CHAPTER2

LITERATURE REVIEW

2.1. Mutual Funds

2.1.1. Definition of Mutual Funds

A mutual fund is an actively managed investment company that pools money from individuals and institutions that share a common financial goal. Professional money managers build a portfolio of securities that they believe will help investors achieve their objectives. Portfolios typically consist of stocks, bonds and money market instruments, or a combination of the three (Franklin Templeton Investment, 2007)

A Mutual fund is a pool used to compile investor funds and then the funds are invested in securities portfolio by the investment manager (Samsul, 2015)

Mutual funds are investors' funds gathered by a profesional investment company. The investment company will do the investment based on what is the investors' decision to invest in terms of the forms of stocks, bonds or another instrument. A mutual fund is an investment for an investor that do not have time to control their money in capital market and then hand over their money to the investment manager. Nowadays, people can start to open an account in mutual funds only with Rp. 100.000.

To open the account people can contact or go to securities that provide a mutual fund service.

Securities that have the mutual fund service are companies that have been listed and have a license from JSX. There are other parties that involve in this securities, which is a custodian bank. The custodian bank is a bank that has an authority to save and protect funds used in the mutual fund transaction. The investment manager do not have an authority to keep the funds so that there is a custodian bank that involves in the business.

2.1.2. Mutual Funds Manager

The company that operates the mutual fund investment is a company that has been listed and has license from JSX. The investment manager of the company operating the mutual funds could be the company which is specially engaged as an investment management company. Or, securities have been one of divisions operating the mutual funds.

A custodian bank has a part in the mutual fund management. It is a bank that has an authority to save and protect funds used in the mutual fund transaction. The investment manager cannot keep the money transacted, and investment manager company cannot have affiliation with the custodian bank to avoid any fraud.

2.1.3. Advantages and Disadvantages of Mutual Funds

According to the U.S. Securities and Exchange Commission in Mutual Fund: A guide for Investors year 2007, there are 4 advantages of mutual funds and 3 disadvantages:

The Advantages of Mutual Funds are:

a) Professional Management:

Professionally managed by investment managers so that the money can be saved and controlled by the professional.

b) Diversification:

Diversification is an investing strategy by investors to invest money to many things or spreading the money to many companiesor sectors. This can help to reduce the risks if one company or sector is failed.

c) Affordability:

It means the mutual funds can be owned with a minimum amount of money.

d) Liquidity:

Liquidity means investors can freely redeem their shares at the recent NAV plus any fees and charges assessed on the redemption at anytime.

The Disadvantages of Mutual Funds are:

a) Costs despite Negative Return:

Investors require paying sales charges, yearly fees, and additional expenses. Investors might also have to pay taxes on any capital gains distribution they get even if the fund goes on to perform poorly after they bought shares.

b) Lack of Control:

Investors cannot interfere the money managers to choose which securities must be bought or sold.

c) Price Uncertainty:

In relation to an individual stock, investors are able to get the real time pricing information data comparison easily by checking financial website or calling the broker. In mutual funds, the price at which the investors purchase or redeem shares will classically depend on the fund's NAV, which the fund might not be calculated form any hours after the investors place the order.

The mutual fund is a simplicity investment. The minimum amount of money that investors must have can attract people to have the mutual fund. It is very different from the other types of investment that the investor must have much amount of money. In mutual funds the investors only need small amount of money to invest. Regarding the transparency in giving information about the progress of the mutual fund, investors will have any updates about where their money is going to, and what product is using the

invested money so that this makes the investor feel safe about their money. Returns in the mutual fund are higher than the returns in deposit.

2.1.4. Forms of Mutual Funds

Mutual funds can be classified into 2 groups, which are company funds and collective investment contract funds. The company funds is a company having activities to manage portfolios. Investors who are interested in investing mutual funds can buy the mutual funds in that company. And, the second group is collective investment contract funds, which is a contract between the investment manager and the custodian bank. Investors that are interested in investing in the mutual funds can buy the investment unit from the company issuing the mutual fund.

2.1.5. Characteristics of Mutual Funds

According to Darmadji and Fakhruddin (2011), the characterictics of mutual funds can be divided into 2, closed-end fund and open-end fund:

a. Closed-End Fund

   It means mutual funds that cannot be bought back of shares that have been sold to investors. Shareholders cannot sell back their shares to the investment manager. If the shareholders want to sell the shares, this should be done through the stock exchange where the shares of mutual funds recorded.

b. Open-End Fund

This means mutual funds that can be offered and bought back of shares from investors until the amount of capital has been issued. Shareholders of this type can resell the shares / units at any time if desired. Investment managers of mutual funds, through the custodian bank, compulsary purchase appropriately with the NAV shares / units at that time.

2.1.6. Types of Mutual Funds

According to Mohamad (2015), types of mutual funds are divided into 4 which are money market fund, fixed income fund, equity fund, and balanced fund.

a. Money Market Mutual Fund

Money market fund is a mutual fund that is only invested in debt securities with maturities of less than one year. Money market mutual fund does not charge sales and the cost of buying back investment units. The terms of cost of sales and cost of purchase refer to the perspective of mutual funds.

b. Fixed Income Mutual Fund

Fixed income fund is a mutual fund that is invested at least 80% of assets in debt securities. The fixed income fund remains relatively stable price for all economic cycles. The new price deviations will happen in the cycle of recession or depression when many bond issuers experience defaults so that the exchange rate of bond drops off.

c. Equity Mutual Fund

Equity fund is a mutual fund that is invested at least 80% of assets in securities which are equity. Equity funds are mutual funds that are the most difficult to adapt to the condition of the economic cycles.

d. Mixed Mutual Fund

Balanced fund is mutual funds invested in equity securities and debt securities that its comparison is not completely like in the stock of equity funds or fixed income funds. Balanced funds are mutual funds that are the most flexible enough to adapt to any economic condition, as can either drastically shifting from stocks to bonds or from bonds into shares.

2.1.7.Purpose of Mutual Fund

According Darmadji and Fakhruddin (2011), the purposes of mutual fund are divided into 3, that are Growth Fund, Income Fund, and Safety Fund.

a. Growth Fund

Mutual funds that emphasis on the pursue of growth in the value of the fund. Mutual funds of this type usually allocate their funds in equity fund.

b. Income Fund

Mutual funds that prioritize in constant income. This type of mutual funds allocates their funds in bonds.

c. Safety Fund

Mutual funds that are more concerned about security than growth. This type of mutual funds generally allocates funds in the money market, such as time deposits, certificates of deposit and short-term of bond.

2.1.8 Differences between Conventional and Sharia

Because of this research will compare the performance between conventional and sharia mutual funds so that it is necessary to explain what is conventional mutual funds and sharia mutual funds as well as their differences.

a. Conventional Mutual Funds

Conventional mutual funds are the mutual funds that are not based on Islamic principles about financial or investing. It is like the regular one, and no Islamic regulations applied. In the conventional mutual funds, the investment manager is free to invest the funds in any types of company, not like in the sharia that forbids to invest in companies that conduct a gambling, pornography, prostitution and *haram* foods or drinks.

b. Sharia Mutual Funds

Sharia mutual funds in the mutual funds follow Islamic principles and avoid that is not allowed in Islam, as what the Islamic National Council has been stated in *fatwa* of Islamic National Council of number 20/DSN-MUI/IV/2001.

a. Shariah mutual fund is a mutual fund that is operating according to the provisions and principles of Islamic Sharia, either in the form of agreement between the investor as the owner of the wealth (sahib al-mal / Rabb al Mal) with the investment manager as vice sahib al-mal, or between investment managers as a vice shahib al-mal with the investment users.
b. Mudharabah / Qiradh is an agreement or a system where a person gives his wealth to others to be managed with the provision that the profits (from the results of the management) is divided between the two parties, in accordance with the terms agreed upon by both parties, while the loss is borne by the sahib al-mal as long as no negligence of mudharib.
c. Investment income that can be accepted by sharia mutual funds is :
    a. From the equity mutual funds
        1. A dividend is a profit sharing from the total profit distributed from the income that the company has made
        2. Rights which are the rights to subscribe for any securities in advance given by issuers and
        3. Capital gains are profits earned from the sale of shares in the capital market.
    b. From the bonds in accordance with sharia can be: Profit sharing received periodically from profit issuers.

c. From money market securities in accordance with sharia can be: Profit sharing received from the issuer.
d. Related to deposits can be: Profit sharing received from the Sharia Banks.

2.2. Mutual Fund Performance Method

There are several methods to analyse the performance of mutual funds. The researcher chose 5 methods, which are Jensen, Treynor, Sharpe, M^2 and Miller.

a. Jensen method

   Jensen method is a measurement method seeking only mutual funds that can generate returns over the expected returns or a minimum rate of returns. The return in Jensen method is an average return in the past, while the minimum rate of returns is the expected return, calculated using capital asset pricing model (CAPM), different between the average return minus the minimum rate of returns called as alpha (Samsul, 2015).

b. Treynor method

   There are some terms used with the same name, namely as Treynor's index, Treynor's measure, and Treynor's model. The purpose of Treynor method is a measurement method using the past average return as the expected return and used beta as a risk benchmark. The beta shows the size of change return of mutual funds on changes in market returns (Samsul, 2015).

c. Sharpe method

According to Sharpe (1966), the mutual fund performance in the future can be predicted by using two measurements, which are expected rate of return and predicted variability of risk expressed as the standard deviation return. The expected rate of return is the annual average of returns and the predicted variability of risk is the the standard deviation from the annual returns.

Sharpe method is a measurement using the expected rate of return and predicted variability of risks expressed as the standard deviasion of returns.

d. M^2

Franco modigliani and Leah modigliani (M^2) method is a measurement using the minimum benchmark return. It is the performance of the market which is the ratio between the market return and market risk. Performance of the market used as bencmark and all of the performance portfolios are adjusted proportionally to the performance of the market (Samsul, 2015).

e. Miller method

Miller modified an appraisal ratio formula into alpha individual divided by portfolio's specific risks which is variance on error.

Miller method is a measurement using a variance from residual as the benchmark of risks.

2.3 Performance of Mutual Funds : Comparison between Conventional and Sharia

In the previous research or in another research about performance of mutual funds, the basic measurement used by them are Treynor, Jensen, and Sharpe. This three methods are the basic measurement of mutual funds. Some researchers added m2 measurement for the better result because they added more methods. The result from the previous research is varied. Some research found that conventional equity mutual funds have better performance, while the other research stated that sharia equity mutual funds have better performance.

Desiana and Isnurhadi (2012) conducted a research about the comparison between the performance of conventional equity mutual funds and sharia equity mutual funds in Indonesia stock exchange. From the three methods to measure the performance of mutual funds using Sharpe, Treynor, and Jensen, the results showed that the performance of conventional equity mutual funds are better (outperform) compared with the sharia equity funds.

Hayati and Haruman (2006) conducted a research about Comparison Analysis between the performance of Conventional and Islamic Mutual Funds as the Basis for Decision Making Knowledge for Investment in Indonesia Capital Market. Based on the results of the research's hypothesis testing related to differences between the rate of return and risk of mutual funds, it obtained significant results as follows: (a) There are differences in the level of results between equity funds, fixed income fund and

balanced fund(b) There is no difference between the rate of returns of sharia fixed income mutual funds and sharia balanced funds, (c) There are differences in the level of risks between equity funds, fixed income fund and balanced funds and (d) There is no difference in risks between sharia fixed income mutual funds and sharia balanced fund.

Ramadya and Isynuwardhana, (2012) conducted a research about The Differences of the Performance Equity Mutual Funds between Sharia and Conventional Mutual Funds, using with Sharpe, Treynor, and Jensen methods in year 2009-2010. The results showed that sharia mutual funds have better performance in Jensen and Treynor methods. While in Sharpe method, conventional mutual funds have better performance.

Saputra (2009) studied about different performances of sharia and conventional mutual funds, in equity, fixed income and balanced fund. From the 12 companies analysed, sharia mutual funds have better performance than the conventional one. Febriyanto (2011) also studied about different performances of sharia and conventional equity mutual funds, using Treynor, Jensen, and Sharpe. The results showed that sharia mutual funds have better performance than conventional mutual funds, and sharia mutual fund performance do not differ significantly with conventional mutual funds.

Before doing a data analysis, the hypothesis must be created as a presumption and must be proven the truth. Because based on the previous research, some researchers said that conventional equity mutual funds have better performance, and some said sharia equity mutual funds have better performance, the researcher conducts this research to prove

the different performances of conventional and sharia equity mutual funds in the 2014-2015 with the hypothesis as follows:

H1 : There is a difference in the performances of conventional equity mutual funds and sharia equity mutual funds.

In addition, this research aims to prove whether Miller method is having the same ranking of performance as the other method or not. The hypothesis is as follows:

H2 : There is a difference rank in the performance between Miller method and Treynor, Jensen, Sharpe and M^2 methods.