Three Essays on Indian Mutual Funds

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Abstract:

This dissertation follows a three essay format, where I examine different aspects of the Indian mutual fund industry. It is divided into four chapters. The first chapter introduces the Indian mutual fund industry. The second to fourth chapters each deal with a new concept.

In the second chapter, we study a potential conflict of interest that may arise out of business group's presence in the mutual fund industry. We find that business group owned funds invest 3-11 times more than non-affiliated funds in equity capital issuances of their affiliated group companies. We show that these results are driven by conflict of interest. We rule out attention bias and informational advantage hypothesis as alternative explanations for our results. We explore two potential reasons for the origination of this conflict of interest. First, through the common ownership of business group funds and their affiliated firms. Second, through a quid-pro-quo relationship between mutual fund managers and other affiliated business group firm managers. Our results suggest quid-pro-quo considerations as the driving force behind this conflict of interest. Our results in this chapter could be of interest to regulators in India and other emerging markets with the prevalence of large business groups.

In the third chapter, we study window dressing in equity funds. Any action fund managers undertake to cosmetically adjust their portfolio, just before the declaration date, to make it look more attractive to the investors is called as window dressing. While existing literature has identified multiple ways through which fund managers window dress, we are the first to provide evidence for Risk-based window dressing in equity mutual funds. We propose a new unified framework to simultaneously study Return-based window dressing, buying winner and selling looser stocks just before the declaration date; and Risk-based window dressing, reducing the risk of the portfolio just before the declaration date. We follow Barras et al. (2010) to control for false discoveries in identifying window dressing in our multiple hypothesis testing framework. We find that, Risk-based window dressing is, in fact, three times more prevalent than Return-based window dressing. Our empirical results suggest that fund managers with poor prior performance indulge in window dressing. We also find that investment choices of retail investors are not impacted by window dressing. Due to differences in tax structure in India, our tests for window dressing are not confounded by tax motivated selling by fund managers.

In the fourth chapter, we study the impact of a new law by SEBI introducing a new mutual fund classification system in India. The regulation aimed to bring uniformity in the definition of fund categories and improve comparability of funds across fund families. Following the new law, we find the flow-performance sensitivity has increased indicating reduction in investor search costs. We also find the performance of funds has increased in response to increased flow-performance sensitivity. However, on the downside, the new law has resulted in predictability of stock returns, and thereby deteriorating market quality.

References:

Barras, L., Scaillet, O., & Wermers, R. (2010). False Discoveries in Mutual Fund Performance : Measuring the Role of Lucky Alphas. The Journal of Finance, 65(1), 179–215. https://doi.org/10.1111/j.1540-6261.2009.01527.x