CHAPTER 2
REVIEW OF LITERATURE

Many studies have been done before to measure the effectiveness of advertising on the investor’s buying behavior but there is a gap to actually understand the real impact of advertising by Mutual funds on the investor’s behaviour. Few studies exist on the measurement of effectiveness of advertisements on investor behavior.

Lichtenstein et al.\(^1\) (1999), in their study found that much evidence exists which suggests that the vast majority of equity Mutual fund managers do not possess differential information (or skills) which allow them to achieve above average market returns for their investors. Thus, when investors pay fees to equity Mutual fund managers for investment advice and management, the very probable outcome is that they are reducing the return that they would otherwise achieve by investing in a non-managed index fund that tracks the total stock market (\textit{e.g.}, Wilshire 5000) or some significant portion of it (\textit{e.g.}, the Standard & Poor's 500). The long-term negative consumer welfare implications are large, very possibly in the hundreds of thousands of dollars for individual consumer investors. Drawing largely on insights from the psychology, consumer behavior, and behavioral finance literatures, this study offers a series of hypotheses that may partially account for such consumer choices. It was concluded with a call for increased government- and employer-sponsored education programs aimed at creating a more informed consumer investor.

Jain & Wu \(^2\) (2000), in their research article examined a sample of 294 Mutual funds that advertised in \textit{Barron's} or \textit{Money} magazine. The pre-advertisement performance of these funds is significantly higher than that of the benchmarks. They tested whether the sponsors select funds to signal continued superior performance or they use the past superior performance to attract more money into the funds. The analysis showed that there is no superior performance in the post advertisement period. Thus, the results do not support the signaling hypothesis. On the other hand, it was found that the advertised funds attract significantly more money in comparison with a group of control funds.

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Jordan & Kaas ³ (2002), in their research study used a large-scale experimental study to detect how risk-return assessments of private investors are influenced by specific elements of print ads. In this context, judgmental heuristics used systematically by private investors play a crucial role. It was found that effective advertising strategies are of growing importance in the Mutual fund industry due to keen competition and changes in market structure. But the dominant variables in financial decision making, investor's perceived investment risk and expected return, have not yet been analysed in an advertising context, although these product related evaluations can be influenced by advertising and therefore serve as additional indicators of advertising effectiveness.

Michael & Tom ⁴ (2003), in their research paper observed that the Mutual fund industry had experienced tremendous growth in recent years. During this time period the Mutual funds had become somewhat of a commodity with many funds using advertising to attract investors. Their current study used the content analysis to determine the informational content of fund advertising. The results indicated that while the average number of informational cues increased during the time period 1979 to 1989, there was no significant increase in the information content of Mutual fund advertising between 1989 and 1999. Relatively few funds included information such as loads, 12b-1 fees, and expense ratios in their advertisements, and fund ads rarely discussed risk.

Huhmann & Bhattacharyya ⁵ (2005), in their paper have found that the accounting and Mutual fund scandals of the last few years have led to increased scrutiny over the information provided by financial services to investors. These scandals have cast doubt on the supposedly honest and impartial reporting of facts by the financial industry. This paper looks at the information available in the marketing of a particular financial product - Mutual funds. This paper examines whether or not the information in Mutual fund advertisements aimed at consumers conforms to theories regarding the information required for investment decisions from the discipline of finance. The findings indicate that Mutual funds advertise to increase perceptions of quality, successfulness, and honesty often without providing the information that consumers need to make optimal investment decisions.

Huhmann & Bhattacharyya ⁶ (2005), in their study used content analysis to investigate whether or not the risk – return trade-off credibility information and the transaction cost information – for investments decisions, is present in advertisements for one investment vehicle – Mutual funds. They found that Mutual fund advertisements are not providing the information necessary for optimal investments decisions. Mutual funds use techniques known to increase the likelihood that their advertisements are noticed, but they also use techniques known to decrease the readership of their advertisements. Also, they rarely included convenience information. Mutual fund advertising is not serving consumers. Regulators should require all Mutual fund advertisements to include an easy-to-read table summarizing necessary investment information to assist consumer decisions making.

Jonathan & Eric ⁷ (2006), used Mutual fund recommendations to test whether editorial content is independent from advertisers’ influence in the financial media. They found that major personal finance magazines (Money, Kiplinger’s Personal Finance, and SmartMoney) are more likely to recommend funds from families that have advertised within their pages in the past, controlling for fund characteristics like expenses, past returns and the overall levels of advertising. They found little evidence of a similar relationship for mentions in the New York Times or Wall Street Journal. Positive media mentions in both newspapers and magazines are associated with significant future inflows into the fund while advertising expenditures are not. Therefore, if the co-efficients are interpreted causally, a large share of the benefit of advertising in the sample of personal finance magazines comes via the apparent content bias. The welfare implications of this apparent bias are unclear, however, since the tests suggest that bias does not directly lead publications to recommend funds with significantly lower future returns than they might have recommended in the absence of any bias. In selecting funds to recommend, magazines overweight past returns relative to expenses, and as a group their recommendations do not outperform even an equal-weighted average of their peers. Nevertheless, this approach leaves magazines with large numbers of funds with high past returns from which to select, and so bias towards advertisers can be accommodated without significantly reducing readers’ future returns. Interestingly, the recommendations of Consumer Reports, which does not accept advertising, have future returns comparable to or below those of the publications which accept advertising.

Cronqvist (2006), in his working paper series examined the role that advertising plays in the Mutual fund industry and whether advertising affects investors’ fund and portfolio choices. The content analysis showed that only a small fraction of fund advertising is directly informative about characteristics relevant for rational investors, such as fund fees. Higher quantities of advertising do not signal ex ante higher unobservable fund manager ability, because funds that advertise more are not associated with higher post-advertising excess returns. Fund advertising is shown to affect investors’ choices, although it provides little information. These results do not seem to be driven by the endogeneity of advertising and are robust to a series of robustness checks. Finally, advertising is found to steer people towards portfolios with higher fees and more risk, through higher exposure to equities, more active management, more “hot” sectors, and more home bias. This evidence has implications for welfare analysis, asset pricing and public policy, and may serve as a starting point for broader analysis of marketing and persuasion efforts in financial markets.

Korkeamaki et al. (2007), in their study have tried to examine the effect of advertising on Mutual fund cash flows in the Finnish fund market and they found that neither past year's performance nor advertising alone is sufficient to produce increased cash flows. However, advertising together with past performance is found to significantly affect cash flows. The positive effect of advertising is limited to the use of non-perishable advertising media. Additionally, it is found that fund families spending proportionately more on advertising receive higher asset flows.

Michael et al. (2007), in their research paper investigated the relationship between advertising, quality and price in the Mutual fund market, considering both equity and fixed income funds. The research considered these relationships based on the results for a time period following the advertisement. Given the complexity of the Mutual fund purchase decision for investors, this research provides an initial investigation into whether investors can infer Mutual fund quality and price from the presence of Mutual fund advertising. Post-advertising period results showed a negative relationship between advertising and fund quality, indicating that previously advertised funds exhibit weaker performance than non-

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advertised funds. During the post-advertisement period, both equity and fixed income funds exhibit lower expenses (ie, price) than non-advertised funds.

Gallaher et al. 11 (2008), in their working paper found that advertising appears to have significant effects on investor flows at the industry, family and individual fund level. At the industry level, flows are higher in months with more advertising dollars spent, even for non-advertising families. At the family level, flows have a convex relation with advertising expenditures, similar to that for performance, with a significant positive effect for high relative advertisers only. At the individual fund level, advertising stems redemptions rather than increasing purchases of fund shares. They further found that advertising can affect the fund's flow-performance sensitivity, dampening it for poorly performing funds and increasing it for highly performing funds.

Fehle et al. 12 (2009), in their working paper series tried to examine whether mood and attention affect investors’ choices. In their paper they have examined whether companies can create such mood and attention effects through advertising. They chose a natural experiment by investigating price reactions and trading activity for firms employing TV commercials in nineteen Super Bowl broadcasts over the 1969 – 2001 period. While there do not appear to be significant abnormal returns for the overall sample, abnormal returns increase in the number of ads employed and are greater for firms readily identifiable from the ad contents, which is consistent with the presence of mood and attention effects. For recognizable companies with the number of ads greater than the sample mean, the event is followed by an average abnormal one day return of 45 basis points. The effect appears to persist in the short term with the 20-day post-event cumulative abnormal returns for such firms averaging two percent. They found significant abnormal net buying activity for small trades in shares of recognized Super Bowl advertisers indicating that small investors tend to be the ones most attracted by the increased publicity.

Haslem 13 (2009), in his working paper series has raised a basic question as to why does Mutual fund advertising work? The summation of external evidence is compatible with

evidence that larger Mutual fund advertising attracts investors with below average financial literacy who find the investment decision process overwhelming:

1. Investor levels of financial literacy predict differences in investment behavior.
2. Investors with below average financial literacy find investment decisions overwhelming.
3. Investors with below average financial literacy make non-normative "revealed preference" choices that include passive investment, avoidance of investment complexity, and decisions based on limited experience.
4. Investors with below average financial literacy are attracted to funds that come to their attention by larger fund advertising.
5. Investors with below average financial literacy favor broker-sold funds, which underperform direct-sold funds even on a pre-distribution fee basis.
6. Broker-sold funds with larger front-end loads and distribution fees provide conflict of interest incentives for brokers to sell higher cost and lower performing funds for their own benefit.
7. Funds sold through selected superior financial advisors are to be favored over broker-sold funds due to higher standards of legal performance, higher quality and range of services, lower cost and higher performing funds, and "fee only" charges.

Chemmanur & Yan 14 (2009), in their research paper studied the effect of advertising on stock returns both in the short run and in the long run. They found that a greater amount of advertising is associated with a larger stock return in the advertising year but a smaller stock return in the year subsequent to the advertising year, even after control for other price predictors, such as size, book-to-market, and momentum. They conjectured that this advertising effect on stock returns is due to the effect of advertising on investor attention. Advertising could help a firm attract investors' attention. The stock price increases in the advertising year due to the attracted attention, but decreases in the subsequent year as the attracted attention wears out over time in the long run. They tested the "investor attention hypothesis" using trading volume and the number of financial analysts covering to proxy for investors' attention on the firm's stock. They documented five consistent findings. First, advertising increases a firm's visibility among investors in the advertising year. Second, an

increased level of investor attention is associated with a larger contemporary stock return and a smaller future stock return. Third, the effect of advertising on stock returns is stronger in firms with more visibility in the advertising year. In particular, when a high advertising firm attracts more investor attention in the stock market, the stock return of the high advertising firm increases to a larger degree in the contemporary advertising year and decreases to a larger degree in the subsequent years. However, the stock return of such a high advertising firm decreases to a smaller degree if the attention attracted in the advertising year persists subsequent to the advertising year. Fourth, the effect of advertising on future stock returns is stronger if investors face a larger cost of arbitrage. Finally, they also found that the advertising effect is stronger for small firms, value firms, and firms with poor ex-ante stock performance or poor ex-ante operating performance.

Koehler & Mercer 15 (2009), in their research study found that Mutual fund companies selectively advertise their better-performing funds. However, investors respond to advertised performance data as if those data were unselected (i.e., representative of the population). They identified the failure to discount selected or potentially selected data as selection neglect. They examined these phenomena in an archival study and two controlled experiments. The study identifies selection bias in Mutual fund advertising by showing that the median performance rank for advertised funds is between the 79th and 100th percentile. It was also found that both novice investors and financial professionals fall victim to selection neglect in a financial advertising task unless the advertisement makes the selective nature of available performance data transparent. The selection neglect associated with a large well-known company can be debiased with a simple extrinsic sample space cue, although individual differences in statistical reasoning also matter. They have also argued that selection neglect results from a general tendency to ignore underlying sample spaces rather than a fundamental misunderstanding about the data selection process or the value of selected data.

Mercer et al. 16 (2010), in their research paper found that more than $11 trillion is invested in Mutual funds in the United States. Mutual fund investors flock to funds with high past returns, despite there being little, if any, relationship between high past returns and high future returns. Because fund management fees are based on the amount of assets invested in

their funds, however, fund companies regularly advertise the returns of their high-performing funds. The SEC requires these advertisements to contain a disclaimer warning that past returns don’t guarantee future returns and that investors could lose money in the funds. Their article presents the results of an experiment that finds that the SEC-mandated disclaimer is completely ineffective. The disclaimer neither reduces investors’ propensity to invest in advertised funds nor diminishes their expectations regarding the funds’ future returns. The experiment also suggests, however, that a stronger disclaimer – one that informs investors that high fund returns generally don’t persist – would be much more effective.

Haslem 17 (2010), in his article explores the relationships of Mutual fund advertising and investor skills in making fund choices. Some key takeaways can be drawn from the analysis of the four factors affecting the relationship between Mutual fund advertising and investors’ fund choices, and whether they lead investors down the path of the “wizards of overconfidence” or the path of the “wizards of advertising.”

Advertising appeals to investor emotions by resonating with current beliefs, not by providing information that enables more informed fund choices. The choices of unsophisticated investors are dominated by fund advertising - “the wizards of advertising.”

The sophisticated investors with self-assessed above-average investment skills believe to make superior choices of actively managed Mutual funds that will outperform index funds. However, sophisticated investors are not superior investors, but overconfident investors - “the wizards of overconfidence.”

Mutual funds will be forced to provide useful objective information if investors “demand it,” but will this ever happen? The test of this change is when the traditional model of persuasion replaces the behavioral model in best matching investor perceived needs in making fund choices.

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<th>S. No.</th>
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<td>1</td>
<td>Lichtenstein et al.</td>
<td>1999</td>
<td>Why Consumers Choose Managed Mutual funds Over Index Funds: Hypotheses from Consumer Behavior</td>
<td>MF must launch more educative programmes to create awareness among the investors for taking investment decisions.</td>
<td>The main emphasis of this study is to encourage the investors to be self aware about the information regarding investments instead of fund manager’s managed funds.</td>
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<td>2</td>
<td>Jain &amp; Wu</td>
<td>2000</td>
<td>Truth in Mutual fund Advertising: Evidence on Future Performance and Fund Flows</td>
<td>The result of the study shows that mutual fund which advertise do not show superior performance. However, advertised funds are attracting more money.</td>
<td>The research study focused on whether MFs indulged in advertising to show their superior performance or use it to attract more funds. The study did not take educating the investors as one of the objectives of advertising.</td>
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<td>3.</td>
<td>Jordan &amp; Kaas</td>
<td>2002</td>
<td>Advertising in the Mutual fund business: The role of judgmental heuristics in private investors' evaluation of risk and return</td>
<td>It was found that effective advertising strategies are of growing importance in the mutual fund industry due to keen competition and changes in the market structure.</td>
<td>The study emphasized on the effects of print ads on the risk return assessment of investors. The study has lacked in co-relating the dominant variables in financial decision making like investors perceived investment risk and expected returns in an advertising context.</td>
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<td>4.</td>
<td>Michael &amp; Tom</td>
<td>2003</td>
<td>The Information Content of Mutual fund Print Advertising.</td>
<td>The study concluded that relatively few mutual funds included information such as loads, expenses ratio in their advertisements and rarely the advertisements discussed risk.</td>
<td>The study focused on determining the informational context of advertising by mutual funds between 1979 &amp; 1999. The study, however does not disclose the real content of advertisements observed in the process of research study.</td>
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<td>5.</td>
<td>Huhmann &amp; Bhattachar yya</td>
<td>2005</td>
<td>Does Mutual fund Advertising Practice Conform to Financial Theories of the Information Needed for Investment Decisions?</td>
<td>The study found that mutual funds advertise to increase perceptions of quality, successfulness and honesty often without giving information to investors required to make optimal investment decisions.</td>
<td>The study’s main emphasis is to find out whether the information given by the mutual funds through advertisements do confirm, to the theories regarding true information required for making investment decisions by the investors. The study however lacks in examining the parameters of sound investment decisions.</td>
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<td>6.</td>
<td>Huhmann &amp; Bhattachar yya</td>
<td>2005</td>
<td>Does Mutual fund advertising provide necessary investment information?</td>
<td>The study found that mutual funds advertisements are not providing the information necessary for optimal investment decisions and is thus not serving the investors.</td>
<td>The main emphasis of the study was to find out whether mutual fund advertisements do include the risk-return trade-off information which are crucial for investment decisions. the study lacks in taking into consideration the parameters of goodwill and management of the mutual fund.</td>
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<td>7.</td>
<td>Jonathan &amp; Eric</td>
<td>2006</td>
<td>Do Ads Influence Editors? Advertising and Bias in the Financial Media.</td>
<td>It was found that the editorial content of the major personal finance magazines are more likely to recommend funds from families that have advertised within their pages in the past.</td>
<td>The research study objective is to test whether editorial content of finance magazines is independent of the general advertisements of mutual funds.</td>
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<td>8.</td>
<td>Cronqvist</td>
<td>2006</td>
<td>Advertising and Portfolio Choice</td>
<td>The analysis in this study showed that only a small fraction of fund advertising is directly informative about features for rational investors.</td>
<td>The study has focused on examining the role of advertising in mutual fund industry and whether investors fund and portfolio choices are affected by advertising. The advertising by mutual fund houses steer</td>
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<td>9.</td>
<td>Korkeamaki et al.</td>
<td>2007</td>
<td>Advertising and Mutual fund asset flows.</td>
<td>The research study concluded that advertising along with the past performance significantly effect cash flows for Mutual Funds. Fund families spending more on advertising receive higher asset flows. The main emphasis of the study is to examine the effect of advertising on mutual fund cash flows in the Finish market. The positive effect of advertising is limited to the use of non-perishable advertising media.</td>
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<td>10.</td>
<td>Michael et al.</td>
<td>2007</td>
<td>Mutual fund advertising: Should investors take notice?</td>
<td>The results of the study showed that in the advertising period both income and growth funds depicted a negative relationship between advertising and fund quality indicating that previously advertised funds show weaker performance than non-advertised funds. The research study has emphasized on investigating the relationship between advertising, quality and price for both income and growth funds. The aim of the study is also to undertake initial investigations into whether mutual fund advertising can provide some information regarding mutual fund quality &amp; price. The study however only studies the post advertisement period.</td>
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<td>11.</td>
<td>Gallaher et al.</td>
<td>2008</td>
<td>Advertising and Mutual funds: From Families to Individual Funds.</td>
<td>The study has concluded that flows are higher in months with more advertising spend even for non-advertised funds. The flows dampen for poorly performing funds and vice versa. The study focused on finding out the effect of advertising by mutual funds on flows and their comparison for advertised and non-advertised funds. The study, however considers more flows when advertising in more, ignoring the fact that it can also be done to better fund performance and fund manager's ability.</td>
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<td>12.</td>
<td>Fehle et</td>
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<th>Influence Investor Behavior through Advertising? Super Bowl Commercials and Stock Returns.</th>
<th>concludes that small investors tend to be the ones, most attracted by the increased advertising and publicity.</th>
<th>emphasizes on finding out whether mutual funds advertising can create mood and attention for making investment choices by the investors.</th>
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<td>Haslem</td>
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<td>Why Does Mutual fund Advertising Work? Some Complementary Evidence.</td>
<td>The working paper summarizes that larger mutual fund advertising attracts investors with below average financial literacy who find the investment decision making overwhelming.</td>
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<td>14.</td>
<td>Chemmanur &amp; Yan</td>
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<td>Advertising, Attention and Stock Returns.</td>
<td>It was found in the study that a greater amount of advertising is associated with a larger stock returns in the advertising year but a smaller stock return in the year following the advertising year.</td>
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<td>15.</td>
<td>Koehler &amp; Mercer</td>
<td>2009</td>
<td>Selection Neglect in Mutual fund Advertisements.</td>
<td>The study concluded that mutual fund companies selectively advertise their better performing funds. However, the investors respond to advertised performance data as if those data were unselected</td>
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<td>16.</td>
<td>Mercer et al.</td>
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<td>Worthless Warnings?</td>
<td>The study concluded that</td>
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Testing the Effectiveness of Disclaimers in Mutual fund Advertisements

mutual fund investors flock to funds with high past returns despite there being little, if any, relationship between high past returns and high future returns. disclaimer by the regulator of Mutual funds, that past returns do not guarantee future returns, has any effect on investors when they read the same in advertisements. The study lacks in analyzing the reasons for non-effectiveness of the disclaimer specified by the regulator.

17. Haslem 2010 Mutual funds and Investor Choice: Paths to the Wizards of Advertising and Overconfidence

It was concluded by the study that for unsophisticated investors, advertising becomes a wizard which helps them taking decision. On the other hand, the sophisticated investors with their self knowledge and assessment are able to make better choices.

The study emphasized on exploring the relationship of mutual fund advertising and the investor skills in making fund choices. It also aimed to find out whether wizards of advertising help make investment choices or it is the overconfidence of the investors.

While going through the literature it was observed that mutual funds which advertise do not show superior performance. However advertised funds are attracting more money. It was also found that effective advertising strategies are of growing importance in the mutual fund industry due to keen competition and changes in the market structure. The literature review also showed that relatively few mutual funds included information such as loads, expenses ratio in their advertisements and rarely the advertisements discussed risk. One author found that mutual funds advertisements are not providing the information necessary for optimal investment decisions and is thus not serving the investors. The literature review also concluded that advertising alongwith the past performance significantly effect cash flows for Mutual Funds. Fund families spending more on advertising receive higher asset flows. One author has concluded that flows are higher in months with more advertising spend even for non-advertised funds. The flows dampen for poorly performing funds and vice versa. The small investors tend to be the ones, most attracted by the increased advertising and publicity.