

# Looking Inside Mutual Fund Advertising: Governance Effects on Fund Flows and Future Performance

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# Agenda

- Conclusion
- The Problem
- Hypotheses
- Literature Review
- Sample and Data
- Variables
- Empirical Results



# Conclusion

- Advertising neither misleads about future performance nor signals superior future performance.
- Governance quality, proxied by board credentials, signals the good governance.
  - Credentials of the boards are positively associated with ***future flows*** and ***future returns***.

## ***Implication***

- Investors can reduce search costs by investing in the advertised funds of high credentialed boards of directors.



# The Problem

- Mutual fund advertising is potentially misleading.
  - Investors chase returns.
  - Share redemptions are not fully functioning.
  - Fund managers might exploit investors.
- Mutual fund boards of directors are not always effective monitors.
  - The Boards negotiate fund fees.
  - Fees are the sources of advertising budget.
  - Hence, boards and advertising should be related.
- Effectiveness of governance is doubtful



# Hypotheses

- Main hypothesis:
  - Advertised funds have better governance mechanisms than control group funds.
- To accept the main hypothesis:
  - Performance of the advertised funds is at least as good as that of the control group funds.
  - Relation between governance and flows is positive.
  - Relation between governance and returns is positive.
- Alternative hypothesis:
  - The advertised funds boards are not distinguishable from those of the non-advertised funds.



# Related Literature

## Advertising, Flow and Board Structure (1)

- Advertising increases fund flows.
  - Jain and Wu (2000)
- Money flows to funds with good past performance. Investors chase returns.
  - Sirri and Tufano (1998), Ippolito (1992), Johnson (2006)
- Flows are positively related to fund fees. Hence, advertising attracts money.
  - Barber, Odean and Zheng (2005), O'Neal (2004), Tufano and Sevick (1997)



# Related Literature

## Advertising, Flow and Board Structure (2)

- The number of independent directors is positively associated with future performance.
  - Ding and Wermers (2005)
- Board size, fraction of independent directors and director compensations do not show significant relation with future performance.
  - Meschke (2006), Khorana, Servaes and Wedge (2007)



# Related Literature

## Performance Persistence

- Mutual fund performance persists.
  - Brown and Goetzmann (1995), Grinblatt and Titman (1992), Hendricks, Patel and Zeckhauser (1993)
- Momentum factor explains mutual fund returns.
  - Carhart (1997), Carhart, Carpenter, Lynch and Musto (2002)
- Performance persistence last three months.
  - Bollen and Busse (2005)
- Return reversal.
  - Jain and Wu (2000)



# Related Literature

## Director Incentives and Control Mechanisms

- Highly compensated independent directors allow funds to charge higher fund fees.
  - Tufano and Sevick (1997), Kuhnen (2005), Kuhnen (2007)
- Director ownership is positively related to fund performance.
  - Meschke (2006), Cremers, Driessen, Maenhout and Weinbaum (2006)
- Monitoring benefits to shareholders motivate directors to own shares.
  - Chen, Goldstein and Jiang (2008)
- Directors' outside directorships are associated with firm performance
  - Fich and Shivdasani (2006)



# Sample and Data

- Advertised mutual funds
  - Domestic (US) equity funds: From January 2003 to June 2006
  - From Barron's and Money Magazine: No advertising during the preceding three months.
  - One fund accounts for one observation
- Control group mutual funds
  - Matched by yesteryear's returns and Lipper objective category.
  - Eight matched funds for one advertised funds: Four funds of lower and four funds of higher yesteryear's returns.
- Governance data
  - Board of directors data from the Statement of Additional Information filed with prospectus (US SEC's EDGAR database)



# Variables (1)

## ■ Returns

- Adjusted returns in post-advertising performance analyses:  
(1) Jensen's alpha; (2) Three-factor alpha; (3) Four-factor alpha;  
(4) EW-objective adjusted returns; (5) VW-objective adjusted returns; and (6) Market-adjusted returns.
- Raw returns, net-of-expense, in regressions

## ■ Fund Flows

- $Flow_{i,t} = TNA_{i,t} - [TNA_{i,t-1} \times (1 + R_{i,t})]$  ; TNA = Total Net Assets
- $Flow_{i,\tau \text{ to } T} = \sum_{t=\tau}^T Flow_{i,t}$



## Variables (2)

### ■ Governance

#### □ Board structure

- The Number of Directors
- Percent of Disinterested Directors

#### □ Incentives

- Average Director Share Ownership
- Average Disinterested Director Compensation  $\div$  10,000

#### □ Board credentials

- Average Disinterested Director Outside Directorships

Table 3. Post-advertising Performance

## Empirical Results (1-1)

Adjusted Returns	Panel A: Month 0 to Month 11						
	t-statistics of mean difference test	Advertised Funds [N = 115]			Matched Funds [N = 892]		
		Mean [Median]	t-statistics	Minimum [Maximum]	Mean [Median]	t-statistics	Minimum [Maximum]
Raw Returns <sub>0to11</sub>	0.40	0.15725 [0.13353]	16.13***	-0.01177 [0.45774]	0.15299 [0.12537]	36.68***	-0.24120 [0.83146]
Jensen's Alpha <sub>0to11</sub>	0.47	-0.00154 [-0.00137]	-4.01***	-0.01037 [0.00985]	-0.00173 [-0.00144]	-10.50***	-0.02756 [0.02248]
Three-Factor Alpha <sub>0to11</sub>	0.32	-0.00118 [-0.00080]	-2.92***	-0.01367 [0.00900]	-0.00132 [-0.00136]	-8.73***	-0.01758 [0.01873]
Four-Factor Alpha <sub>0to11</sub>	0.14	-0.00095 [-0.00099]	-2.23**	-0.01687 [0.00989]	-0.00102 [-0.00122]	-6.43***	-0.02782 [0.02225]
Market Adjusted Return <sub>0to11</sub>	0.77	-0.01534 [-0.01962]	-2.91***	-0.17683 [0.12647]	-0.01982 [-0.02186]	-8.26***	-0.57247 [0.39303]
EW Objective Adjusted Return <sub>0to11</sub>	0.79	0.00142 [-0.00100]	0.30	-0.13413 [0.13038]	-0.00264 [-0.00328]	-1.24	-0.57449 [0.33490]
VW Objective Adjusted Return <sub>0to11</sub>	0.79	-0.00265 [-0.00667]	-0.58	-0.12940 [0.12323]	-0.00661 [-0.00890]	-3.12***	-0.55390 [0.35548]

- Advertised funds do not underperform their counterparts

Table 3. Post-advertising Performance (cont'd)

## Empirical Results (1-2)

Adjusted Returns	Panel B: Month 0 to Month 23						
	t-statistics of mean difference test	Advertised Funds [N = 115]			Matched Funds [N = 892]		
		Mean [Median]	t-statistics	Minimum [Maximum]	Mean [Median]	t-statistics	Minimum [Maximum]
Raw Returns <sub>0to23</sub>	0.47	0.28509 [0.26244]	20.79***	-0.07441 [0.90459]	0.27749 [0.24972]	50.15***	-0.31900 [1.62230]
Jensen's Alpha <sub>0to23</sub>	0.32	-0.00110 [-0.00091]	-3.47***	-0.01064 [0.01207]	-0.00121 [-0.00089]	-10.68***	-0.01698 [0.02565]
Three-Factor Alpha <sub>0to23</sub>	0.32	-0.00059 [-0.00068]	-2.14**	-0.00813 [0.01187]	-0.00069 [-0.00081]	-6.77***	-0.01584 [0.02288]
Four-Factor Alpha <sub>0to23</sub>	0.28	-0.00058 [-0.00062]	-2.09**	-0.00796 [0.01130]	-0.00066 [-0.00091]	-6.43***	-0.01620 [0.02122]
Market Adjusted Return <sub>0to23</sub>	0.86	-0.02152 [-0.03436]	-2.20**	-0.25599 [0.40012]	-0.03057 [-0.03850]	-7.70***	-0.82347 [1.11783]
EW Objective Adjusted Return <sub>0to23</sub>	0.95	0.01450 [-0.00636]	1.74*	-0.16960 [0.31836]	0.00591 [0.00247]	1.66*	-0.80775 [1.13355]
VW Objective Adjusted Return <sub>0to23</sub>	0.96	0.00556 [-0.00548]	0.67	-0.16847 [0.30923]	-0.00304 [-0.01050]	-0.85	-0.77425 [1.16705]

- Advertised funds do not underperform their counterparts

Conclusion

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The Problem

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Hypotheses

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Literature Review

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Sample and Data

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Variables

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Empirical Results

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## Empirical Results (1-3)

- Advertised funds do not underperform their counterparts in the aftermath.
- Advertised funds outperform the control group funds in every return measure, though with weak statistic significances.

- **Conclusion:**

- Advertising neither misleads about future performance nor signals superior future performance.

Governance analyses confirm this conclusion

## Empirical Results (2-1)

Table 4: Future Flow

Regressions Variables	Panel A: Year +/- 1		Panel B: Year +/- 2	
	Dependent Variables			
	Flow <sub>0to11</sub>		Flow <sub>0to23</sub>	
	1	2	3	4
Ads	47.7689 (2.00)**	103.7835 (3.54)***	211.9355 (3.31)***	279.8130 (3.85)***
LnTNA	6.4188 (1.83)*	2.3381 (0.66)	6.44032 (0.68)	-2.0870 (-0.22)
Flow <sub>,-12to-1</sub>	0.8084 (37.49)***	0.9156 (32.08)***		
R <sub>,-12to-1</sub>	-63.9097 (-1.77)*	-33.2201 (-0.88)		
Flow <sub>,-24to-1</sub>			0.6843 (21.59)***	0.8228 (17.01)***
R <sub>,-24to-1</sub>			73.3789 (1.02)	95.6716 (1.25)
Ads × Flow <sub>,-12to-1</sub>		-0.2363 (-5.50)***		
Ads × R <sub>,-12to-1</sub>		-278.7969 (-2.47)**		
Ads × Flow <sub>,-24to-1</sub>				-0.2459 (-3.82)***

- Advertising significantly brings in more money to the advertised funds.

- A 10% decrease in  $R_{,-12to-1}$  associates with an increase of \$6.39 million.

- On average, a decrease of 1% in  $R_{,-12to-1}$  is associated with an increase of \$2.78 million flows

- Ads helps funds of lower past returns and past flows.



## Empirical Results (2-2)

- Advertising significantly brings in more money to the advertised funds as opposed to the control group funds.
- This conclusion is consistent with that of existing literature.

## Empirical Results (3-1)

Table 5:  
Governance Effects  
on Flow

		Panel A: Year +/- 1		Panel B: Year +/- 2	
		Dependent Variables			
		Flow <sub>,0to11</sub>		Flow <sub>,0to23</sub>	
		1	2	3	4
Variables	Regressions				
Advertising Dummy	...	29.1291 (1.15)	133.3911 (0.42)	154.1475 (2.27)**	-102.3642 (-0.12)
Average Director Share Ownership	...	-10.6333 (-1.35)	-12.9036 (-1.57)	-43.4627 (-2.06)**	-41.4760 (-1.88)*
Average Disinterested Director Outside Directorships	...	22.7818 (2.53)**	14.5160 (1.53)	93.2774 (3.89)***	73.9336 (2.92)***
Percent of Disinterested Directors on Board	...	-114.5136 (-1.63)	-64.2440 (-0.87)	-402.6121 (-2.14)**	-306.2124 (-1.55)
LnTNA	...	6.8515 (1.80)*	6.7311 (1.77)*	10.2396 (1.01)	9.0291 (0.89)
Flow <sub>, -12to-1</sub>	...	0.8041 (37.14)***	0.8024 (36.52)***		
R <sub>, -12to-1</sub>	...	-60.5082 (-1.65)*	-60.5439 (-1.65)*		
Flow <sub>, -24to-1</sub>	...			0.6797 (21.49)***	0.6690 (20.83)***

Reputations are positively associated with future flows.

## Empirical Results (3-2)

Table 5: Governance Effects on Flow (cont'd)

<b>Ads × Average Director Share Ownership</b>	17.3276	-45.5292
	(0.64)	(-0.63)
<b>Ads × Average Disinterested Director Compensation ÷ 10,000</b>	2.6605	-10.6112
	(0.60)	(-0.9)
<b>Ads × Average Disinterested Director Outside Directorships</b>	<b>61.0556</b>	<b>152.7986</b>
	<b>(1.82)*</b>	<b>(1.71)*</b>
...	...	...
...	...	...

- The positive relation is greater in magnitude for the advertised funds.



## Empirical Results (3-3)

- Board reputations, represented by an average disinterested director outside directorships, are associated with future flows.
  - The positive relation between board reputations and **future flows** is greater in magnitude for the advertised funds *vis-à-vis* the control group funds.

Table 6: Governance Effects on Return

## Empirical Results (4-1)

		Panel A: Year +/- 1		Panel B: Year +/- 2	
		Dependent Variables			
		$R_{,0to11}$		$R_{,0to23}$	
		1	2	3	4
Variables	Regressions				
Advertising Dummy	...	...	...	...	...
		0.0096 (0.94)	-0.0086 (-0.07)	0.0235 (1.30)	-0.0969 (-0.42)
	...	...	...	...	...
Average Disinterested Director Outside Directorships	...	...	...	...	...
		0.0079 (2.19)**	0.0089 (2.34)**	0.0153 (2.40)**	0.0168 (2.49)**
	...	...	...	...	...
Percent of Disinterested Directors on Board	...	...	...	...	...
		-0.0589 (-2.09)**	-0.0796 (-2.68)***	-0.1168 (-2.33)**	-0.1568 (-2.98)***
	...	...	...	...	...
$R_{,-12to-1}$	...	...	...	...	...
		-0.4255 (-28.97)***	-0.4237 (-28.81)***		
	...				
$R_{,-24to-1}$	...			...	...
				-0.1271 (-6.60)***	-0.1267 (-6.54)***

- Advertised funds do not underperform
- Reputations are positively associated with future returns
- Percent of disinterested directors on board is negatively associated with future returns
- Return reversal

Table 6: Governance Effects on Return (cont'd)

## Empirical Results (4-2)

Ads × Average Director Share Ownership	0.0079 (0.73)	0.0193 (1.00)
Ads × Average Disinterested Director Compensation ÷ 10,000	-0.0032 (-1.81)*	-0.0069 (-2.21)**
...	...	...
...	...	...
...	...	...

- For the advertised funds, director compensation is negatively related to future returns
- However, the compensation is not related to future flows



## Empirical Results (4-3)

- A combination of board characteristics that is positively associated with future returns is:
  - (1) low percentage of disinterested directors;
  - (2) low director compensation and;
  - (3) high average outside directorships
- Both advertised and non-advertised funds exhibit return reversal.
- **Conclusion:**
  - Governance quality, proxied by board credentials, signals the good governance.



# Conclusion

- Advertising neither misleads about future performance nor signals superior future performance.
- Governance quality, proxied by board credentials, signals the good governance.
  - Credentials of the boards are positively associated with ***future flows*** and ***future returns***.

## ***Implication***

- Investors can reduce search costs by investing in the advertised funds of high credentialed boards of directors.

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# Thank You



## Discussion Questions and Answers

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Equity Income Fund (PRFDX)	★★★★	12.08%	7.39%	10.88%
Personal Strategy Growth Fund (TRSGX)	★★★★★	15.30%	5.29%	10.06%
Value Fund (TRVLX)	★★★★	13.70%	7.58%	11.87%

As of 11/30/05

As of 9/30/05

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Capital Appreciation	★ ★ ★ ★	Yes
Equity Income	★ ★ ★ ★	Yes
Growth Stock	★ ★ ★ ★	Yes
Personal Strategy Balanced	★ ★ ★ ★	Yes
Personal Strategy Growth	★ ★ ★ ★	Yes
Tax-Efficient Growth	★ ★ ★ ★	Yes

Funds were rated against the following number of funds in U.S. domestic categories for the overall rating and the 1-, 3-, and (if applicable) 10-year periods as of 6/30/03: Blue Chip Growth, Growth Stock, and Tax-Efficient Growth were rated among 912, 912, 540, and 178 large growth funds; Equity Income was rated among 632, 632, 509, and 172 large value funds; Balanced, Capital Appreciation, and Personal Strategy Balanced were rated among 669, 669, 476, and 118 moderate allocation funds; Personal Strategy Growth was rated among 1,632, 1,632, 717, and 222 large blend funds.

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	1-Year	3-Year	Life of Fund
<b>Janus Contrarian Fund</b> (2/00) Multi-Cap Core Funds	<b>1<sup>st</sup></b> (43 of 825)	<b>1<sup>st</sup></b> (3 of 597)	<b>1<sup>st</sup></b> (52 of 341)
<b>Janus Core Equity Fund</b> (6/96) Large-Cap Core Funds	<b>1<sup>st</sup></b> (8 of 889)	<b>1<sup>st</sup></b> (29 of 765)	<b>1<sup>st</sup></b> (4 of 264)
<b>Janus Growth and Income Fund</b> (5/81) Large-Cap Core Funds	<b>1<sup>st</sup></b> (22 of 889)	<b>1<sup>st</sup></b> (8 of 765)	<b>1<sup>st</sup></b> (5 of 103)
<b>Janus Orion Fund</b> (6/00) Multi-Cap Growth Funds	<b>1<sup>st</sup></b> (7 of 410)	<b>1<sup>st</sup></b> (13 of 356)	<b>2<sup>nd</sup></b> (85 of 232)
<b>Janus Overseas Fund</b> (5/94) International Funds	<b>1<sup>st</sup></b> (6 of 880)	<b>1<sup>st</sup></b> (66 of 757)	<b>1<sup>st</sup></b> (2 of 122)

Lipper ranks Janus Contrarian Fund in the 1st quartile, 42 of 407 for the 5-year period.

Lipper ranks Janus Core Equity Fund in the 1st quartile, 37 of 608 for the 5-year period.

Lipper ranks Janus Growth and Income Fund in the 2nd and 1st quartile, 170 of 608 and 5 of 225 for the 5- and 10-year periods, respectively.

Lipper ranks Janus Orion Fund in the 1st quartile, 23 of 266 for the 5-year period.

Lipper ranks Janus Overseas Fund in the 2nd and 1st quartile, 270 of 500 and 7 of 197 for the 5- and 10-year periods, respectively.

*Data presented reflects past performance, which is no guarantee of future results. Investment results and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Due to market volatility, current performance may be higher or lower than the performance shown. Call your financial advisor or Janus or visit [janus.com](http://janus.com) for performance current to the most recent month-end.*

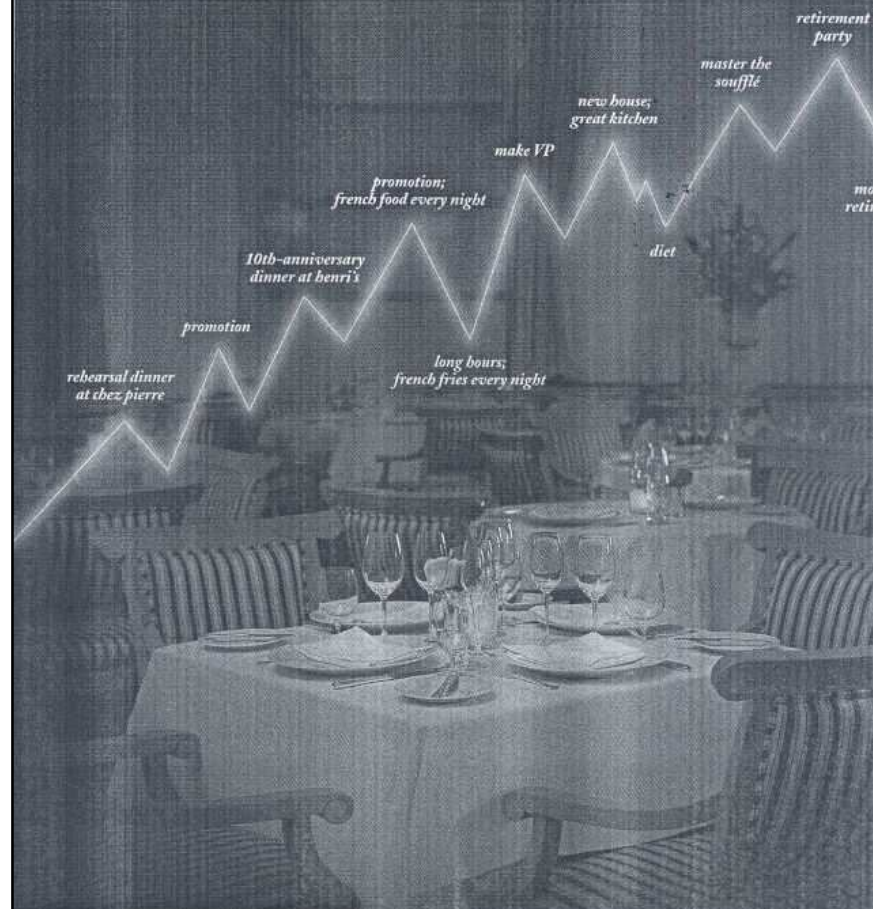
*Please consider the charges, risks, expenses and investment objectives carefully before investing. For a prospectus containing this and other information, please call Janus or download the file from [janus.com](http://janus.com). Read it carefully before you invest or send money. There is no guarantee that stated objectives will be achieved.*

A fund's performance may be affected by risks that include those associated with non-diversification, investments in foreign securities, non-investment grade debt securities, undervalued companies or companies with a relatively small market capitalization. Please see a Janus prospectus for more detailed information. The date of since-inception Lipper rankings is slightly different from when the fund began operation since Lipper provides fund rankings as of the last day of the month or the first Thursday after fund inception.

Lipper Inc. - A Reuters Company, is a nationally recognized organization that ranks the performance of mutual funds within a universe of funds that have similar investment objectives. Rankings are historical with capital gains and dividends reinvested.

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