

CHAPTER 1

INTRODUCTION

1.1 Introduction

Islamic finance has grown rapidly over the past decade and is still expanding. According to the Islamic Finance Outlook (2020) for the Islamic Financial Services Industry (IFSI), the overall amount of IFSI rose to USD2.4 trillion in 2020, which grew 11.4% compared to 2019. According to the State of Global Islamic Economy (2019), total Islamic finance assets will grow to USD3.5 trillion by 2024. Islamic finance applies to transactions performed in ways that are compliant with *Sharia* law, in which the economy does not include illegal practices and elements, and is based on strict ethical precepts.

Islamic finance started its journey in the savings institutions of Egypt and Malaysia, pioneered by the Mit-Ghamr Islamic Saving Associations (MGISA) in the former and the Pilgrims Fund Corporation (Tabung Haji) in the latter (Hussain et al. 2015). Islamic products are complementary to conventional financial products and have spread throughout all aspects of modern financial services (Ahmad et al. 2017). The Stability Report for the Islamic Financial Services Industry (IFSI, 2019) addresses the reasons for growth in Islamic finance. First, the significant improvement in Islamic banking, Islamic capital market, and *takaful*. Second, enhancing the resilience of the Islamic Financial Services Industry based on adequate metrics of financial stability and meeting most international regulatory requirements. Iran accounted for 29% of global Islamic financial assets as of 2018, then Saudi Arabia with 25%, while Malaysia accounted for 11%. Islamic finance offers a number of products, including Islamic

banks and Sukuk, and Islamic mutual funds (IMFs). One of the Islamic finance's main items is the IMFs.

Islamic mutual funds (IMFs) are one of the types of mutual funds. In 2020, the mutual fund industry accounted for about USD89 trillion of global assets under management (AUM) compared to USD52.6 trillion in 2009, and the number of mutual funds increased globally from around 83 thousand in 2009 to around 126 thousand in 2020 (The Global Asset Management report, 2020). A mutual fund is one of the main investment vehicles in many countries around the world, raising money from investors and investing it in various shares, such as money market instruments, stocks, and bonds. The largest form of IMF is equity funds, which account for 42% of total assets, then money market funds 26% and commodity-based funds 14%. Other major asset classes include fixed-income funds 10% and mixed-allocation funds 7%, and Islamic funds are spread across several regions of the world, especially the Middle East and North Africa, Asia Pacific, Europe, and North America (GIFR, 2018).

Malaysia and Saudi Arabia are the main domiciles that contribute to the industry's largest market share of global Islamic funds. Malaysia and Saudi Arabia controlled more than 66 percent of the total assets. Saudi Arabia contributed 38.5 percent and Malaysia contributed 28 percent (Malaysia World's Islamic Finance Marketplace MIFC 2020). Money market and equity funds continue to dominate the Islamic fund portfolio globally following closely the composition of the form of funds in Saudi and Malaysia being the two biggest drivers in this space. Pakistan followed with USD2.6 billion, of AUM. Islamic funds can work with conventional funds in combination, and all forms of funds can operate within the same fund family.

Fund families serve as financial intermediaries offering a variety of mutual funds under a common brand name and through a common channel of marketing and

distribution. Fund families can be described as a fund group that is managed by one asset management company (AMC) (Aleemi et al. 2019). It is necessary to research mutual funds at a fund family level for several reasons (Nanda et al. 2004). First, a fund family structure adds economies of scale to the distribution, servicing, and funding promotion. Second, a fund family has more flexibility in reallocating its human and other capital in response to market opportunities compared to stand-alone funds. Third, the reputation of a fund family will help reassure investors about the investment managers' selection and monitoring. Interestingly, most mutual funds work under the fund family umbrella.

The United States ranks first in the number of fund families. The Morningstar Fund Family 150 Report (2019) indicated that the number of fund families in the United States, as of end-2019, was 777 fund families with USD19.3 trillion invested. According to the Securities Commission (SC) in Southeast Asia, there were 80 fund families in Malaysia, with USD181.1 billion as of end-2018, compared to 55 fund families as of end-2017 containing USD169.24 billion. While Indonesia has 86 fund families with USD38.82 billion according to the Asset Management Industry In Rating Perspective (2018), compared to 77 fund families containing USD34.11 as of end-2017. According to the Securities and Exchange Commission of Pakistan report (SECP 2018), Pakistan has 30 fund families with USD4.35 billion, compared to 22 fund families containing USD2.66 billion as of end-2015. As of the end-2018, Saudi Arabia in the Middle East had 41 fund families with USD110.2 billion, compared to 33 fund families as of the end-2015 (www.Tadawel.com.sa).

According to the growth of the fund family industry, it is important to study the performance at the fund family level. This is because most investors use the top-down approach when making decisions. The top-down approach means investors first choose

the fund family and then pick the funds within that fund family. According to the reports of Morningstar and Barron, it is possible to use the fund family performance to provide investors a ranking of the fund families. They began reporting on the classification of fund families using the performance of the fund family (weighted average performance of all funds in the fund family) to create the most successful investment data and research for investors. The aims of these reports are, first, to make it easier for investors to find data about fund families. Second, to remove the asymmetry of knowledge and check the statistics provided by the fund families. Third, these reports will give investors more confidence about the fund family they want.

The main purpose of these reports ratings is to help fund families attract more investors and thus increase the assets under management. Accordingly, fund families aggressively publicise the performance of their best-performing funds (star funds) to encourage visibility, thereby drawing higher cash inflows to the fund family as a whole. That means, having star funds in the fund family can draw new flows, not just for itself, but to other funds in the fund family; this is called the "spillover effect" (Joo & Park 2011). Consequently, funds are dependent on the organisation of the fund families working under their umbrella and cannot be regarded as if they were stand-alone entities (Nanda et al. 2004). The presence of star funds in the fund family would eventually help investors pick funds from the same fund family, and reduce search costs arising from looking for new fund families (Elton et al. 2007). Ultimately, in turn, this will affect the future performance of the star fund families, as investors direct their money to these families in the hope that they will be compensated in the future through the continued stellar status of these families.

This thesis will address three important issues related to the fund families in four countries from the Middle East and South Asia; these four countries hold 65% of

Islamic equity funds. These countries are Malaysia, Saudi Arabia, Indonesia, and Pakistan. This thesis will compare the performance of Islamic and conventional-focused families. Furthermore, this thesis will also compare Islamic and conventional star fund contributions to fund family flows. The first issue concerns the analysis of fund family performance. The contributions in this issue are to test the skills of fund family managers and test the impact of star and poor funds on the fund family performance. This issue also seeks to contribute by investigating the fund family performance persistence. The second issue concerns the analysis of fund family flows. The contribution of this issue is to explore the contribution of star funds to the fund family flows, especially the existence of Islamic star funds. This issue also seeks to test the spillover effect. The third issue concerns the analysis of the future performance of star fund families. The contributions of this issue are to test the effect of star and poor funds on performance persistence of fund family and test the persistence of holding star funds in the fund family.

1.2 Research Problem

Fund family dominates in the fund industry by offering a variety number of managed funds depends on different investment styles. Gavazza (2011) indicates the reasons why fund families provide a large number of mutual funds. First, that the investors value product diversification and avail of lower search and switching costs when transacting within a fund family as compared to across families. Second, the industry has high fixed and low variable costs that allow the fund families to offer more products and to prevent new entrants. Both individual funds and their portfolio managers in the fund family take benefit from shared resources like research, trading, product development, and human resources (Hazenber 2020). This motivates the study

of the performance and flows; the two most important issues of the fund industry, at the fund family level rather than the fund level. As the studies at the fund family level are considered very few compared to studies at the fund level. This thesis also seeks to compare two types of fund families; families are focused on the IMFs (Islamic focused family IFF) and families are focused on conventional mutual funds (CMFs) (conventional focused family CFF). There is a difference between IFF and CFF because of the different characteristics of the funds that each type focuses on. IFF focused on the IMFs, in addition to traditional goals (liquidity and diversification), IMFs focuses on religious, social, and ethical goals. In addition to the Islamic funds undergo the *sharia* screening. That could affect the overall performance and flows of the fund family.

Performance evaluation is an integral part of the investment management process to provide decision-making input to managers and investors. The two main performance issues are, first, whether the professionally managed asset yields a greater return than the passive investment strategy; and, second, whether such performance persists or not. If the managers have durable superior skills, the skills are reflected in the persistence of performance. Research on the performance of individual mutual funds is extensive and widely spread across the various markets (Treydor, 1965; Sharpe, 1966; Jensen, 1968; Marzuki & Worthington 2014; Zouaoui 2019). Nevertheless, the emphasis on performance at the fund family level is limited to just a few (Elton et al. 2007; Tower & Zheng, 2008; Premachandra et al. 2012), perhaps because of the complex nature of the analysis involved. Some evidence at the individual funds indicates that the fund family plays an important role in the individual funds' performance. Further, fund family controls the resources of all individual funds work under their umbrella (Hunter

2020; Bosen 2008; Ferreira et al. 2012). So, the issue is how is the performance at the fund family level?

This is an important area of study because investors in mutual funds continue to invest in funds within the same fund family rather than across several families. The reasons for investing in a single fund family include convenience in searching for investment opportunities (Kempf & Ruenzi 2008) and flexibility of switching funds without the additional sales costs and limitations imposed by the fund family (Elton et al. 2007). In addition, the performance of fund families as a whole serves as an indicator of quality for investors (Premachandra et al. 2012). While choosing new funds, most investors opt for a top-down strategy (Kempf and Ruenzi, 2008; Massa, 2003). That is, investors can start by selecting the best attributes of the fund family, and then select their preferred individual funds in the fund family. Therefore, the issue is whether fund family managers have selectivity skills and timing ability to outperform market performance and whether there is persistence in the fund family performance?

The Top-Down approach reveals why fund families are inspired by a variety of ways to boost their reputation, such as having a top-performing fund. Past literature shows that the existence of star funds signals that the manager is skilled and provides a good financial reputation for the fund family (Ferreira et al., 2012; Jank, 2012; Nanda et al. 2004). Fund families have an exclusive ability to promote star funds within their fund families, the good performance of a star fund at the same time enhances fund family returns, investor inflows, and effectively ameliorates fund family performance (Hunter et al. 2020). So, this issue also seeks to answer the question as to whether having a star and poor funds influence the performance of the fund family?

Accordingly, the presence of star funds signals that the manager is skilled and provides a good financial reputation for the fund family, which contributes to the flow

of affiliated funds within the fund family (Nanda et al. 2004; Reuter, 2006; Joo & Park 2011). Joo & Park (2011) suggested that some fund families raise more capital from investors than others; they concluded that this is because these families either have popular funds or that they are popular among investors. It is reasonable to assume that a fund or fund family is famous when investors think it will yield better returns and that the best way to convince the general public that a fund or fund family can yield better returns in the future is to prove that some fund(s) in the fund family have done so in the past. Fund families demonstrate their superior performance by advertising their star performing funds to draw investors' interest and investment to other family funds and are inclined to take advantage of the spillover effect to maximise their overall inflow (Adrianto et al. 2019). Nanda et al. (2004), and Adrianto et al. (2019) found that the spillover effect occurred in families with at least one superior performing fund. Indeed, they have shown that, in the past, stellar performance can draw more cash flow to a fund itself and to the fund family to which it belongs. Therefore, the issue is will the existence of star funds in the fund family contribute to the overall fund family flows, and to flows of other funds in the fund family (spillover effect)? In the case of the spillover effect, the thesis focuses on a distinction between the contributions of having Islamic star funds and conventional star funds in the families.

Accordingly, attention is drawn to investor behaviour that puts more money into the fund family with star funds and the rationality of such behaviour. If investors' decisions to put more money into funds belong to the star fund family are rational, greater returns should be rewarded at the aggregate level (Joo & Park 2011). The evidence at the fund level shows that outperforming funds in the past often tend to outperform other funds in the future (Zhang 1999; Arifin 2018). Then, the future performance of fund families with star funds is highly debatable (Joo & Park 2011).

The issue does fund families with star funds outperform in the future? If the star funds have a positive effect on the inflows of fund families, they will generate more revenue. This will, of course, encourage families with star funds to maintain their current star funds in the category of star funds and/or launch new star funds for the fund family. However, a fund family can only achieve this goal if it has the potential to consistently outperform the market. Joo & Park (2011) stated that if there is a continuity in the ownership of the star fund, the star fund acquires that status not because of chance but an effective strategy or superior management ability for creating star funds. Hence, this issue also seeks to answer the question of whether fund families will have the capability in the future to maintain the status of having star funds.

1.3 Research Objectives and Questions

The main aim of this thesis is to examine the fund family performance and flows in four countries that represent 65% of the global Islamic equity mutual funds. This aim is divided into three main objectives as follows:

1. To investigate the performance of mutual funds at the fund family level.

The first objective divided into three sub-objectives. First, to examine the fund family manager's selectivity skills and market timing ability. Second, to investigate that having the star and poor funds in the fund family impact on fund family performance. Third, to test the performance persistence of fund families. This part also investigates the difference between the performance of the Islamic-focused family (IFF) and the conventional-focused family (CFF). Hence, investigate the selectivity and timing ability of IFF compare to CFF. In addition to investigating the effects of having a star and poor funds on IFF performance compare to CFF. Finally, investigate the performance persistence of IFF compare to CFF.

2. To investigate the flow-performance relationship of mutual funds at the fund family level. The second objective divided into two sub-objectives. First, to examine whether the new money growth (NMG) for a fund family with a star fund is higher than that of a fund family without a star fund, and, conversely, whether the new money growth for a fund family with a poor fund is less than that of a fund family without a poor fund. Second, to examine whether the increase (decrease) in new money growth is towards the star (poor) funds themselves and to see if there is a spillover effect to other funds in the fund family. In particular, to examine whether Islamic star (poor) funds are able to increase (decrease) the cash flows to the fund family and whether conventional star (poor) funds are able to increase (decrease) cash flows to the fund family. In this part, in the first sub-objective, investigate the effects of having a star and poor funds on the new money growth of IFF compare to CFF. While, second sub-objective, also investigate the spillover effect of having star (poor) Islamic funds compare to star (poor) conventional funds.

3. To investigate the future performance of the star fund family. The third objective divided into two sub-objectives. First, to test whether fund families with star (poor) funds outperform (underperform) the rest of the fund families in the future. The second sub-objective is to examine whether fund families with star funds have the capability of maintaining their star fund status in the future. In this part, also investigate the future performance of star IFF compare to star CFF.

Depend on these objectives, this thesis will address the following questions:

1. How is the performance of mutual funds at the fund family level? The first question also divided into three sub-questions. First, is whether or not the fund family managers appear good or have poor selectivity skills and timing ability?

Second, is the star and poor funds in the fund family impact the performance of the fund family? Third, is the fund families appear persistent in their performance?

2. How is the flow-performance relationship of mutual funds at the fund family level? The second question also divided into two sub-questions. First, is the existing star (poor) funds in the fund family affect the overall fund family new money growth? Second, is the existing star (poor) funds in the fund family affect the new money growth of other funds in the fund family?

3. How is the future performance of the star fund family? The third question divided into two sub-questions. First, is fund family that holds a star (poor) funds able to outperform (underperform) in the future? Second, is fund families with star funds have the capability of maintaining their star fund status in the future?

1.4 Research Significance

This thesis provides two aspects of novel importance related to Islamic finance. First, introducing a new concept "Islamic focused family" and comparing it with a conventional focused family. Second, providing evidence about the contribution of the existence of Islamic star funds in the fund families. This also provides a good understanding of the IMFs industry and Islamic finance. It also offers a strong overview of the Islamic finance industry and the IMFs Industry. Islamic finance has emerged as a topic of great interest to academia, international investors, and policymakers.

The analyses of fund family performance, fund family flow, and future performance of star fund family are critical to providing a good understanding of the fund family and the mutual fund industry for investors, practitioners, regulators, and academics. First, fund family performance is key to understanding the behaviour of managers. The fund family organisation plays an important role in shaping managerial

portfolio decisions and fund performance, which is important to investors who invest in funds within the same fund family rather than across several fund families. Studies at the individual fund level fail to reveal information on the performance of the fund family to which the individual fund belongs. This thesis has implications for fund families and investors. By providing useful information, it can help investors make informed decisions. The results will help future investors by providing information about the behaviour of fund families' managers, and, thus, help them to choose and allocate their money in funds with good managers; those having good selectivity skills and market timing ability as well as providing information about fund family attributes. Finally, the results may help fund family managers choose the best strategies that they have to follow to get the best performance and then be persistent in their performance. By helping them choose the right mix of individual fund types in their family, also helps them to know the most important attributes of families that may help them maintain the status of star in the future. The new evidence of fund family performance persistence would bring practical value to the investors of fund families who continue to pool their money into funds run by a single fund family. This thesis will answer the question as to whether fund families can consistently outperform the market, and whether past top performers will be future top performers.

Second, fund families flow. In spite of previous studies at the fund level proposing that the fund performance has a positive impact on fund cash flow, no study has tested the rationality of fund investors who buy into another fund from the same star fund family. Also, it is not known if star fund-owning families perform better than non-star fund families. So, this study is different from the previous studies in that it tries to analyse star fund-related phenomena at the fund family level and not at the individual fund level. This perspective is very important because many investors select funds based

on the name and reputation of the fund family instead of the fundamentals of the individual funds (Adrianto et al. 2019). This tendency is especially strong in emerging fund markets, where the lifetime and track records of individual funds are short, and, therefore, investors do not possess enough information about individual funds (Joo & Park 2011).

Third, this thesis also provides evidence of the future performance at the star fund family level, the existence of this effect helps investors to anticipate the good performance of funds in the future, to which they can direct the flow and thus generate profit. It is understandably important to know if a fund family which has owned star funds in the past would outperform in the future at the fund family level of the fund.

1.5 Thesis Structure

Chapter Two provides an overview of Islamic financial history, evolution, principle, and development. It serves as a broad theoretical and conceptual background for the understanding of Islamic finance in general and IMF in particular. These principles form the foundation of Islamic finance, while also underlie the principles of every contract established to facilitate all financial transactions and activities in Islamic finance. In addition, it is also to highlight the evolution and concept of both mutual funds and fund families. Finally, this chapter provides a background of the four countries markets under study.

Chapter Three discusses the theoretical and empirical literature pertaining to the mutual fund industry, focusing on modern portfolio theory (MPT), efficient market theory (EMT), and behavioural finance. This chapter also provides a background for understanding recent work in the mutual fund industry and the performance of the fund

family as well as providing the necessary guidance for methodological choices to be used in this thesis.

Chapter Four details the data collection techniques and research methodology used to analyse fund family performance and flows, and the future performance of the star fund family. This chapter also provides the sources of data and explains the methods used to address these empirical concerns. The first empirical analysis relates to the fund family performance. The second empirical analysis concerns the flow of money into the fund family including the relationship between flow-performance and spillover effect. The third empirical analysis study is on how the star fund families view performance persistence.

Chapter Five presents the empirical findings on the performance of the fund family, fund family flows, and future performance at the star fund family level. This chapter starts with the results of the analysis of fund family performance, includes selectivity and timing ability, performance persistence, and impact of having star (poor) on fund family performance. Followed by fund family flows, includes the impact of having star (poor) funds on fund family flows, and spillover effects. Finally the future performance at the fund family level, and the capability of fund family having star fund to maintain their star funds status.

Chapter Six summarizes the study and highlights the contribution of this thesis to the existing literature fund family. This chapter also provides the implications for industry policy and industry practice, discusses some of the limitations of the thesis, and suggests some directions for further research.