charge. Many investment companies give their shareholders the option of taking their net realized capital gains in the form of a stock dividend of investment company shares or of receiving cash.

d. Transparency

Every investment company has a duty to inform the growth of portfolio and the fee continuously, so that the investors are able to watch the return, fee and anticipate the risks[2] in the future every time routinely.

A fund manager must announce the Net Asset Value (NAV)[3] of mutual funds that he managed daily in newspaper and publish financial statement and prospectus regularly and continuously, so that the investors can monitor the growth of their fund routinely.

e. Liquidity

Investors are able to redeem their shares (participation unit) every time based on the agreement between investors and investment company.

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[2] Like other investment vehicles, mutual fund also involves risks beside advantages. These risks are explained and attached in prospectus of mutual fund that becomes a consideration for investors before buying mutual fund products. The risks that are mostly informed by the prospectus are; *Decrease of participation unit risk;* this risk caused by the decrease of security prices. *Liquidity risk*; it is related to the huge redemption in the same time that makes fund manager hard to get cash money to pay the investors who resell their unit shares. *Political and economical risk*; the policy changing in economy and politic are able to influence the performance of companies including go public companies, in which impact on the performance of mutual fund in turn. and *default* (wanprestasi) *risk*; this risks happen when insurance company that guarantees and insures the mutual fund asset is late to pay the guarantying or pay lower than the insurance should pay. It is also happen when institutions (Brokerage Company, Custodian Bank) that involve in the mutual fund industry suffer from default.

[3] Net Asset Value (NAV) is market value of fund's equity (assets – liabilities = equity) divided by the number of shares outstanding. Basically, it is the market value of shares of the mutual fund's portfolio, which is determined by the value of the securities it holds. In another words, NAV is found by taking the total market value of all securities (and other assets) held by the fund, less any liabilities, and dividing this amount by the number of fund shares outstanding. For example, if the market value of all the securities (and other assets) held by the WISH mutual fund on a given day equaled Rp. 100 million, and if WISH mutual fund on that particular day had 500,000 shares outstanding, the fund's asset value per share would amount to Rp. 200 (Rp. 100,000,000 ÷ Rp. 500,000 = Rp. 200). This figure is then used to derive the price at which the fund shares are bought and sold.

f. Low Fee

Referring to its existence of mutual fund that pools funds from many investors and then is managed professionally, the capability and ability of mutual fund to be invested in various investment securities will result in efficient investment fee. The investment fee becoming lower compared with an investment done by a single investor.

g. Regulation

The regulation of mutual fund supports and protects the investors to make an investment decision. Regulation that arranges the Capital Market mechanism is also applied in mutual fund; even there are additional and special regulations for mutual fund industry. These regulations make the investors feel safe to invest their money in mutual fund.

3.1.4.2. Types, Characteristics and Kinds of Mutual Fund

According to its type, mutual fund is categorized as follows:

a. Corporate Type

In the corporate type, a corporation issues mutual fund to gather fund by selling stock, and then the gathered

fund is invested in various securities traded in capital market and money market.

Corporate mutual fund type can be differentiated based on its characteristics; they are Closed-end Fund and Open-End Fund. The form of corporate mutual fund type has specifications below:

1. The legal form of corporate mutual fund type is a corporate (Perseroan Terbatas/PT).
2. The management of mutual fund asset is based on contract between Director of company and appointed fund manager.
3. The storage or deposit of mutual fund asset is based on contract between fund manager and custodian bank.

b. *Contractual Type*

The Contractual type (Kontrak Investasi Kolektif) is defined as a contract between a fund manager and custodian bank that string the shareholder (participation unit holder); where the fund manager has an authority to manage the fund, meanwhile the custodian bank has an authority to keep and deposit the mutual fund assets.

The contractual type is the popular mutual fund compared with the corporate one. Like corporate one, the

contractual mutual fund also has the following specifications:

1. The legal form of corporate mutual fund is contractual type (*Kontrak Investasi Kolektif*/KIK).
2. The management of mutual fund asset is based on contract.
3. The storage or deposit of mutual fund asset is based on contract and done by custodian bank.

The mutual fund is also differentiated based on its characteristics. There are two characteristics of mutual funds:

a. *Closed End Fund*

Closed End Fund is mutual fund that can not redeem the shares (unit participation) sold to investors. In other words, investors cannot resell their shares to fund manager. They can resell their shares through market mechanism in Stock Exchange Market where the shares are listed.

The prices of shares fluctuate as those are influenced by supply and demand force in the market, like other listed shares of go public companies.

b. *Open End Fund*

It is a mutual fund that offers redemption of shares from investors. The shareholders of this open end fund are

able to resell their shares anytime when they want to. Meanwhile the fund manager through custodian bank has a duty to buy the resold shares at the current price based on NAV per share.

Based on the regulation about "The Guidance of Daily Announcement of Net Asset Value of Open End Fund" no. IV.C. 3, mutual fund is also classified as follows:

a. *Money Market Funds*; the kind of money market fund investing the funds in short term money instruments, like Bank Indonesia's Certificate (SBI), Depository Certificate, SBPU (*Surat Berharga Pasar Uang*), SPH (*Surat Pengakuan Hutang*).
b. *Fixed Income Funds*; the kind of mutual fund which invests 80% of its assets in bonds, in which aims to result in stable return.
c. *Equity Funds*; a kind of mutual fund that invests 80% of its assets in equities or stocks. The risk of this mutual fund is higher than both money market and fixed income funds, referring to the characteristic fluctuation of stock prices itself in short term. Likewise, in long run this kind of mutual fund gives higher return; its higher risk brings about higher return.

d. *Discretionary Funds*; this mutual fund invests its assets in equity and bond proportionally, in which the portfolio is various in bonds, equity.

This thesis is not focused on particular types, characteristics and kinds of mutual fund, since the term of mutual fund that becomes the main object in this thesis covers all those mutual fund classifications. The previous description and explanation is meant to make a clear and bright framework of mutual fund in order to have a good understanding about mutual fund and anything related with.

3.1.4.3. Mutual Fund Growth in Indonesia

Mutual fund has existed in Indonesia since September 1995, when PT. BDNI Securities established PT BDNI Reksadana and issued a closed end fund with 300 million shares that were listed at Jakarta Stock Exchange in October 1995 (Cahyono, 1999: 281).

The implementation of Act No. 8 1995 about Capital Market supported the growth of mutual fund in Indonesia broadly. Moreover government permitted the establishment of Open End Mutual Fund. The act influenced the growth of mutual fund in which the guidance, mechanism, and legal basis were accommodated in it. Since the mutual fund existed with one product of mutual fund in 1995 that managed

Rp. 356 billion, in 1996 the impact of Act could increase the total fund invested and managed in mutual fund as much as Rp. 5.02 quintillion that spread on 25 mutual fund products (Darmadji and Fakhruddin, 2001: 151).

According to Stock Exchange statistical report of Research Bureau of Bapepam, there are 171 products of mutual fund with Rp. 85, 831 quintillion of fund managed by fund managers in mutual fund per September 2003. This number increases amazingly compared to 2002 with Rp. 46.613 quintillion that spread in 131 mutual fund products. The following table shows the mutual fund growth since 1996 until September 2003.

Table 3.1.
The Growth of Mutual Fund in Indonesia

Year	The Value of Fund Managed in Mutual Fund (Million Rp)	The Number of Mutual Fund Products	The Number of Investors
1996	2782322.50	25	2441
1997	4916604.80	77	20234
1998	2992171.40	81	15482
1999	4974105.00	81	24127
2000	5515954.10	94	39487
2001	8003769.80	108	51723
2002	46613833.20	131	125820
2003	85831863.70	171	179356

Source: Stock Exchange statistical report of Research Bureau of Bapepam September 2003

3.1.4.4. Actors, Institutions and Mechanisms of Mutual Fund

3.1.4.4.1. Actors and Institutions of Mutual Fund

There are some parties who involved in the activity mechanism of mutual fund, they are:

a. Fund Manager; is one who has license from Bapepam to manage securities portfolio for investors, or manage investment portfolio for group of investor, except insurance company, pension fund, and bank that does its work based on regulation. Bapepam has special term for fund manager; that is Wakil Manajer Investasi (WMI). Individual who wants to be a fund manager should pass the profession exam standard for capital market profession (Broker, Dealer, Underwriter, Fund Managers).

b. Custodian Bank; is an institution that gives depository and storage service of securities and assets related to securities. It also provides other services such as: completing securities transaction, receiving dividend, interest, and representing account owner or holder that becomes its client.

c. Sales Agent of Mutual Fund; or known as WAPERD (Wakil Agen Penjual Efek Reksa Dana) is an individual that has a license from Bapepam to act as a broker of Investment Company and sell the mutual fund products.

d. Public Notary; is a public official that has authority to make a legal certificate. A public notary functions to make some legal certificates and contracts needed when a mutual fund is established.

e. Legal Consultant; is a legal expert who gives a legal opinion and signs all opinions when a mutual fund is offered through Initial Public Offering (IPO) legally.

f. Public Accountant; is a party who is responsible on the validity and accountability of mutual fund's financial statement and report.

3.1.4.4.2. Mechanism of Mutual Fund

The mechanism of mutual fund is divided into two general mechanisms; they are corporate type and contractual type of mutual fund (Bapepam, 1997: 32). The mechanisms are shown in the following figures:

Figure 3.1
The Activity Mechanism of Corporate Type Mutual Fund

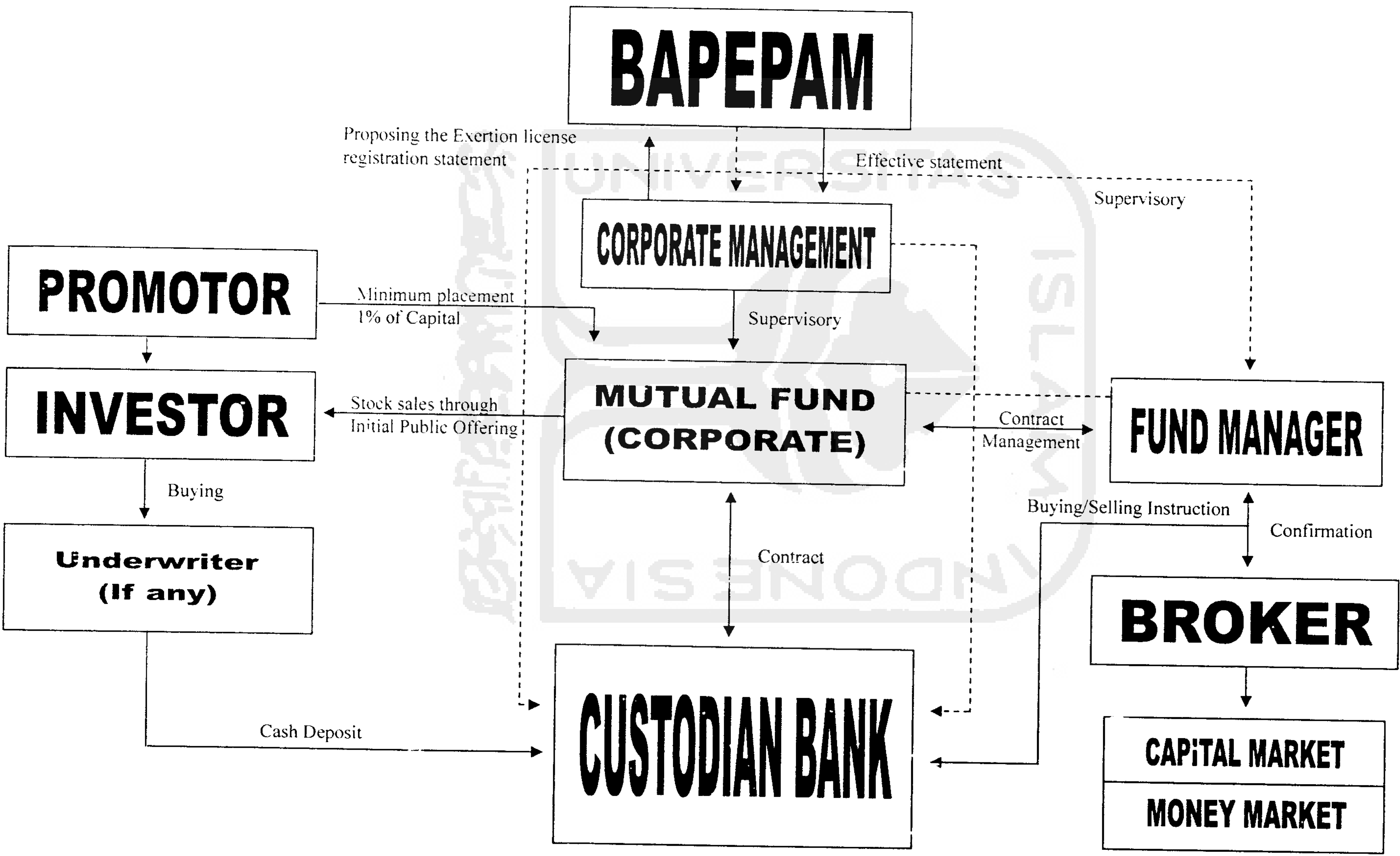
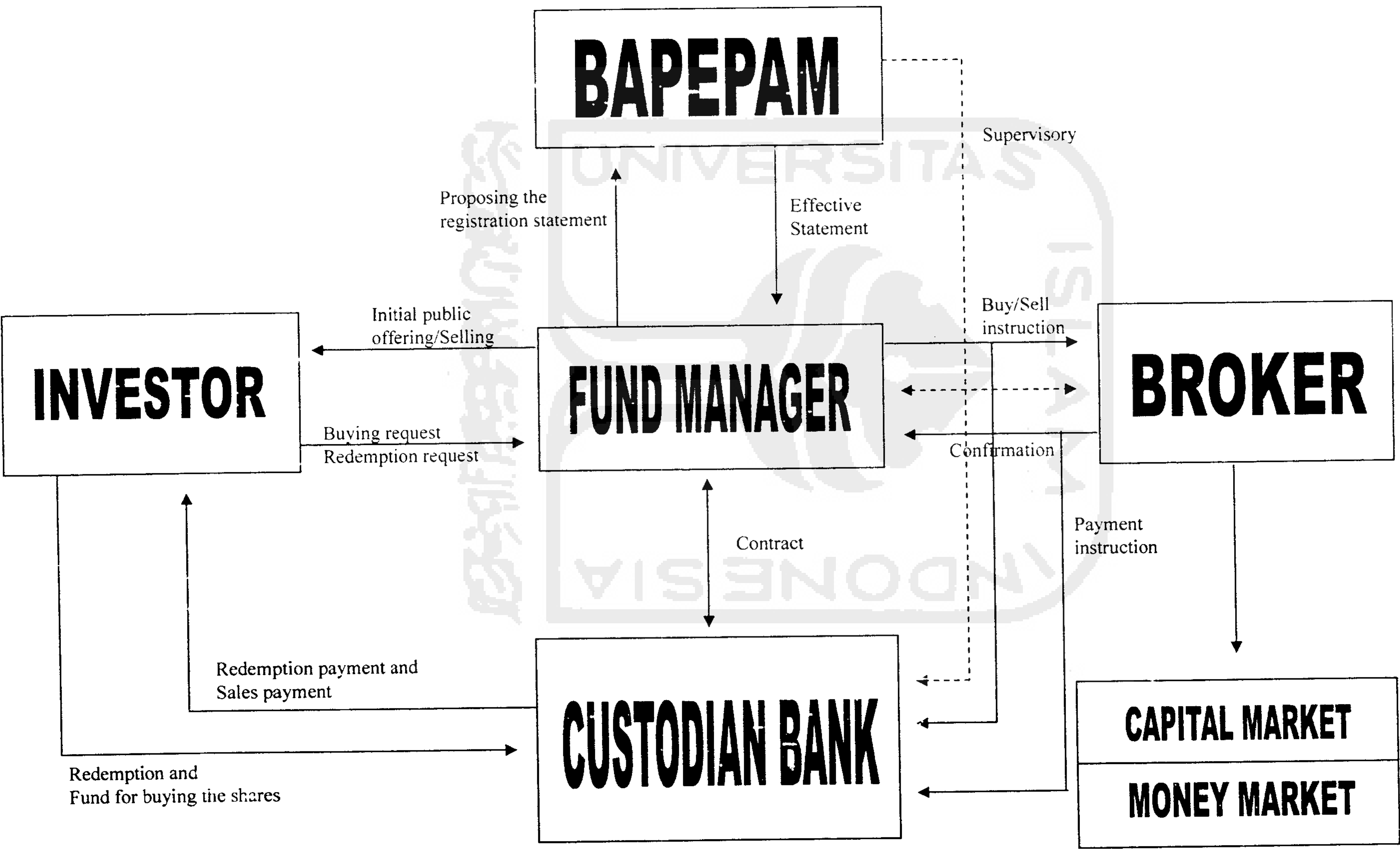


Figure 3.2
The Activity Mechanism of Contractual Type of Mutual Fund



3.1.4.5. Taxation of Mutual Fund

Based on the regulation issued by General Directorate of Taxation number: SE-18/PJ.42/1996 on 30 April 1996, government regulates the income tax (PPh) system for mutual fund (Bapepam, 1997: 27)) as follows:

a. Taxation for Close End Fund

Table 3.2
Taxation of Close End Fund

Description	The Treatment of Income Tax
Mutual Fund Return:	
1. Dividend	Not Income Tax object
2. Coupon Bond	Not Income Tax object
3. Deposit Interest	Final Tax Income (15%)
4. Capital Gain	Final Tax Income (0.1%)
5. Commercial Paper	General Tax Income
Form of Accepted Return:	
1. Corporate (PT), Cooperative, BUMN, Foundation	Not Income Tax object
2. Another points except previous points,	General Tax Income
3. Personal/individual	General Tax Income
Accepted profit by shareholders from the shares selling	Final Tax Income (0.1%) for Closed End Fund and General Tax Income for Open End Fund; because it is not traded in Stock Exchange.

b. Taxation for Open End Fund[4]

Table 3.3
Taxation of Open End Fund

Description	The Treatment of Income Tax	Legal Basis
1. Dividend	General Tax Income	Article 4 (1) of Tax Income Act
2. Coupon Bond	Not Income Tax object	Article 4 (3) letter I of Tax Income Act.
3. Deposit Interest	Final Tax Income (15%)	Government Regulation (PP) no. 51 1994.
4. Capital Gain	Final Tax Income (0.1%)	Government Regulation (PP) no. 41 1994.
5. Other Bonds	General Tax Income	Article 4 (1) of Tax Income Act.
Part of profit including the redemption profit of the shares that accepted by shareholders (investors)	Not Income Tax object	Article 4 (3) letter h of Tax Income Act.

The special treatment of tax income on mutual fund specifically on Open End Fund type compared to other investment vehicles also becomes a trigger of mutual fund's increase. The tax dispensation imposed to mutual fund is meant to attract people in investing their money in mutual fund.

[4] The regulation system of income tax for Open End Fund type is treated differently. The special tax treatment on Open End Funds aims to support and increase the growth of mutual fund in Indonesia.

3.1.5. Factors Affecting the Growth of Mutual Fund in Indonesia

3.1.5.1. The Interest Rate of Bank Indonesia Certificates

Based on Act No. 13 Year 1968 about central bank, one of Bank Indonesia's duty is serving as monetary authority to help government in managing, controlling and keeping the stability of Rupiah. Bank Indonesia runs its duty by applying some monetary instruments, which consists of reserve requirement, discount facility, open market operation. Bank Indonesia trades Bank Indonesia Certificates in its open market operation. Bank Indonesia Certificates is Bank Indonesia's securities or bonds that are issued by Bank Indonesia as short-term bonds with discount system (Bank Indonesia, 1999).

Bank Indonesia that functions as monetary authority has a duty to control the stability of Rupiah. A common paradigm states that the excess supply of money in society can influence the stability of Rupiah in the economy. Bank Indonesia Certificates is issued to control the money supply in society. The sales of Bank Indonesia certificates can absorb money from society. This will automatically be able to minimize the excess money supply.

The sales of Bank Indonesia Certificates are done through auction system and targeted to bank parties. However,

any individual or other institution may buy them through appointed banks or brokers. Buyers that bought Bank Indonesia Certificates will earn discount that is determined by the buyers as the participant in the auction.

The discount rate of Bank Indonesia Certificates tends to affect the interest rate of deposit in the banks. Agus Sugiarto (2003a) states that the interest rate of Bank Indonesia Certificate has a significant affect on the growth of mutual fund in Indonesia. The decrease of interest rate of Bank Indonesia Certificates from 17.62% in December 2001 to 10.44% in May 2003 caused banks to lower the deposit interest rate. This condition impacts people to find out another investment alternative that offers higher rate of return compared to deposit interest rate. One of those investment alternatives is mutual fund that is able to give higher return for its investor.

When the interest rate of Bank Indonesia Certificates increases, the interest rate of deposit in the bank also increases. The interest rate of deposit has a significant impact on the investment in mutual fund negatively. Higher interest rate of deposit can attract money from society to be saved in the banks. More people will shift their money to be saved in the banks caused by the higher interest rate. It is more

profitable and promising in resulting in return. In addition, money that is deposited in the banks is guaranteed by the government. These are the reasons for people prefer to save their money in the banks compared to other investment vehicles that mostly involve higher risks without guarantee from government. This explains why the relationship between investment growth in mutual fund and interest rate is negative.

Bank Indonesia Certificates is traded in money market. It is the most marketable of all money market instruments. As monetary instrument in open-market operation, Bank Indonesia Certificates can control the money supply in market. In this case, Bank Indonesia is able to influence the level of interest rate in the market indirectly by announcing the Stop Out Rate (SOR). SOR is the accepted interest rate based on the best interest rate bids in the Bank Indonesia Certificates auction. The SOR furthermore, is used as interest rate indicator for transaction in money market (Martono, 2003: 200)

3.1.5.2. The Gross Domestic Product

In general, economists judge macroeconomic performance by looking at a few key variables, the most important of which is gross domestic product (GDP) beside the inflation and unemployment. Gross Domestic Product

(GDP) is the value of all final goods and services produced in the economy in a given time period (quarter or year). It is the basic measure of economic activity (Dornbusch and Fischer, 1994: 8).

GDP can be computed in two ways. One is to add up the amount spent on all final goods during a given period. This is the expenditure approach to calculating GDP. The other is to add up the income (wages, rents, interests, and profits) received by all factors of production in producing final goods. This is the income approach to calculating GDP. These two methods lead to the same value for GDP for the reason: *every payment (expenditure) by a buyer is at the same time a receipt (income) for the seller.* We can measure either income received or expenditures made, and we will end up with the same total output[5] (Case and Fair, 1999: 136).

Gross Domestic Product is the key concept in national income accounting as the total market value of all final goods and services produced within a given period by factors of production located within a country. It represents the welfare

[5] Suppose the economy is made up of just one firm and the total firm's output this year sells for $1 million. Because the total amount spent on output this year is $1 million, this year's GDP is $1 million. Remember: The expenditure approach calculates GDP on the basis of total expenditures for final goods and services in the economy. But *every one* of the million dollars of GDP is either paid to someone or remains with the owners of the firms as profit. Using the income approach, we add up the wages paid to employees of the firm, the interest paid to those who lent money to the firm, and the rents paid to those who leased land, buildings, or equipment to the firm. What is left over is profit, which is, of course, income to the owners of the firm. If we add up the incomes of all the factors of production, including profits to the owners, we get a GDP of $1 million.

and economic growth of a country. The level of welfare is determined by the value of a country's national income divided by the number of its population that is called per capita income. The higher a country's GDP value the higher per capita income of people in that country. When people have more income, they will have extra money to be saved or invested in various investment vehicles including in mutual fund, beside fulfilling their consumptions.

In addition to holding money for transaction needs, people may also hold money as store of value. People who have extra fund to be invested, consider about portfolio theory. It is related to how rational investors allocate their wealth among different financial assets – that is, how they put their wealth into a portfolio (or group of securities). Portfolio theory begins with the fundamental assumption that people seek high return on their investments but are averse to risky investments. In other words, people will generally hold risky investments only if their returns are sufficiently high. Given two assets with equal returns, people seek the safer investment. To draw people away from low-risk assets into risky stocks or real estate, the high-risk asset must offer a higher return.

Portfolio theory analyzes how a risk-averse investor should allocate wealth. One important rule is to diversify the portfolio among different assets. "Don't put all your eggs in one basket" is one way of expressing this rule. In addition, advanced studies of portfolio theory show that an optimal portfolio would generally contain a mixture of low-risk and high-risk assets. The low-risks assets might well include interest-bearing checking accounts. We should not be surprised, therefore, that in today's world many household will hold money as part of their strategy for investing their wealth and not for transaction purposes (Samuelson and Nordhaus, 1995: 487). The calculations show that by diversifying wealth in terms of portfolio among a broad group of investments – different common stocks, different kinds of bonds, perhaps real estate – people can attain a good return on their wealth without incurring unacceptable risks.

3.1.5.3. The Exchange Rate

Exchange rate is the price of one currency in terms of another (Mishkin and Eakins, 2000; 331). Each country has a currency in which the prices of goods and services are quoted; the dollar in the United States, the Poundsterling in Britain, the Yen in Japan and the Peso in Mexico, to name just a few. Exchange rates play a central role in international trade

because they allow us to compare the prices of goods and services produced in different countries (Krugman and Obstfeld, 1997: 332).

Foreign exchange rates, for the most part, are not fixed over time. Instead, like any other price, they vary from week to week and month to month according to the forces of supply and demand. The foreign exchange market is the market in which currencies of different countries are traded; it is here that foreign exchange rates are determined. Foreign exchange is traded at the retail level in many banks and firms specializing in that business. Organized markets in New York, Tokyo, London, and Zurich trade hundreds of billions of dollars' worth of currencies each day (Samuelson and Nordhaus, 1995: 668).

Exchange rate affects the economy because when the Rupiah become more valuable relative to foreign currencies, for example US. Dollar, Indonesian goods become more expensive and foreign (American) goods become cheaper. When the Rupiah falls in value, Indonesian goods become cheaper and American goods become more expensive. In addition, changes in exchange rate have a major impact on financial institution because many of their assets are denominated in foreign currencies. When the value of foreign

currencies changes, the market value of financial institutions changes as well (Mishkin and Eakins, 2000; 331).

Some companies that operate and produce output which depend on imported production factors will suffer from the increase of exchange rate. The increase of exchange rate impacts on the higher production cost that influence productivity. The increase of production costs then will burden the companies and force them to shift the increase to the consumers, by raising the prices in the market. As a consequence, the products are difficult to be sold in expensive prices. This will affect company's income. The lower the income earned by a company, the worst the performance of the company[6] in the economy and the lower the possibility for the company to share dividend[7]. The dividend is one of triggers for investors to buy stocks in capital market.

Exchange rate also has a significant effect on investment in mutual fund. It impacts the tendency of society to buy Mutual Fund. When US$ reaches the profitable and

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[6] The performance of a company (a listed company in the Stock Exchange Market) in the economy becomes a consideration by investors to buy its shares. Investors always watch the growth of a company in which influence its prospect to share dividend to the shareholders.

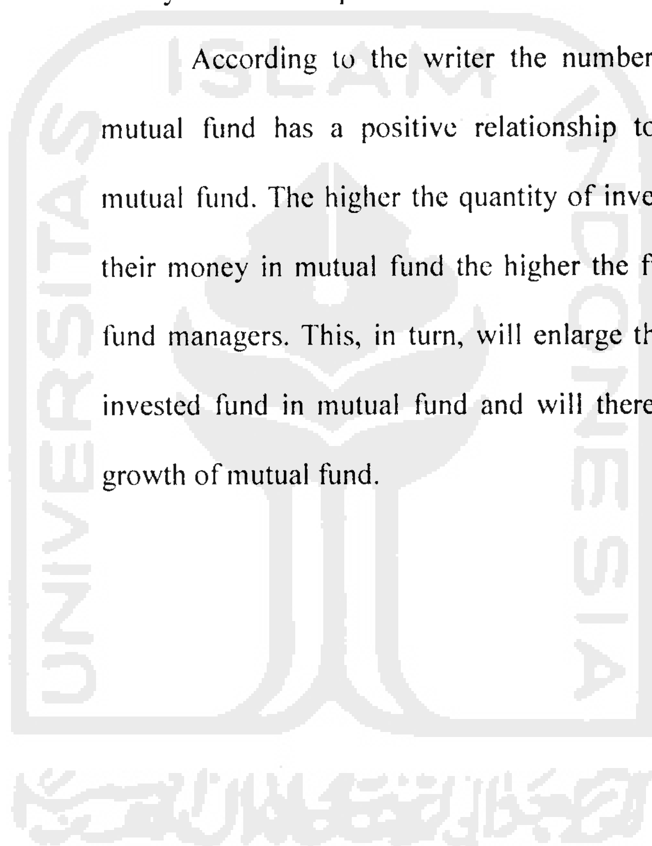
[7] Dividend is part of company's profit that is shared to the shareholders. The proportion and value of dividend are determined in the shareholder meeting. Usually a company does not share all its profit to its shareholders, but there is a proportion of the profit that reinvested to enlarge the company. A company shares its profit in terms off dividend when the company experiences and earns profit from its performance. In other words, a company will not share the dividend when it losses.

promising level, more people tend to invest and allocate their money in Foreign Exchange Market.

3.1.5.4. The Number of Investors

The number of investors of mutual fund means the quantity of investors who invest their money in mutual fund or buy mutual fund product as their investment vehicle.

According to the writer the number of investors in mutual fund has a positive relationship to the growth of mutual fund. The higher the quantity of investors who invest their money in mutual fund the higher the fund managed by fund managers. This, in turn, will enlarge the amount of the invested fund in mutual fund and will therefore support the growth of mutual fund.



3.2. Hypothesis Formulation

Hypothesis is defined as something that temporary considered valid to express some opinion about the variables and the model that will be proved later on statistical test and econometrics. The hypotheses which are examined in this research are as follows:

1. The interest rate of Bank Indonesia Certificate has negative effect on the growth of mutual fund in Indonesia.
2. The Gross Domestic Product of Indonesia has positive effect on the growth of mutual fund in Indonesia.
3. The Exchange Rate of US$ to Rupiah has negative effect on the growth of mutual fund in Indonesia.
4. The number of investors has positive effect on the growth of mutual fund in Indonesia.