The Performance of the Romanian Mutual Funds

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Abstract
A very promising market in Romania is that of mutual funds. The development of financial instruments on the Romanian capital market and the growing liquidity at the stock exchange allow a better flexibility of mutual funds with respect to their investments so that they can diversify or specialize on certain type of investment. High returns have been achieved by common stock funds which tend to become a majority on the market as an approach to the situation in UE, where most mutual funds invest on the stock exchange.
We try in this paper to present the legal framework of the Romanian mutual funds and to stress the necessity of finalizing the harmonization of investment funds functioning at European level and to analyze the evolution of Romanian investments and especially mutual funds investments as compared to other East European countries.
As the Romanian capital market is an emergent market but which is also expected to provide the first signs of maturity it is interesting to enlighten the performance and the perspectives of these funds as compared to the situation in other central and east European emergent markets of countries that have adhered to the UE

Keywords: risk-adjusted returns, market timing, selectivity

Introduction

One of the most exciting research aria in finance is connected to investment companies and especially mutual funds. At the moment mutual funds are a preferred investment vehicles for at least five reasons:

- they offer great risk reduction as a direct consequence of portfolio diversification
- they have professional managers that construct, optimize and manage portfolios, otherwise not attainable for individual investors;
- they must perform a very transparent activity and a constant communication with investors
- mutuality, which implies equal treatment regardless of the amount of money invested in the mutual funds
- they offer the chance to small investor to detain diversified portfolios by pooling the investment funds.

Yet, these investment vehicles raise a great number of questions, most of them related to their performance evaluation. The main question is whether actively managed mutual funds managers are able to add value for their investors. Even if the results of academic studies aren't very flattering for these professionals, they haven't lost investors' confidence, active management still being the favorite option. Managers of actively managed portfolios are expected to consistently outperform the index or the benchmark. In order to prove their ability in generating excess returns, managers have to rely on their past performance. Financial industry spends considerable amount of resources in measuring and ranking the performance of actively managed portfolios. The academic evidence on this matter is not conclusive. Studies have shown that the relative performance of equity mutual funds persists from period to period. The persistence is strong for the top 25% and the bottom 25%, while for the middle 50% no persistence has been detected.

Over the long-term, the success or the failure of an investment in a fund will also depend on factors as:

- investor demand for mutual funds is influenced by a variety of factors, among the most important being the ability of the fund to assist investor in achieving a wide variety of investment objectives
- the age and size of the fund. Newly created or small funds may have excellent short-term performance records, because these funds invest in a small number of stocks and a few successful stocks can be of strong impact to their performance. When these funds grow older and increase the number of stocks they hold, each stock's impact will be diminished and the previous results will be hard to keep
- the fund's sales charges, fees and expenses. A fund with high costs must evolve better in generating returns than a low-cost fund. Running a mutual fund involves costs, including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Funds pass along these costs to investors by imposing fees and expenses. So when investing in a mutual fund not only past performance is important but also the stated investment policy and management fees and expenses. Studies have shown that the average mutual funds' under-performance compared to a benchmark corresponds to the average fee
- the distribution taxes paid by the investor
- the fund's risk and volatility. The solution for a risk-averse investor who aims returns above money-market is a balanced portfolio.

A portfolio manager must accomplish two major requirements:

- he must posses the ability to diversify the portfolio in order to completely eliminate unsystematic risk
- he must have the ability to derive above-average returns for a given risk class.

We will present the situation of the Romanian mutual funds beginning with the legislation on collectives investment schemes.

Legal framework

There is no harmonization at a global level with respect to conceptual and terminological delimitation of investment company. In the USA, according to the Investment Company Act of 1940 there are two main categories of investment companies:

- unit investment trusts, which are investment companies with a pre-established life duration that buy and hold a generally fixed portfolio of stocks, bonds, or other securities;

- management companies which can be either open-end funds or closed-end funds. Open-end funds or mutual funds redeem outstanding shares at any time upon a shareholder's request, at a price based on the current value of the fund's net assets. All mutual funds continuously offer new funds shares to the public. Closed-ended funds are investment companies that issue a fixed number of shares, which trade on the stock exchange.

At European level is very difficult to realize the harmonization of this investment area because of the specific regulation of each country. The European Directive 85/611/EEC tried to harmonize the laws, regulations and administrative provisions relating to undertakings of collective investments in transferable securities (UCITS). It has two objectives:

- to bring near the competitive conditions among UCITS at the European level in order to facilitate funds activity in member countries
- to ensure an effective and uniform protection for investors.

The Directive was designed to simplify cross-border marketing and to support the construction of a single European capital market. But the Directive treats only open-ended schemes and is hard to transpose in each country legislation. More than that since 1985 when the Directive was elaborated, there were tremendous changes in financial instruments and institutions playing on the market. There still are disparities between organization and functioning of investment funds in European countries. A complete harmonization in this respect would be beneficial for the integration of this industry. In a recent study, EFAMA (European Funds and Asset Management Association) enlightened the necessity of the completion of a real single market for savings and investment products.

In Romania, the framework low that rules mutual funds' industry is Law 297/2004 regarding the capital market and Regulation 15/2004 regarding the organization and functioning of management companies, collective investment schemes and depositors. This legal framework is the result of 15 years (1989-2004) of "trials and errors" of bad and worse country governance. The history of the Romanian market after the communist period is a very dark one. As far as mutual funds are concerned we can assert that the defaults in the legislation were responsible for several huge collapses that have shaken the industry as a whole and have tremendously reduced Romanian investors' trust in these vehicles. Only after the year 2000 the Romanian capital market started a stable ascending road to a maturation which is still far away, but at least is reachable.

In Romania collective investment schemes are divided into two categories:

- open-end collective investment schemes which can be either mutual funds established through a civil partnership contract (contractual funds) or open-ended investment companies organized as joint-stock companies (corporate companies)
- close-end collective investment schemes which can be either close-ended funds (contractual funds) or financial investment companies (corporate companies).

According to the funds' stated objectives, the National Union of Collective Investment Schemes, classifies them into four classes:

- Equity funds are mainly orientated to listed stocks. These funds represent a very strong investment vehicle by offering access to the stock-exchange growth. Investing in such a fund implies less effort, money and risks than the direct investment on the stock-exchange. They offer smaller investors the benefit of diversification and professional management. They include different investment styles such as growth, value or growth and value, and concentrate in alternative-sized firms, including small-cap, mid-cap and large capitalization stocks. The investment term is long and very long. The criteria of funds enclosure in this category is a minimum investment of 45% in stocks.
- Bond funds or fixed income funds that invest in long-term government, corporate or municipal bonds. The enclosure criteria is an investment of more than 90% in bonds and money market instruments. These are investments on the medium term implying small risks. They address to investors with high risk aversion and also to stock investors who aim an equilibration of the global portfolio and risk diminution.
- Balanced funds invest both in fixed income instruments and in stocks, adopting a balanced strategy in order to obtain high returns but keeping a medium risk level. They invest between 10% and 45% in stocks and the rest in fixed income instruments. They address to investors who aim performances above interest rates without exceeding a medium level of risk.
- Money market funds invest above 90% of the total active in money market instruments deposits, deposit certificates, treasury bills. They are short term investment and represent cash management instrument. They appear to individuals as an alternative to bank savings accounts because they are safe and provide yields above what is available on most savings accounts, are available in any moment without loosing the accumulated gains.

Each mutual fund has a specified investment policy, which is described in the fund's prospectus. Equities, bonds and money market instruments are major assets categories, largely used by long-term portfolio investors.

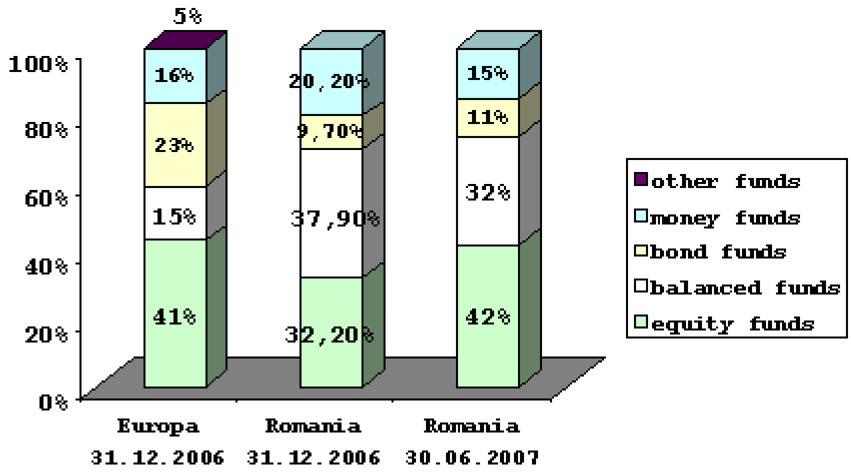
In Romania real estate and venture capital are out of mutual funds investment policies. Real estate has some characteristics which limit the investment such as: lack of liquidity, difficulty in valuing the investment, limited understanding of its risk character and relatively high cost of management. Venture capital even if offers great rewarding implies several disadvantages such as lack of liquidity, high cost of management and difficulty of valuation.

The safety of any mutual fund is determined by the fund's strategy, activities and investments. The risk is the same whether it is sold by a bank, stockbroker, financial adviser or other marketing organization.

We present below the structure of mutual funds total assets corresponding to the fund category. For Romania we present the structure in two different moments, before and after UE adhesion.

Keeping into account that the UCITS structure couldn't have changed too much (we don't dispose of precise data) we can assert that after the first of January 2007 Romanian investors' preferences have changed in favor of equity funds nearing the situation in the UE.

Figure 1: Structure of mutual funds assets in Ramania and EU



Source: The data is picked from the UNOPC Reports for the Romanian funds and from EFAMA UCITS 2006 Annual Report, for the European Funds

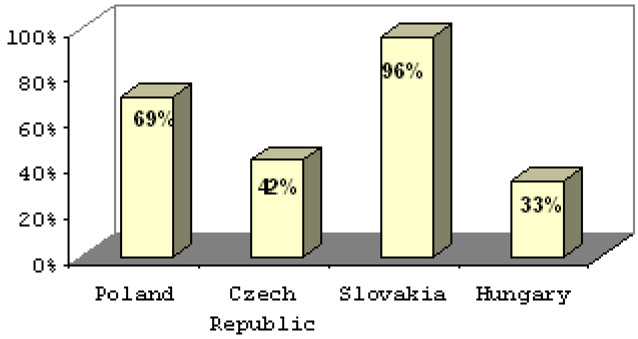
If investor support the efficient market theory they will choose a passive investment strategy. The most common strategy for passive investment is to create an index fund which tries to match the performance of a broad market index. The fund will buy shares in securities included in a particular index in the same proportion as they are represented in the index.

Index funds imply low costs and offer the chance to small investors to pursue a passive investment strategy. The index fund strategy is located at the lower end of the risk-return spectrum because it remains totally passive with respect to return opportunities.

In Romania is operating only one index mutual fund since July 2006, which is the BT Index Fund. It is an equity index fund with an asset allocation that tries to follow the structure of the ROTX index. ROTX was launched by the Vienna Stock-Exchange and the Bucharest Stock-Exchange and it includes the most liquid securities on the Romanian market. The recommended investment horizon is of one year. We hope that in the future Romanian mutual funds will invest even in European indexes offering investors the chance of gaining the market return.

We expect Romanian fund industry to continue growing in total net assets in the future. We present below the annual average growth rate of total assets for other four countries from Eastern Europe in the period of transition and shortly after.
Despite of this impressive growth of total assets these four countries detain together only 0,54% of the total UCITS net assets in UE (Czech Republic 0,1%, Hungary 0,1%, Poland 0,3% and Slovakia 0,04%).

Figure 2: Annual Average Growth Rate of Total Net Assets of UCITS (1994-2005)

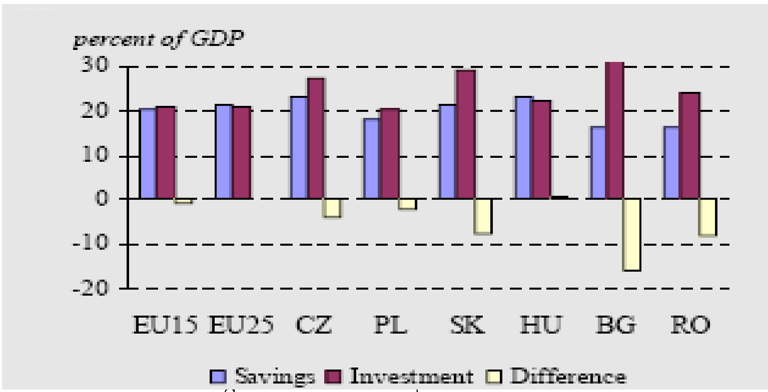


Source: The data is picked from EFAMA UCITS Report 2006 www.efama.org

Investments in Romanian funds

Even if Romania lags behind the other EU-8 in terms of economic growth, the investment rate as share of the GDP is among the highest in the region.

Figure 3: Savings and investment rate



Source: www.bnro.ro

Yet if we look at the Romanian financial systems structure as share of the GDP we are surprised to note the infinitesimal of investment funds among financial institutions (table 1).

Table 1: Financial system structure (2002-2006)

(share in GDP %)

Financial institutions	2002	2003	2004	2005	2006
Credit institutions (1)	31.0	30.8	36.6	44.6	50.6
Insurance companies (2)	1.5	1.8	1.9	2.2	2.5
Investment funds (3)	0.1	0.1	0.2	0.2	0.3
Financial investment companies (4)	1.4	1.4	1.3	1.8	2.3
Leasing companies (5)	1.5	1.8	3.0	3.6	3.4
Other institutions engaged in financing	0.4	0.4	0.6	0.9	1.3
Total	**35.9**	**36.3**	**43.6**	**53.3**	**60.4**

Source: www.bnro.ro NBR, NSC, ISC, BLS, NIS

Nevertheless in the last year the market share of mutual funds registered a significant growth but more impressive is the increase in net assets which rose by about 86%. We present below the market share of financial institutions in total assets (table 2). As the table shows, the banking sector is the most significant component of the Romanian financial market (83.8% in 2006). Funds owe a very small share in the financial system.

Table 2: Market share of financial institutions in 2002-2006

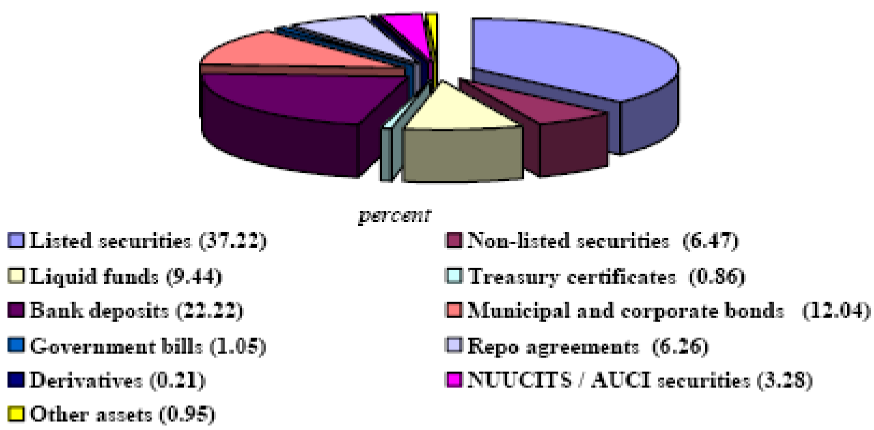
(% in total assets)

Financial institutions	2002	2003	2004	2005	2006
Credit institutions	86.3	84.8	83.9	83.7	83.8
Insurance companies	4.2	4.9	4.4	4.1	4.1
Investment funds, of which:	0.2	0.2	0.5	0.3	0.5
Mutual funds	0.2	0.1	0.2	0.2	0.3
Financial investment companies	4.0	4.0	3.0	3.3	3.8
Leasing companies	4.1	5.0	6.8	6.8	5.6
Other institutions engaged in financing	1.2	1.1	1.4	1.8	2.2

Source: www.bnro.ro NBR, NSC, ISC, BLS, NIS

The upward trend of mutual funds is attributed to new funds that appeared on the market but also to the improvement of the value of financial instruments held in their portfolios. We present below the mutual funds portfolio structure at the end of 2006:

Figure 4: Structure of assets in mutual funds portfolios dec.2006



Source: www.bnro.ro

Corporate bonds primary market increased significantly in 2006: the sustainability of such dynamics in the future remains to be tested. Even the investment in shares traded on regulated markets increased consistently in the last years nearing the situation in the European Union where certain funds have a 100% stock exposure. After the EU integration, Romanian investors will have access to these funds, some management societies having already announced their intention to distribute foreign mutual funds shares.

The Romanian mutual fund industry registered in the last years a constant growth in assets but most important is the consolidation of the market with respect to such investment. After huge frauds in the industry finally we have a law and an authority that supervises these institutions. A solid infrastructure will ensure future development of these investment companies which will have to face in the nest years a strong competition with funds from other European countries.

We present below the evolution of the Romanian mutual funds performance in the last three year compared to inflation rate and the growth rate of BET, which is the Romanian capital market index.
The average performance is calculated as the average variation of the unitary value of mutual funds (we include all Romanian mutual funds regardless their investment policy) net assets taking into account the market share of each mutual fund.

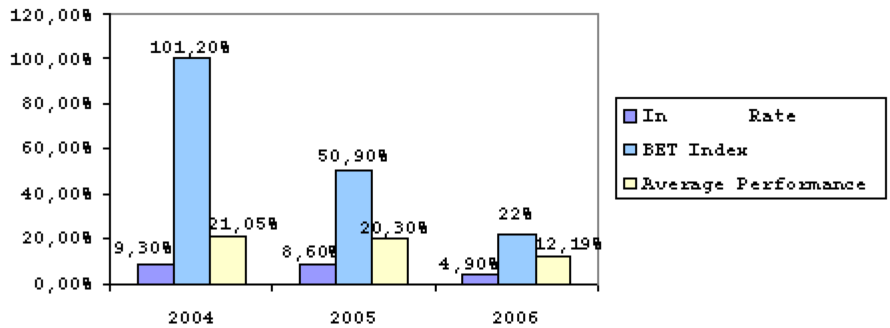
Table 3: Average mutual funds performance

Indicator	2004	2005	2006
Inflation Rate[1)]	9,30%	8,60%	4,90%
BET Index[2)]	101,20%	50,90%	22%
Average Performance[3)]	21,05%	20,30%	12,19%
BUBOR 3M[4)]	17.56%	7.63%	8.58%

Source: 1) www.bnro.ro; 2) www.kmarket.ro 3) author's calculation 4)www.bnro.ro

Each year the mutual funds average performance exceeded the inflation rate and was exceeded by the BET Index. This high positive variation of the market index is due to under-evaluated stocks on the market. As the market matured the evolution of the index normalizes.
Meanwhile mutual funds adopted a more prudent strategy and balanced their portfolios by investing in monetary instruments with low risk and return characteristics.
Taking into account that BET Index is composed of the 10 most liquid stocks on the market which have also registered the highest performance, that mutual funds diversify their portfolios and that we don't expect managers to have had high selectivity capacity, the discrepancy between BET and average performance is understandable.

Figure 5:Mutual funds average performance



Conclusions

Mutual funds performance is a controversial subject. These institutions don't seem to obtain returns above the market but they still exist. The question is why? Maybe the market is so efficient and sophisticated that small investors need to appeal to such professionals in order to gain access to investment products and investment techniques far from the reach of individuals.

As far as the Romanian capital market is concerned it seems to continue a positive process of convergence to other European markets in terms of market indicators and market infrastructure. The Romanian market benefits from harmonized regulation to best standards and practices, which stimulate growth.

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