Construction of fund of funds portfolio for double diversification advantage

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Abstrak

<i>Investors are provided with two main categories of investment alternatives, financial investment and real investment. Real investments include investment in real assets such as real estates, land, machines, and others. These real assets represent productive capacity of economy. On the other hand, financial investments include investments in financial assets such as stocks or bonds. These financial assets contribute to the productive capacity of economy indirectly since they allow separation of ownership and transfer of funds among market players. While the real economy creates wealth by producing goods and services, financial dimension does so by bearing, trading, and managing risks. Financial assets and the markets in which they trade thus play crucial roles in emerging and developed economies.

As these economies continue to grow, structural shifts in financial markets are taking place and profoundly altering the nature of wealth from corporate to retail investment. Investment players are no longer dominated by large corporations. The most popular phenomenon of retail financial investment is the emergence of mutual funds. Mutual funds are pool of investors money. They invest in ways specified in their prospectuses and issue shares to investors entitling them to a pro rata portion of the income generated by the funds Important factors contributing to the popularity mutual funds are their simplicities along with other attributes providing great benefits to investors with limited knowledge, time, or money.

One new concept that has not been quite popular in Indonesia is fund of funds. Fund of funds is a mutual fund which invests in other mutual funds. Just as a mutual fund invests in a number of different securities, a fund of funds holds shares of many different mutual funds. These funds were designed to achieve even greater diversification than mutual funds, known as double diversification advantage. Fund of funds has proven to be an attractive investment alternative in a number of developed countries. However, this concept has not been popular amongst investors in Indonesian market. This thesis aims to explore whether the concept of fund of funds can be applied to diversify mutual funds traded in Indonesian markets in order that investors may benefit from double diversification New fund of funds portfolio are to be developed for each class of fund, comprising highest performing mutual funds as measured by Sharpe, Treynor, Jensen, and Appraisal Ratio measurement. Performance of the newly constructed fund of funds is then compared with that of corresponding market proxy and the highest performing individual mutual fund. Observations are limited to fixed income funds, equity funds, and balanced funds actively traded in Indonesian market for the period December 2000-June 2005. Money market fund is not covered in this thesis.

This research concludes that pooling of these high performing mutual funds into fund of funds may provide even greater diversification, called double diversification. Double diversification is reflected in increase in risk adjusted return of the newly constructed fund of funds. Through improved Sharpe Index, fund of funds

has proven to increase risk adjusted return. Therefore, it can be concluded that fund of funds reduces the risk even further through the diversification of already diversified mutual funds, thus providing double diversification advantage.

For Fixed Income Fund of Funds (FFF), optimum portfolio is reached by investing 3.84% in Indovest Dana Obligasi, 94.21% in Panin Dana Uta.ma, and 1.95% in Jisawi Mix. FFF demonstrates highest Sharpe among individual fixed income funds being observed. This number beats that of the highest performing individual funds, Panin Dana Utama. For Equity Fund of Funds (EFF), optimum portfolio is reached by investing 36.14% in Phinisi Dana Saham, 25.32% in Rencana Cerdas, 32.13% in Bira Dana Saham, 3.48% in Bahana Dana Prima, and 2.93% in Panin Dana Maksima EFF demonstrates highest Sharpe among individual equity funds being observed. This number beats that of the market as well as the most performing individual funds, Phinisi Dana Saham. For Balanced Fund of Funds (BFF), optimum portfolio is attained by investing 0.78% in Niaga Kombinasi Seri A, 0.31% in Schroder Dana Prestasi, 0.25% in MeesPierson Finas Investa Pesona, 98.22% in Dana Unggul Investasi Terpercaya, and 0.44% in Sam Dana Berkembang. BFF demonstrates highest Sharpe among individual balanced funds being observed. This number beats that of the market as well as the most performing individual funds, Dana Unggul Investasi Terpercaya Eventually, all these funds are combined altogether to form Combined Fund of Funds (CFF). Optimum portfolio is reached by investing 0.55% in Indovest Dana Obligasi, 6.40% in Panin Dana Utama, 0.13% in Phinisi Dana Saham, 0.13% in Rencana Cerdas, 0.37% in Bira Dana Saham (SiDana Saham), 1.29% in Schroder Dana Prestasi, 0.57% in MeesPierson Investa Pesona, and 90.56% in Dana Unggul Investasi Terpercaya CFF (comprising fixed income funds, equity funds, and balanced funds) demonstrates highest Sharpe among all individual funds being observed. This number beats that of the market as well as the most performing individual funds, Dana Unggul Investasi Terpercaya which falls under balanced funds category.

Therefore, the concept of Fund of Funds can be taken into considerations when it comes to investment decision since this investment alternative has been proven to be profitable. However, careful attention must be given to government regulation that until now still has not covered Fund of Funds. In addition, careful attention must also be given to the mutual funds selection. Mutual funds selection must take into account the macroeconomic factors since returns of various investment instruments are highly dependent upon macroeconomic variables such as economic growth, inflation, exchange rate, and fiscal policy.</i>