The Behavioral Aspects of Mutual Funds and the Lessons Learned from the Financial Crisis

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Summary

Title: The Behavioral Aspects of Mutual Funds and the Lessons Learned from the Financial Crisis
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Introduction: The fund industry has grown tremendously over the last decades and the function for mutual funds and their managers have gained importance. Sweden is today the greatest fund saving country in the world however the function of the mutual funds and their managers is still rather unexplored. Mutual fund managers were blamed for the recent financial crisis and their irrational behavior was highlighted. This indicated how weak the classic financial theories are when trying to explain the function of human behavior and the irrationality in the market.

Research question: With the recent financial crisis and the importance of mutual funds the following questions were asked: How present are behavioral aspects in the mutual fund industry? and what have been the greatest eruditions for mutual fund managers from the recent financial crisis and what will it lead to in the future?

Purpose: The purpose of this study is to bridge a gap in the academic literature regarding the function of behavioral aspects among mutual fund managers.

Method: This thesis has implemented a hermeneutic approach and was carried out with ten semi-structured interviews with mutual fund managers from different financial institutions in Sweden.

Results: The respondents have highlighted the importance of the behavioral aspects in the mutual funds. The function of efficient markets were discussed and rejected in its current shape. The future will have to bring financial innovation that is constructed for the buyer and not for the seller.

Conclusion: Behavioral aspects for fund managers are greater than previously thought and there is a need to incorporate this better in the financial theories. The financial crisis together with the possibility of earning excess return over a long time period has indicated that the markets are not efficient. The confidence for mutual fund managers from the public is low because of the last financial crisis. There is a need for more regulation, better-suited payment schemes, greater transparency and products that everyone can understand in order to raise the confidence back to the previous level.
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# Table of Contents

1. Introduction .................................................................................................................. 1  
   1.1 Problem Background .............................................................................................. 1  
   1.2 Research Question ................................................................................................. 4  
   1.3 Purpose .................................................................................................................. 4  
   1.4 Significance of the study ....................................................................................... 4  

2. Theoretical Framework ................................................................................................. 5  
   2.1 Financial crises ...................................................................................................... 5  
   2.2 Classic Financial Theories .................................................................................... 6  
      2.2.1 Modern Portfolio Theory ............................................................................. 6  
      2.2.2 Efficient Market Hypothesis ................................................................. 7  
   2.3 Behavioral Finance ............................................................................................... 8  
      2.3.1 Prospect Theory ......................................................................................... 9  
      2.3.2 Behavioral Portfolio Theory .................................................................. 10  
      2.3.3 Overconfidence ...................................................................................... 11  
      2.3.4 General criticism towards Behavioral Finance .................................. 12  
   2.4 Stock Selection .................................................................................................... 13  
      2.4.1 Herding ...................................................................................................... 15  
      2.4.2 Contrarian Strategies ............................................................................... 16  
      2.4.3 Home Bias ................................................................................................ 16  
      2.4.4 Diversification ....................................................................................... 17  
   2.5 Managerial Objectives ........................................................................................ 18  
   2.6 Fund Size Behavior .............................................................................................. 20  
   2.7 Liquidity ............................................................................................................... 21  
   2.8 Exchange Traded Funds ....................................................................................... 21  
   2.9 Summary of Theoretical Framework .................................................................. 22  

3. Methodology .............................................................................................................. 23  
   3.1 Choice of Topic .................................................................................................... 23  
   3.2 Perspective .......................................................................................................... 23  
   3.3 Preconceptions ................................................................................................... 24  
   3.4 Scientific Approach ............................................................................................ 24  
   3.5 Research Approach ............................................................................................. 26  
   3.6 Choice of Method ............................................................................................... 27  
   3.7 Research Design ................................................................................................ 27  
   3.8 Primary Sources ................................................................................................. 28  
      3.8.1 Selection of respondents .......................................................................... 29  
      3.8.2 Conduction of Interviews ....................................................................... 31  
      3.8.3 Transcription and Translation ................................................................ 32  
   3.9 Criticism of Primary Sources ............................................................................ 32  
      3.9.1 Interviewer and Interviewee bias .............................................................. 32  
      3.9.2 Misinterpretation ..................................................................................... 33  
   3.10 Analytical Framework ....................................................................................... 33  
   3.11 Secondary Sources ............................................................................................ 33  
      3.11.1 Information Search .................................................................................. 34  
      3.11.2 Criticism Towards Secondary Data ....................................................... 34  
   3.12 Truth Criteria’s ................................................................................................ 35  
      3.12.1 Reliability ............................................................................................... 35
List of Figures

Figure 1 - Behavior Development ................................................................. 9
Figure 2 - Hypothetical Value Function ......................................................... 10
Figure 3 - Summary of Theoretical Framework ............................................ 22
Figure 4 - Hermeneutic Spiral ................................................................. 26

List of Tables

Table 1 - Key Choices of Research Design .................................................. 28
Table 2 - Overview of Interviews .............................................................. 29
Table 3 - Brief Interview Guide ................................................................. 32
1. Introduction

This chapter aims at providing the reader an introduction to the problem background and why it is relevant for research. The chapter will also introduce the problem statement and the purpose of the study. In the end of the chapter delimitations will be introduced.

The financial industry has grown rapidly over the last decades. The stock market has gone from being something only for the very wealthy to being something for almost everyone. As of today, the Swedish people are the ones that invest the most in funds. The fund industry in Sweden has grown from being a 300 million industry in 1970 to 1600 billion SEK in 2006. Today more than 9 out of 10 own shares in funds, premium pension included (Fondbolagen, 2010).

The access to the financial markets has made it easier for people to trade in stocks. The globalization that has aroused from the technological advances has further improved availability to access news from company’s worldwide. With online trading the different financial markets moved into the personal computer. Other reasons for the increased interest in the stock market have been the strong historical return compared to other financial instruments. Between the time period of 1900 and 2009 the stock market in Sweden had an average return of 7.2%, something that only is marginally beaten by Australia. This can be compared to bonds that had an annual return of 2.5% per year and bills with 1.9% annual return (Dimson et al. 2009 p.39). When the Swedish citizens make their decisions regarding fund selection; fees and risk are the most prominent factors (Fondbolagen, 2010).

However, people tend to forget the risks that investment brings. Run-ups in the stock market are not anything new. Bubbles or financial miss happenings have been occurring since the Dutch tulip mania in the 17th century. The most recent financial crisis is still a hot topic of discussion. Shiller (2010) argues that bubbles occur because of rational and irrational behavior. Psychology does according to him contribute to a downward spiral that in the end leads to financial distress and recession. The Swedish Central Bank (Sveriges Riksbank) governor Stefan Ingves said in a speech that the financial crisis has lead to a diminishing confidence of the professionals in the financial markets. (Ingves, 2009)

1.1 Problem Background

The most recent financial crisis has been described as the worst since the depression in the 1930’s. The financial markets fell tremendously and there is still great uncertainty in where it will end. Hilsenrath et al. (2008) argues that there are several factors that led up to the crisis and they further show evidence that fund managers of hedge funds and mutual funds have acted for their own interests and not in the interest of the saver. They mean that fund managers have taken part in trading with products where only a few were aware of the risks.
The mutual fund industry has changed tremendously since the beginning, after the Second World War. Different investment vehicles characterize mutual funds where equity is the most common. Today there are a large number of companies that offer mutual funds, and the idea of diversification, that the industry once was built upon, is vanishing. Whether this is all good is still debatable (see for instance Bogle, 2005). The characteristics of the mutual fund manager have, as the industry in large, changed over the years. However, the literature offers surprisingly little in the function of the mutual fund manager.

The classic financial economic theories have encountered problem when trying to explain these odd events known as bubbles. Accordingly investors are rational when they are making their decisions. Simplified that means that investors assess new information regarding a company in the same manner. A rational investor can thus correctly assess the probabilities of outcomes in all situations. This is contradictive to what actually happens when bubbles occur. The classic financial theories do not encounter the human behavior in their calculations. This has lead to complicated financial theories that appears sophisticated, nevertheless are not accurate. Behavioral finance has emerged as a reaction to the classic financial theories. Where the classical financial theories cannot explain certain anomalies, behavioral theories offers an explanation that is related to psychological and social factors. This should not be seen as new phenomena, economists like John Maynard Keynes and Irving Fisher put great emphasis on the human behavior and its rather unreliable nature (DeBondt & Thaler, 1995, p.385).

Kahneman and Tversky (1979, pp263-264) broke the barrier in the late 1970’s when they presented their work on prospect theory and loss aversion. From that point until today academics has put greater emphasis on trying to understand what function the human behavior plays in the financial decision making process. Today behavioral finance is gaining more and more acceptance from the academic world. According to a recent report from Capgemini and Merrill Lynch (2010 pp. 8-10), behavioral finance is taking a greater part in the companies as well, albeit in different ways. The recent economic crisis is being explained from behavioral angles, and financial advisors are today using behavioral finance in order to retain the confidence of their clients and the public. The report further states that behavioral finance will grow in importance in the future, if the financial advisor can gain a better understanding for investor psychology.

The importance of actively managed mutual funds has been fiercely debated over a long time period (see Jensen 1968, Fama 1998, and Carhart 1997). Whether mutual fund managers earn abnormal return has been discussed and will continue to be discussed. More recently a number of papers have indicated that it is possible for actively managed funds to outperform benchmarks (see for instance Wermers, 2000 and Baker et al. 2006). The supporters of the efficient markets will argue that it is not possible to earn an abnormal return without taking on additional risk. Several have contradicted this and famous investors as Warren Buffett and Peter Lynch are good examples that it is possible. Pastor and Stambaugh (2010, pp.1-2) concludes in their article that even if a great deal of research has been done in the field of actively managed mutual funds, there is still a great deal of explanations for the behavior and decision making that needs to be done, something that this study aims at.
This thesis will with the wording of classical financial theories imply the function of efficient markets and the rationality that it is based upon. However it is not sufficient to simply find flaws with EMH. Sharpe (1976:142) argues that financial theories are supposed to be rigorous and fairly abstract, in the sense that the use of it in the financial world is limited. This is contradicted by Fama (1976:23), who mean that financial theories are not abstract, and that the use of it is what makes it unique compared to many other economic theories. This indirectly implies that Fama meant that the function of EMH should be considered as a practical theory and that the use of it is not only limited to the theoretical field of finance and economics. Fama’s view is that in order to be able to make an abnormal return in the market you need luck, because the law of one price and the efficiency of the markets where all the information is incorporated and with that additional risk needs to be taken on. This has later been fiercely debated (see for example Barberis & Thaler (2003) and Werner (2000)).

There are a number of flaws that the function of rationality among the participants in the mutual fund industry has not been able to explain with the help of classical financial theories (Barberis & Thaler. 2003 pp.1053-1054). Some of these flaws include the function of the human behavior and in particular how irrational behavior leads to a different outcome than predicted by classical financial theories. Kahneman and Tversky (1979, pp.264-267) proved that humans are not fully rational as suggested by EMH when facing wealth and gain decisions. Human irrationality has later been proved and will to a certain extent be tested in this thesis in the form of questions regarding mutual fund managers trading strategies. Frankfurter and McGoun (2000 pp.378-380) argues that classic financial theories and behavioral finance is a good example of a set of different theories that helps each other developing and re-thinking the function of rationality in economics. The empirical findings of the behavioral finance literature have given rise to an investment strategy that systematically exploits the fact that the market is not as efficient as EMH would have it and takes positions contrary to what efficiency proposes. This indicates that there is a need for financial theories that are based on other facts than rationality and that there is a practical use for it in the investment industry. This thesis will with the help of interviews with fund managers try to recognize the importance of behavioral aspects and investigate their view of the two theoretical paradigms. The shortcomings of financial theories and different anomalies will be investigated in these interviews.

This thesis will differentiate between classic financial theories (the function of rational behavior) for example efficient market hypothesis and Modern Portfolio Theory and the function of the behavioral finance (human irrationality) in mutual funds. A few of the behavioral anomalies that will be researched in this paper include overconfidence, herding, and portfolio theory and contrarian strategies. The fact that even the most prominent and well educated institutional investors, as well as individual actors, were affected by speculative bubbles as the IT-crash and the recent financial crisis demonstrates that something is fundamentally wrong in our current models of rational market behavior. This leads us to ask whether other financial models better can explain the financial markets and thereby help us preventing them from happening again.
1.2 Research Question
Based on the theory of efficient markets hypothesis and modern portfolio theory, all investors should be rational when they are making their investment decisions. The recent financial economic crisis is an example of how irrational the markets behave in certain circumstances. With these mixed results as a base, the following research questions are proposed, where the first one can be seen a more theoretical and the second as more practical:

- How present are behavioral aspects in the mutual fund industry?
- What have been the greatest eruditions for mutual fund managers from the recent financial crisis and what will it lead to in the future?

1.3 Purpose
The purpose of this thesis is to view and evaluate the contribution of the function of behavioral finance in the mutual fund industry, and put in to relation of classic financial theories. Classic financial theories cannot adequately explain financial crises and there is a clear need for better understanding of these anomalies. This will be done with the help of analyzing how a fund manager is making his decisions and to see what it is based upon and whether or not it is rational as suggested by the classic financial theories. This study aims to get a deeper understanding for how behavioral factors are present in the mutual funds. Behavioral aspects that will be included in this thesis is the before mentioned, herding, contrarian styles, behavioral portfolio theory and other forms of anomalies that is contradicted by classic financial theories. The results from the empirical part will be analyzed with the help of behavioral finance and classic financial theories. The classic financial theories will help contrasting the behavioral aspects of the mutual fund managers. The theoretical contribution of this thesis is two-parted where the first one is the behavioral aspect of the mutual fund industry. Some of the aforementioned anomalies will be investigated and compared between the theoretical views of classic financial theories and behavioral finance. The second theoretical purpose is to investigate the future of both views and determine whether there is a need for both.

Considering the significance of this topic in the theoretical and the practical field, as well as the limited research on the Swedish market, this thesis will try to explain what impact the financial crisis had for the rationality in the mutual fund industry. Additionally, motivated by the economic circumstances this thesis will attempt to research what function the mutual funds will have in the future.

1.4 Significance of the study
Even if this study will not make any generalizations, institutions that are offering mutual funds should consider the results. The study is important from the perspective of knowing the behavior of the mutual fund managers, something that other studies have researched, however not in combination with a behavioral finance perspective in Sweden. The academic value of this master thesis will incorporate behavioral finance with neo classic financial theories and compare the relevance in the practical field, thereby developing new theoretical knowledge. The practical significance of this study could help financial institutions learn from the recent financial crisis and realize what it will lead to.
2. Theoretical Framework

The theoretical framework chapter introduces the base that the analyze part is based upon. It is further used as the foundation for the questions that are used in the interviews. In order to get a deeper understanding for behavioral finance is the precedent neoclassical view presented. Other parts included in the theoretical framework is stock selection, exchange traded funds and portfolio theory.

2.1 Financial crises

In order to be able to describe a bubble from different perspectives it is important to define what it actually is. DeMarzo et al. (2008 p.21) defines a bubble as: where the future discounted cash flows is lower than the asset price, there is no negative risk correlated with cash flows and lastly that the rational investor is aware of this and still decides to hold the asset. That means that in order to take advantage of a bubble there have to be a risk free arbitrage.

Among the most famous theories in behavioral finance is the price-to-price feedback theory (Shiller, 2003, pp.91-92). The idea behind the theory is that the price drives the price. This has been proved in several financial crises and the “word of mouth” is often blamed for it. This was part of what happened in the IT crash at the beginning of the millennium and what drove the Dutch tulip mania in the 1630. Often there is a certain style or investment category that is included in the mania. The process is that there are no fundamentals in play and that new models try to vindicate the new prices instead is replace by greater prices. The higher price interests more people to join the crowd. For a bubble to occur this procedure must happen a few times and more and more people get involved in it. This happens both in downward movements as well as the more often occurring upward. Laboratory experiments have shown that feedback trading actually leads to bubbles (Smith et al., 1988 p.1119-1121).

Shiller (2003, pp. 94-95) argues that the feedback methods of word of mouth and media played a significant part in the speculation of the technological companies in 2000. Greenwood and Nagel (2009, p.257) put part of the blame for the most recent crisis on young mutual fund managers because of their tendency to follow the herd and drive the prices to absurd levels. The classical ways of looking at financial statement and trying to forecast future earnings was outdated during the crises. Investors, both individual and mutual fund professionals were influenced by this “new” way of attacking the problem. Shiller (2003, p.95) argued that that this “new era” reminded of a Ponzi scheme (or pyramid scheme) and that media coverage further diluted the common investor.

Penman (2003, p.77) goes even further and argues that momentum trades drives the prices instead of fundamentals. Dass et al. (2008, p.95-96) argues that the much of the blame for a bubble is because of the mutual funds. The argument is that mutual funds and hedge funds often has a short-term investment horizon, something that lead to a heavy reliance of investing on past winners and thereby trying to ride the bubble. Further evidence for this was that fund manager’s contracts played a vital part with short-term contracts often leading to shorter time horizons and thereby buying more of the past
winners. Other reasons that academics have found to drive the asset prices to bubble levels include constrain of short selling (Haruvy & Noussair, 2006), limits to arbitrage (Shleifer & Vishnu, 1997) and heterogeneous beliefs (Scheinkman & Xiong, 2003). As seen, there is no clear way of describing the reasons for financial crises. There are many underlying reasons that are connected to each other. The most recent crisis is still an ongoing topic of discussion and there are limited numbers of academic researches done in the area.

The function of mutual funds in a financial crisis is not clear. In this thesis the respondents will be asked of their view of the recent financial crisis and its influences on the mutual fund industry and what can be learned from it. The recent financial crisis highlighted the fact of irrationality from the actors in the market. The practical purpose of this thesis will be to research what function the financial theories have played in the financial crisis and what the greatest eruditions from the crash is. There is an unclear relation between the actual behavior of the mutual fund managers and what is proposed in the next section regarding classic financial theories.

**2.2 Classic Financial Theories**

In order to fully understand the new paradigm of financial theories incorporating behavioral approaches, it is necessary to have a sense of the preceding financial theories, what behavioral finance emerged from. Starting point in this paper is Markowitz modern portfolio theory, however one should be aware, the actual starting point is before this. As will be described, the modern portfolio theory and the efficient market hypothesis have had a great impact on the financial industry in general and in particular the mutual fund industry. There are other theories that are considered classical, however have they with the purpose of the study in mind been excluded.

**2.2.1 Modern Portfolio Theory**

Markowitz presented the Modern Portfolio Theory (MPT henceforth) in 1952 and it has since then been further improved by several (see for example Elton & Gruber, 1997). MPT has been extremely important in the financial industry because of its appealing relation between risks and return. MPT was groundbreaking because of its quantitative calculations that diversification would reduce the risk of the portfolio. MPT is a mean-variance theory that is based on covariance between assets. It is built upon that investors are rational and risk averse, that they want appropriate compensation for additional risk they take on. The risk of holding one stock is greater than holding ten stocks; the expression “not all eggs in the basket” was quantified by Markowitz in his article from 1952.

The relation between stocks would determine how well a portfolio is diversified. Consider a simplified example with one ice cream producer and one umbrella producer. Both of these would be considered risky on their own, however would they together cancel each other out and the downside risk will be substantially smaller than on their own. Risk is divided into two different settings, systematic and unsystematic risk. Systematic risk, or market risk as it is known, is not possible to diversify away. This is for instance interest rate, wars and other macro related risks. It is the unsystematic risk that is interesting in MPT; this risk known as specific risk can with the help of MPT be
diversified away. Evans and Archer’s study (1967, p.762) argued that above 10 stocks would not give any further benefits of diversification. This was for a long time accepted as correct, however has recent studies by Solnik (1995, p.89) indicated that 10 is not enough and that at least 20 stocks will reduce the unsystematic risk. However, Statman (1985, p.353) argue that there is a need for more than 30 stocks to reach a well-diversified portfolio. There is as of today, no uniform number for where perfect diversification is met. It should be noted that the number of stocks is not the only issue; a need to have stocks within different industries and geographical areas is significant as well.

MPT have during the years met massive criticism (see for instance Murphy, 1977; Haugen & Heinz, 1975). Foremost has the criticism been that the theory is just a theory and that its use in the financial world is limited because of its many shortcomings. MPT is a mean variance theory, which means that each stock is given a standard deviation depending on how volatile it is. All the stocks represent the mean and this is one of the great shortcomings in the theory. The universe of stocks is gigantic and there is tremendous task to calculate the expected return. Historic return, as the mean and variance is based upon, is far from always the same as future return. Other criticism that has been directed towards MPT is that the investors are risk averse, which means investors avoid risk unless it substantially increases the return (Murphy, 1977, p.5-7). This has from a behavioral perspective been regarded as false, since investors are not always rational something that we will return to in the chapter regarding behavioral finance.

The function and importance of MPT for mutual fund managers constructing funds will be asked to the respondents. MPT is one part of the section regarding the practicality of theories. The second one is the efficient market hypothesis.

2.2.2 Efficient Market Hypothesis

Eugene Fama’s (1965) collective work on the Efficient Market Hypothesis (henceforth EMH) is among the most influential work in the financial academic world. The hypothesis has since it was published divided the financial academic community into two sides, against and for. The advocates of the theory have admitted that the theory is not perfect and has later on modified it to fit better. The idea behind the hypothesis is that all information regarding a company is included in the price of the stock. That means that no one can make an abnormal profit out of being active on the stock market. There have been a few amendments made to the EMH; it now consists of three different forms. The weak form of EMH states that historical information, for example prices and volume, cannot be used to make an abnormal return. This is contradictive to what practitioner of technical analysis believes, which is based on looking at historical records and is a counterpart to fundamental analyze, that is based on looking at fundamentals of a company, for example projected earnings and expected industry development. The semi-strong form of EMH states that all public available information is already incorporated in the price of the asset. That means that it is only possible to outperform the market and make an abnormal return based on inside information. The strongest form of the EMH states that it is not possible to make an abnormal profit with inside information and that it is only luck that could make an investor beat the market consistently. The core idea with
the EMH is that new information will instantly be incorporated into the price of the asset; the market will thereby be efficient. (Fama, 1970, p. 383)

The validity of the hypotheses has since Fama made it famous been discussed. Milton Friedman (1970, p.19) fenced off the criticism with a baseball reference, that even if the catcher could not calculate where the ball would land, he could still be there when it landed. This “as if” defense has been used to answer for the simplification of the theory (DeBondt & Thaler, 1995, p.386). Fama (1991, p.1576) has stated that market efficiency can only be tested with a specific asset-pricing model. Often has the capital asset pricing model (CAPM) been used, however the result has not been satisfactory. Among the problem with CAPM is that it is a one period model and that the market portfolio that is necessary do not exist. That means that anomalies that have been found in the financial markets could either be because of wrong or false models or market efficiency that would mean mispricing. If the market efficiency would be violated would it implicitly mean that the fundament of EMH, the law of one price, would be inaccurate. The law of one price states that assets that have the same payoff should have the same price (DeBondt & Thaler, 1995, p.386).

The idea of EMH is appealing and the respondents will be asked what their view of it is and what it means to them. It has been seen that it is possible to consistently outperform the market where famous investors for instance Peter Lynch and Warren Buffett have proved that simple strategies work. This would according to the EMH not be plausible. Several anomalies from the efficient market have lead to questioning of the classic financial theories. In the light of this dispute has behavioral finance emerged.

2.3 Behavioral Finance
Behavioral finance has emerged as a reaction to the classic financial theories. Where the classical financial theories cannot explain certain anomalies, behavioral theories offers an explanation that is related to psychological and social factors. Kahneman and Tversky (1979) broke the barrier in the late 1970’s when they presented their work on prospect theory and loss aversion. From that point until today academics has put greater emphasis on trying to understand what role the human behavior plays in the financial decision making process.

The term behavior literary means “the aggregate of all the responses made by an organism in any situation” and “a specific response of a certain organism to a specific stimulus or group of stimuli” (The American Heritage Dictionary, 2003). Accordingly, behavior is both external to the actions of the outside world as well as the internal physical conditions. Put simply, it means that all the actions that are carried out are everything that a person do or try. The figure below explains the development of behavior and is for this study used for describing the underlying reasoning and thus not intended for the analytical or concluding chapters.
2.3.1 Prospect Theory

In order to understand certain behavior for investors there is a need to know what preferences and choices a fund manager is facing. Classic financial theory has supposed that expected utility is how investors evaluate different investment and gamble situations. Expected utility is based on a number of axioms. However has the last decades brought a new viewpoint on how gambles are evaluated. The most prominent of these is the prospect theory by Kahneman and Tversky (1979). The prospect theory is included in this thesis to highlight the significant difference mutual fund manager’s face when making investment decision, in the light of gains and losses and the difference of how investors perceive the function of wealth and gain. This is the natural starting point for a person to develop a deeper understanding of how the financial theories are connected to different behavioral aspects.

The theory is based upon loss and gain and how different alternatives are evaluated. Markowitz (1952, p.77) proposed the expected utility function based upon final wealth, while the prospect theory is based on gain or loss. The expected utility hypothesis is like the efficient market hypothesis based on rational individuals.

The form of the value function is as in the figure presented below, s-shaped. This can be understood from a gambles perspective. In the original paper the respondents get the chance to choose from a certain (100%) 500 Israeli liras or 1000 Israeli lira with 50% chance, most people took the 500-lira option. The second question was whether the respondents rather would prefer a loss of 1000 with 50% chance or a certain (100%) loss of 500 lira. The most popular answer was that people would rather take the chance and lose 1000 lira then 500 for certain. This rather simple example indicated that even if the outcomes would be identical in terms of their final wealth, the outcome prove different. This is according to Kahneman and Tversky (1979, pp.264-267) because people favor certain positive outcomes, while negative outcomes tries to be avoided. A utility function would be linear, while the value function is not. That people overvalue their certain outcomes before more uncertain effects is called the certainty effect. Kahneman and Tversky call the effect that can be seen in the figure below around zero, reflection effect (1979, p280). This makes individuals avoid risks at the upside while taking risks at the negative downside.
Criticism has been aimed at the Prospect theory. The problem with the first edition from 1979 was that it only included a gamble of two possible outcomes in each setting. The original authors further expanded this in 1992 where more than two gambles were added to the theory. Other criticism has been that the theory is based on inexperienced individuals and that the learning curve should be considered, something that was rejected by List (2004, p.24). The author agrees with Kahneman and Tversky that losses and gains are perceived with a different notion and that this would subsequently lead to choices that diverse from efficient markets hypotheses. Making choices different from the EMH implicitly means building portfolios different from Markowitz classic portfolio theory, which leads us to the behavioral portfolio theory.

2.3.2 Behavioral Portfolio Theory

The classical financial theories rely heavily on Markowitz modern portfolio theory (MPT). The behavioral finance equivalent is the behavioral portfolio theory (henceforth BPT). Criticism has been directed towards the use of MPT that it suggests unrealistic positions and that it is overlooking of individual assets. Extreme positions both long and short make it often impossible to follow the suggestions from MPT. Instead is a behavioral approach suggested where the layer-by-layer function is the significant difference. BPT is appealing because of its simplicity and that positions do not need to cancel each other out (Shefrin & Statman, 2000, pp.3-4). The function of BPT in this thesis will be to draw attention to the number of ways a fund or portfolio can be constructed.

The purpose with BPT is to protect the downside and to leave room for the upside. Each layer is build with a purpose and with a specific goal and risk attitude. This means that the covariance’s that is fundamental of MPT will be overlooked (Jorion, 1994, p.48). The BPT is reluctant to short positions and buying on margin because of the positions. The restrictions of short selling stems from the impossibility of having a reference point that is below zero. With short selling of securities it is possible to lose more than you have and thereby is the downside protection outplayed (Shefrin & Statman, 2000, pp.3-5).
A further problem that Shefrin and Statman (2000, pp.4-5) finds with the MPT is that the attitude towards risk is supposed to be constant, while in the real life it is not. The close ties with the prospect theory makes BPT attractive and constructing a portfolio is done in the same way as the prospect theory, where the first stage is editing and the second evaluation. The first stage, editing, means that the investor has downside protection and an upside potential. For example could the downside protection be safe governmental bonds while the upside possibilities layer could be more risky blue chips stocks. The allocation of different classes of securities is decided upon the risk level of the layer as well as transaction costs, expected returns and the current monetary situation. An increase in transaction costs would reduce the number of securities. An illustrative example of the role the different layers play can be with lottery tickets. A person that is acting in accordance with BPT would buy a lottery ticket for the upside possibilities in some level. It would not be bought for their downside protection. A person that acts according to the mean-variance theory would not buy lottery tickets since it is not rational (Shefrin & Statman, 2000, pp.4-5).

In this thesis BPT will be used as a framework of how funds ought to be constructed. The respondents will be asked how they construct their funds and these answers will be interpreted. The next section covers overconfidence and its consequences, an aspect that classic financial theories never have been able to explain.

2.3.3 Overconfidence

A famous article by Ola Svenson (1981, p.146) stated that 77% of the drivers in Sweden tend to think that they are better drivers their peers. This number was even greater in the United States, where 93% thought they were more skillful drivers than the median driver. This highlights the problem with overconfidence, something that is present when individuals make investment decisions. According to Barberis and Thaler (2003, pp. 1063-1064) overconfidence comes in two different shapes. The example provided above with the driver’s overconfidence is an example of poor confidence in interval assignment. The second form is that people are overestimating probabilities to certain events.

Overconfidence leads to more trading, something that several studies have shown (Glaser & Weber, 2007, Barberis & Thaler, 2003 and Statman et al., 2004). More trading implicitly means higher transactions fees for the fund. Odean (1998, p.1887) concludes that even when trading costs are excluded, will the overconfident investor lower their returns through trading. A hypothesis of why this is occurring could be that the overconfident investors are making their trading decisions based on past winner information and will thereby be the last one making a profit on winner and the first one making a loss, when the momentum is gone. Fund managers seem to posses the same qualities as individual investors when it comes to overconfidence (Dow & Gordon, 1997, pp.1024-1025). Fund managers tend to make substantially more trading than is necessary in order to earn their fees and to have something to show off, so that they are not “simply doing nothing”. High return has proved to lead to overconfidence after a bull market period (Statman et al., 2004, pp.26-27). Bull periods have been followed by an increase in trading on stock markets. Men tend to be more confident than women, which have been proved further by men being more active and trading more (Barber & Odean, 2001, p.261). Another study by Barber and Odean (2002, pp.455-457) shows that the more
information to base a forecast on an investor is given the higher the overconfidence will be. This illusion of control leads to a personal engagement where the investor thinks that he/she can control the outcome. The strong belief in themselves has also been proved to lead to problems accepting other investor’s investment ideas.

Heath and Tversky (1991, p.26), finds that self-cleared expertise within a field, leads to overconfidence within that field. Griffin and Tversky (1992, pp.412-413) finds evidence that people tend to be more overconfident in work where there is a high level of unpredictability, like the financial markets. Odean (1998, pp.1910-1912) suggests that individuals who are overconfident in the investment market would be the one that is most likely to look for a profession within the financial sector, as a trader, analyst or fund managers. Overconfident investors have a strong tendency to overestimate their future profits and thereby engage in more trading that in some cases leads to pure speculation. How overconfident investor process information has been of great interest for researchers (see Odean 1998 and Wang 2001). The research has been rather diversified and the results have not proved to be static. Odean (1998, p.1916) concludes in his research that overconfident investors overstate the meaning of the information they have, before making an investment decision. This can in worst-case mean that they overstate the signals of the information they have been given and that the real scenario is that the information is useless.

There has been criticism towards the research done in the overconfidence area. Massa and Simonov (2005, pp.1-2) argue that much of the previous research in the area have been done with only short-term behavior in mind. They instead focus on holding and long-term behavior. Odean (1998) focus on daily data, Massa and Simonov (2005, pp.1-2) instead focus on yearly data and argues that it gives a more correct idea of the behavioral decision making process. Their research shows that overconfidence is still present on a yearly horizon, however not as prominent as in Odean’s research. Other criticism that could be aimed at the studies mentioned in this section is that they could be seen as outdated, where a part of them took place before Internet trading took off. Glaser et al. (2004, p.528) mean that some of the overconfidence theories have sprung out of data mining and that others predictions are made with loose assumptions, however do they conclude that overconfidence is present in the financial markets. Glaser et al. (2004, p.534) further means that overconfidence is never directly observed and that it is either indirect studied or only proxies.

The importance of being aware of overconfidence is vital for fund managers. Only by knowing this it is possible to change trading behavior. Overconfidence will be present in the interviews and the respondents will be asked to whether it plays a part of their strategies and if so, how it can be prevented.

2.3.4 General criticism towards Behavioral Finance
The upbringing of behavioral finance has meant a lot of criticism directed towards the classical view of finance. However have the defenders of the classical theories not been late on criticism of the new guy in town. Eugene Fama (1998, p.304) famous for the EMH means that behavioral finance is partly due to bad models and mostly to data mining or model dredging as Fama expresses it. His strongest argument is that it is still not possible to outperform the market based on behavioral finance and that market
efficiency cannot be abandoned because of a few anomalies that have passed the robustness test. Fama concludes his article with that the behavioral finance models of today, are not good enough substitutes for other classical financial theory models.

Another Chicago professor, John Cochrane (1991, p.480) has also been criticizing the behavioral finance field. His view is that the behavioral finance use psychology in order to add a free parameter. Cochrane argues that there is no significant discipline in the field and that the free parameter makes it possible to prove anything. Thaler (1999, p.12) a professor in behavioral finance goes as far as predicting that all financial theories will in the future be redundant. Behavioral finance is the first step towards that according to him, and soon will more realistic assumptions be incorporated into the models and be more alike the real world.

The next section of the theoretical framework is regarding stock selection and different strategies that are present. The idea is to incorporate behavioral finance anomalies and identify them as non-rational.

2.4 Stock Selection
The stock selection skills of fund managers have been under severe investigation (see for example Wermers, 2000 and Chevalier & Ellison 1999). The researchers has not reached any unified conclusions, however has the sentiment been moving from skepticism of fund managers towards a more favorable tone. One of the first essays presented in the topic was done by Jensen in 1968 where he presented evidence that mutual fund managers does not add any extra value that would cover the costs. In Wermer’s (2000, p.1690) paper it was shown that over a 20-year period mutual fund manager’s stock selection did perform on average 1.3 % better annually. A recent study by Barras et al. (2010, p.180) showed that fund managers in 75.4% of the stock picking cases covers the other costs of the fund, for instance management and trading costs.

There seems to be that professional fund managers have the ability to value stock correctly. Trades that are motivated by valuation outperform other trades with a statistically significant 3.45%. Those results are greater than the transaction costs and other charges, indicating that value based motivation for buying and selling does offer an abnormal return. This is particularly true on the buy side (Alexander et al. 2007, pp.19-20).

Baks (2003 pp.1-3) investigated whether it is the manager or the fund itself that drives the performance in funds where new mutual fund managers recently has been engaged. The result is that more than half of the return can be credited to the fund, in other words the past managers selection and that the new managers skills attributes somewhere between 10-50% depending on the trading activity of the new manager. The holding period of stocks are generally longer in mutual funds than the return forecast, this has been attributed to the high transaction costs and tax gains (Chen et al. 2000, p.367-368). However has the holding period as described in the introduction section been under fierce debate as the holding period constantly gets shorter and with that higher transactions costs (Alexander et al. 2007 p.29).
Baker et al. (2006, pp.1-3) researched how mutual fund managers buy and sell stocks around earnings announcements. Their study concluded that there seems to be some stock picking skills associated with this method, and that stocks that are bought generally tend to perform significantly higher returns after announcement compared to matching stocks. The same goes for selling before earnings announcements, where the sold stock usually performs worse than similar stocks after the announcement. In an article by Kosowski et al. (2006, pp.2551-2552) it was tested whether mutual fund managers were lucky or whether superior performance actually was because of stock selection skills. The result of their funds was that much of the difference in performance by low-ranked funds and high-ranked funds was due to stock selection and only a small part was because of other costs (for example transactions fees and managerial fees). Luck plays a part however not as significant as Jensen (1968, p.390) suggests. The costs were higher for low-ranked funds, which means that the higher-ranked funds not only had superior stock picking skills, they were also more cost efficient. The Kosowski et al. (2006, p.2552) study indicate that the performance of the fund managers has been worse over the last years, and after 1990 has the percentage of superior fund managers considerably declined. This was further established by Barras et al. (2010, pp.179-181), where they tested whether stock-picking skills was due to luck or skills. Their results was that prior to 1995 was there a great number of skilled mutual fund managers while there in the end of 2005 had vanished to a much smaller number. However does the number of fund managers that performs under their benchmark rise as the number of funds does. “Hot hands” or short term stock picking skills is rather rare according to Barras et al.’s study, where only 2,4% of the managers posses it over a rather short time-horizon.

Stock selection is the most common way for fund managers to generate a positive alpha. Factor timing is another direction where fund managers have the possibility of showing their skills. Factor timing consists of bets on the entire sectors, industries and is more exposed to systematic risk. There are few studies made on factor timing because of the difficulties of tracking risk to a comparable benchmark. Cremers and Petajisto finds in their study that among the funds they investigated, factor timing does not seem to be present, however are they cautious with the interpretation of the results (Cremers & Petajisto, 2009, pp1-3).

There is a great deal of criticism in this area of the research. There is today no clear method of how to measure fund managers performance and how to attribute it. There has been extensive research in this area, where several of the above mentioned authors have taken part. The literature has from Jensen in 1968 up until today not agreed on whether superior performance from fund managers is recognized as skill or luck by chance. The sentiment of the literature has moved from being pessimistic about the skills of fund managers to gradually change to more acceptances of skills and superior information. Chen et al. (2000, pp.343-345) finds only weak evidence in their study that the best past performers have a superior stock picking skills, implicitly indicating that much of these skills is attributed to luck or chance. The debate is still ongoing and there is no clear answer. The subject is nevertheless, complex and difficult to investigate because of the problem with defining the risk adjusted return. How to make this adjustment for risk that is necessary for funds is still unknown (Baker et al. 2006, pp.1-2).
The respondents trading strategies and mindset around stock selection and investment opportunities will be investigated. The next section of the thesis will present another behavior pattern that has been linked to how investors trade and follow the crowd.

2.4.1 Herding
One of the weakest points of classical financial theories is the proof of herding. If the EMH would be true, it would mean that there would only be peripheral trading since the rational investor would hold the market portfolio and would force the noise traders out of the market (DeBondt & Thaler 1995, pp.387-388). Noise traders are according to the efficient market hypotheses not rational and not as informed as the smart traders (Shleifer & Summers, 1990, p.19). The noise traders will with less information become more risky and thereby follow the crowd. In the long run will the noise traders lose out and leave the market. Nevertheless, a considerable amount of trading and extensive research shows that herding is present in the market (see for example Grinblatt et al. 1995 and De Long et al. 1990). The concept behind herding in the financial markets is that a large group stops thinking rational and follow others. Herding has in extreme cases lead to bubbles like the Dutch Tulip mania or more the recent IT-crash in the beginning of 2000 (Shiller, 2000:148-149). Herding is greater on the buy side then on the sell side, and it is most profound in small stocks (Wermers 2000, p.1689).

Herding among fund managers has shown dissimilar results. Lakonishok et al. (1992, p.24) finds weak evidence that pension fund managers exhibit herding behavior. However, a large body of studies found evidence that there is herding behavior among fund managers (see for example Wermers 2000; Grinblatt et al., 1995). There have been a few theories presented of why fund managers are showing herd behavior. Scharfstein and Stein (1990, pp.465-466) argue that herd behavior is largely because fund managers are afraid of acting in a different manner than their peers and lose out. John Maynard Keynes presented in his book The General Theory (1936:137-138) his view of investors and their ability to follow each other will only depend on their own investment strategy. Keynes argues that the investor who does not trust himself will be the one that follow the rest. A second reason for “follow the crowd” mentality among fund managers could be that they often share the same preferences for risk and return (Falkenstein 1996, p.112-113). A third reason could be because of information sharing among managers and that creates trading in the same direction (Bickchandani et al., 1992, pp.993-994). Much of the information that the managers are acting upon is highly correlated and thus led to same decisions. However has this been contradicted by Sharfstein and Stein (1990, pp.465-466) that argues that even if the managers has private information they rather follow another mutual fund manager than acting on their own information. This could be contributed to “share the blame” and the famous phrase “is better for reputation to fail conventionally than to succeed unconventionally” Keynes (1936, p.158).

Recent studies (Brown et al. 2009 p.1) has shown that mutual fund managers tend to herd in the same stocks and direction as analysts provide. When stocks were recommended by investment analyses mutual funds did in general buy and when the recommendation from the analyst was to sell, the mutual funds most often sold. Downgrading from an analyst had a stronger impact than an upgrade, indicating that there is strong information sharing among mutual funds. However it has been seen that the unskilled mutual fund managers,
the ones who perform under their benchmarks, often follow the information they get to a larger extent than the skilled manager (Kacperczyk & Seru, 2007, p.486). This herding that unskilled managers commit to could be because of stress of not making mistakes and missing out on the opportunities.

Classical financial theories have not been able to explain the extensive herding that occurs in the financial markets. It has been proved that herding occurs on all levels from beginner to the most experienced investor and mutual fund manager. Nevertheless, there have been a number of different reasons presented for why this is happening, but no uniformed reason has been presented. The interviewees will be asked of their trading style and their answers will be analyzed from different aspects, herding one of them. The next section of the chapter could almost be seen as the opposite of herding.

2.4.2 Contrarian Strategies
Other strategies that are popular among both individual investors and mutual funds are contrarian strategies (Lakonishok et al. 1994, p.1541). A contrarian strategy is based on buying stocks that are underpriced something that also is known as value investing and practiced famously by Warren Buffett. According to efficient market supporters, the abnormal return that value investing is leading too, is because of a higher degree of risk. However this has been proved wrong in several studies (see Lakonishok et al. 1994 and Fahlenbach 2009). Value investing as it is practiced today stems from the Graham and Dodd, the logic behind it is simple, buying stocks that at the moment are out of favor and then hold for a long time horizon. Graham and Dodd’s idea was based on both psychology and fundamental analysis, where “hot” stocks were overlooked for not so “hot” stocks (Lakonishok et al. 1994, p.1541).

DeBondt and Thaler (1985, pp.793-795) took the value investing one step further and examined past losers. The outcome of their study was that it is possible to outperform the market and earn abnormal return if the investment strategy is based on buying the extreme losers for the past two to five years. Criticism was directed towards their study that the high risk justified the abnormal return, however was it later showed that the strategy of buying past losers is more risky than buying past winners, nevertheless not as risky as it suggests (DeBondt & Thaler 1987, p.557). Contrarian strategies will like herding be analyzed from the respondents mode of operation.

2.4.3 Home Bias
Home bias is another infrequency that is supported by BPT. Home bias is the tendency of investors to put a greater emphasize on the markets close to themselves. This has been motivated in the academic literature to be because of recognition (Strong & Xu, 2003, pp.307-308). Domestic stocks get a stronger position in its home country and the region surrounding it because of familiarity, nevertheless is this far from optimal. The term domestic gives an often-false impression of being safer than foreign investments (Fisher & Statman, 1997, pp.13-14)

Home bias has been tested in a number of studies (see for example Fletcher, 1999 and Gruber 1996). For instance it has been proved that local mutual funds tend to outperform foreign mutual funds (Otten & Barns, 2007, p.719) and that local investors outperform non-local investors (Coval & Moskowitz, 2001, p.813). This has been attributed to
superior information among local investors compared to non-locals. In Otten and Bams (2007, p.719) study there is clear evidence that domestic (U.S) fund managers outperform foreign (UK) in their home market. This has proved especially in small-cap funds where information tends to be more local. Thus implicating that home bias is not always necessary bad. Other reasons for home bias could be because of lower transaction costs, fund constraints and currency risk (Otten & Bams, 2007, p.703).

Mutual fund managers and investors in general with a greater confidence and competence have a greater tendency to invest abroad and not only rely on the domestic market (Graham et al., 2009, p.1105). Their study concludes that people with more confidence trade more according to their beliefs and consequently feel more comfortable with investing in other more unfamiliar markets and thereby diversify more. The function of home bias in Sweden among mutual fund managers has not, to the authors’ knowledge, been investigated thoroughly. The purpose to include it in this thesis is to investigate whether it is present and to what extent the respondents are aware of the behavior. The reason for home bias has as previously stated been contributed to more knowledge in the home market and is closely linked to the function of overconfidence. Home bias is a good example of poor diversification, opposite of what MPT suggest.

2.4.4 Diversification
The classical financial theories are as previously stated based on rational agents. There has been a great debate whether the financial market actors really are that rational. Benartzi and Thaler (2001, pp.79-80) points at the case of diversification, and its inconsistency with rational markets, where a portfolio should be diversified in order to reduce the risk level. They researched U.S. pension plans and found that the diversification between risky stocks and governmental bonds where dire. The authors argued that the irrationality that the investors of these funds demonstrate is not in line with rational agents. One example of naïve diversification is the 1/N heuristic. This simple strategy has proved to be easier to implement than classical diversification that requires the correlation between assets and has despite the advance of optimization software kept rising in popularity (DeMiguel et al., 2007, p.1916) The idea behind this diversification strategy is to evenly distribute the wealth on the number of assets in the portfolio. The concept works well, however there is often an overload of stocks and 1/N heuristic should be used as a benchmark and not be seen as the truth (Benartzi & Thaler, 2001, p.80).

Pollet and Wilson (2008, p.2968) researched how the size of the mutual fund affects its behavior. Part of their conclusion was that diversification was far from always optimal and that the smaller funds were more often better diversified than large funds. There has also been strong evidence that mutual fund managers tend to rely on recognition and invest in companies that are familiar to them (Massa & Simonov, 2005, p.483). This has been particular true after financial crisis when brand recognition among both private and professional investors is stronger, often leading to disproportionate portfolio or fund. This familiarity has been attributed to heuristics within behavioral finance. In this case it means that humans simplify when facing decision-making. Because of the familiarity nature of well-known brands and that you already posses a great deal of information
regarding the companies. This leads to non-rational behavior. Information that is in the background will not be processed (Frieder & Subrahmanyam, 2005, pp.57-58).

More evidence that the market players are not always rational comes from the influences of framing. Tversky and Kahneman brought the concept of framing to the financial literature in 1981 (p.453). The thought behind framing is that people make their decisions based on how the problem is presented and their frame is constructed. This is contradictory to the theory that people are always rational in their decision making process. Framing is hard to avoid and is not necessarily bad. When new investment information is presented it is of big influence whether it has been positively or negatively framed. Framing is good for when exemplifying how fundamental information for instance news is processed differently for different individuals (Kirchler et al. 2005, p.98). The respondents will be asked of diversification, what importance it has to their fund and the difficulties with implementing it. The preceding section of the thesis will build on this and see how different objectives of the mutual fund managers affect their funds.

2.5 Managerial Objectives

It is important to establish what the objectives of the mutual fund manager are. In a neo classical view would the objective be to maximize the return of every investment. However has there lately been a change of focus and today’s mutual funds promote a number of different objectives, for instance has funds been created to follow certain ethical criteria’s. Fund managers have two objectives for the choices they make. They want to keep their works and more importantly perform well and thereby keeping the money inflow and get a high compensation (Kempf et al. 2009, pp.93-94).

There has been a great deal of research in the area of mutual fund managers and their compensation. Several of the studies evolve whether monetary incentives make a mutual fund managers perform better (see for example Grinblatt & Titman, 1989 and Kuhnen 2009). Massa and Patgiri (2009, p.1778) has concluded in their paper that incentives and risk is highly correlated. They find that for every additional 1% of incentive that the mutual fund manager is awarded increases the volatility (and implicitly the risk) with 1%. Because of the higher volatility, the chance of the mutual fund surviving will decrease. An increase of 1% in the incentive will lead to an 8.46% bigger chance that the fund will resolve.

Higher monetary incentives are not only bad for the investors of the mutual funds. A higher incentive fund outperforms funds that have managers that have low incentive schemes. This could be because of the higher risk that is taken on and partly because of better managerial efforts that makes the high incentive fund outperform the low incentive fund. The difference between the high quintile fund and the low quintile incentive fund is 22 basis points on a monthly average, adding to a total of 264 basis points over a year, after risk adjustments. There has been a discussion of whether high incentive funds have superior information and that there could be more information sharing at these stages, compared to lower incentive funds. Other factors that has been discussed is that the effect of performing poorly is smoothed out and thereby securing the work for the manager (Massa & Patgiri, 2009, p.1778).
Brown et al. (1996, pp.108-109) has found a correlation for mutual funds that perform under average in the beginning of a year and an increase in risk as the year continues. According to their study, mutual funds that perform poorly over the first 6 months try to make up for the loss and catch up with the better performers. In order to do that, they take on additional risk. Higher risk entails the chance for the fund manager losing the job. Warther (1995, pp.209-210) argues that during bear-markets when money inflows to funds are scarce, a compensation incentive program is of little use. Kempf et al (2009, pp,92-93) has found evidence that midyear loser’s increase their risk in a bull market compared to what midyear winners. In a bear market the situation is different and the midyear losers take less risk then the winners. Both of these scenarios have been linked to the job security. In a bull market is the fund manager that performs under average more willing to take on additional risk in order to keep their job, while in a bull market are the fund managers not as likely to get laid off.

Mutual fund manager’s asset selection has been held responsible for recent crisis (Greenwood & Nagel, 2009, p.240). However this has been contradicted by Dass et al. study (2007, pp.51-52) where they mean that high incentive funds do not persuade investment in assets bubbles. Fund managers of high monetary incentive funds tend to have a contrarian trading style or avoid these assets that are caught up in the frenzy. This is partly because of the reputation that the high incentive fund managers care about.

Chevalier and Ellison (1998) focused their research on the concern of reputation and future career concerns for managers. The mutual fund manager role is often discussed out of the perspective of how well a fund is doing compared to a pre-determined benchmark. That leads to wonder how a fund manager is making different choices with regard to their future careers prospects. Fama (1980) studied how decisions in funds of future career possibilities could solve the agency problem. Holmström (1982, p.324) focused on the same thing and concluded that, while a few agency problems can be solved most are still present and remain, for instance that new managers often tend to overwork situations while the opposite most often is true for older mutual fund managers.

The structure of mutual funds gives the manager incentives to trade for other reasons than to generate profits. Almost all of the mutual funds have stated how the fund will be constructed and this is what the mutual fund manager has to work from, for instance which sectors, countries or regions to invest in. This creates problem for funds when stocks appreciate in value and funds are by their own rules forces to sell winners in order to maintain the correct balance. Taxable distributions are a second reason for managers to trade more than is necessary. A third reason that Alexander et al. find in their study is that managers trade in order to window-dress, which is selling recent losers and buying past winners before reporting. These trade’s, as they are based on other reasons than superior information makes it noise trades. This does affect the performance of the mutual funds in a negative way (Alexander et al., 2007, p.125-126).

In the interviews the respondents will be asked questions of how different payment schemes influences the way of working and whether a good or poor start affects the investment strategy for the rest of the year. The importance of mutual fund managers for their funds has in this section been established. The next section investigates the importance of the fund families they belong to.
2.6 Fund Size Behavior

More than 90% of the U.S. equity that mutual funds hold belongs to larger fund families. This has an indirect implication that the fund managers work for a bigger conglomerate than only the fund they are managing (Gaspar et al., 2006, pp.73-74). The subject of the size of mutual funds is rather new. There is clear evidence that the better performing a fund is, the more money will both existent and new investor invest in it. However is the opposite not true, that the worst performing funds suffer capital outflow, something that puzzles academics (Berk & Green, 2004, p.1270).

Investment ideas are not a constant source. The problem arises when the investment strategies run out and more money is flowing in. Pollet and Wilson (2008, p.2968) find indications that in those situations the funds increase their ownership in already existing shares of the portfolio. The shares of stocks do not increase in the same pace as the capital inflow. Alexander et al. (2007, p.148) finds evidence that capital inflow to funds underperform their benchmarks with 0.41%.

Khorana and Servaes (1999, pp.1043-1044) identifies that for funds that are incorporated into a bigger family of funds, capital inflow will lead to new funds being set up. This is not always uncontroversial since the investor invests in the old fund for a particular reason and gets another fund. The larger fund families often diversify more slowly than smaller funds. This is largely because the bigger funds insist that there is a need for the investor to invest in more than one fund of the large family in order to reach a proper diversification (Pollet & Wilson, 2008, p.2968). The slower diversification among the large funds has however leaded to lower costs, which could partly explain the behavior. Sirri and Tufano (1998, p.1589) has found that increase in marketing and advertising has lead to more new funds and that it is more preferred to set up new funds instead of finding new managers to incorporate into already existing funds. Marketing plays a bigger part for the large fund companies, compared to the smaller funds that have a more constrained room for advertisement. Well-performing funds within a fund family often tends to have somewhat of a spillover effect on the other funds (Nanda et al., 2009, pp.329-330). However have there been indications that within fund families there is a form of favoritism to the funds that charge a higher fee. This favorable treatment towards the high fee funds comes at the cost of the lower fee funds (Gaspar et al. 2006, pp.73-74).

Carhart (1997, p.57) shows that there is a negative correlation between fees charged and fund performance. The higher the fees the worse is the fund performing. The fees around the world are diverse in the mutual fund industry. The fees differ consequently between the different types of funds, and to whom the fund is aimed at (Khorama et al. 2005, pp.145-146). Larger fund families have proved to have economies of scale (see for example Otten & Bams, 2002 and Dermine & Röller 1992). Khorama et al. (2005, p.146) finds evidence that funds that are distributed in several countries posses a higher fee compared to similar funds that only are sold in one country. In a recent study by Pastor and Stambaugh (2010, pp.1-2), found that actively managed funds could not outperform their benchmark as industries size grows. The arguing could be that active mutual funds are best in situations where the information is scarce and there are few players.
The function of fund size and what fund family it belongs to seem to play an important part of the fees and in the end the returns. The respondents will be asked of advantages and disadvantages of belonging to large and small fund families. In the next section an important factors that the mutual funds are providing to the financial industry be described.

2.7 Liquidity
The function of the mutual fund industry has grown tremendously over the last decades. The role of the industry to the economy in general has often been linked with the role of the equity industry, something that Chen et al. (2004, p.1300) argues is a simplification and that the industries needs to be separated. The mutual fund industry offers the market a high liquidity in a large proportion of the stock market although the subject has been scarcely researched. Classic financial theories suggest a minimal amount of trading, and that a market portfolio should be held and only changed upon when reallocation is necessary. One of the strongest arguments against this is the extensive trading that is occurring.

The extensive trading that funds today posse’s leads as previously described to higher costs for the owners of the funds. The upside with the large trading volume is the liquidity of individual stocks that it creates. The liquidity that is provided by mutual funds makes it possible for smaller investors to trade in individual stock that otherwise would be more difficult. It further shows that lower ability managers often trade more and thereby provide more liquidity compared to managers with a better than average track record in general buys less and holds the stocks in the portfolio longer. One of the problems that are found in the study is that individual investors are often looking for funds that are more liquid and thus overlook the better funds in order to protect themselves from liquidity shocks (Nanda et al. 2009, pp.329-330).

Often has the function of liquidity been taken for granted from the markets. With the recent financial crisis has the view changed and there is today a concern of what the future of the mutual fund industry will look like. The thesis will try to answer what the future will bring for industry and thus it is necessary to incorporate liquidity. The following section will discuss the possibility of other forms of investing that will compete with the classic mutual fund in the future.

2.8 Exchange Traded Funds
Exchange Traded Funds (henceforth ETF) is a relatively new investment vehicle that resembles open-end index mutual funds. ETF’s are traded at the stock exchange like regular stocks; the difference is that each stock of an ETF is claim of pooled assets, for instance S&P 500. Mutual funds and ETF are often categorized together, however are there some major differences including the way they are managed. ETF’s have been seen as the future of the mutual fund industry because of its lower management fees and the simplification it offers in relation to actively managed mutual funds (Poterba & Shoven, 2002, pp.422-423). Poterba and Shoven links mutual funds and ETF’s to attract different investors because of their nature. Constraints that are often apparent in mutual funds are absent for ETF’s. The liquidity for mutual funds is often lower than it is for ETF’s, making the later more attractive for short-term investors. The innovation of ETF’s has
changed the view of how efficient a fund can be managed. The passive nature of the funds has attracted attention and interests from investors. Tufano (2003, p.325) argues that financial innovation like ETF’s is an example of a financial product that provides the investor of more cost efficient and less agency problems.

The respondents will in their interviews be given the chance to speak about future financial innovation and what importance ETF’s will have. The next section will summarize the findings of the theoretical framework and illustrate how different parts interact with the function of the fund manager.

2.9 Summary of Theoretical Framework
The picture below explains how the theoretical framework is constructed and the basis for the interview questions. The fund manager is the central figure and the different aspects that are around him or her. How the recent financial crisis has affected the mutual fund industry will be investigated and help determining what the lessons learned from it is. The classical financial theories with EMH and MPT is one of the characteristics that the fund industry in general is arguing about, this will be captured in the thesis with questions regarding the subject and interpretation of the answers given. Managerial objects include the function of bonuses and salaries while stock selection will be around mode of operation and trading style. The behavioral finance theories will both be questioned in the interviews and interpreted with the help of the theoretical framework.

![Figure 3: Summary of Theoretical Framework](image-url)
3. **Methodology**

This chapter will identify the most appropriate research method for this thesis. More in detail, this chapter will present how the empirical data has been gathered and how it will be analyzed. The importance of validity and reliability will be discussed towards the end of the chapter.

**3.1 Choice of Topic**

The idea to analyze mutual funds in Sweden from a behavioral finance perspective was born from numerous conversations with both professionals within finance and scholars from the academic world. This was further established after a literature review. There was a gap in the academic world and most of the research previously done in the area was done in a quantitative manner, without any deeper understanding. The authors had no specific knowledge regarding the subject of mutual fund managers and approached the subject with an open mind.

Most of the theories used in the theoretical framework have therefore been acquired in the process of the thesis. The function of the mutual fund managers have been fiercely debated, however has the subjects themselves rarely been of interest for the researchers. That is what this thesis aims at, bridging that gap through a qualitative research and analyzing it from a behavioral finance perspective. This attracted the author and together with a personal interest in the financial industry provided a great opportunity for research and new knowledge.

Behavioral finance is a relatively new area of research and it is if not in its infancy still regarded as new in the academic world. Thus there is not as extensive research done in all areas of finance as there is with classical financial theories. The function of mutual funds is an interest that is widespread and often mentioned in the news. It is important to be aware and updated on what is happening in the area, something that following the news provides. However is it important to stay as objective as possible and always be critical to what is being said and written, something that the author has been throughout this thesis. Deeper understanding for the research process has been gained with lectures in research methodology. The reasoning of writing the thesis in English is practical and it reaches a wider audience. Almost all of the literature is written in English, less of a chance that there will be a misunderstanding in translation.

**3.2 Perspective**

The purpose with this thesis is to study mutual fund managers based on a behavioral finance perspective. Since behavioral finance is assembled of a variety of theories, the topic of interest can be attacked in a number of different ways. In order to be able to do that it is necessary to have a broad background research. The perspective of the thesis is important for the result and how it is interpreted in the analytical section. Nevertheless the author of this thesis argues that it is impossible to cover every angle of the problem. However, the secondary data provide both the reader and the researcher a quantitative and qualitative background to the problem that will be answered in the interviews. The complexity of the research problem and the time constrain forces the author to have a perspective and to exclude the non-professional side of the mutual fund industry and
hence concentrate on the professionals. This insider perspective will allow the researcher
to gain a better understanding of the behavior and decision making of fund managers. However this will be on the expense of the individual investor side.

The decision to cover a number of different institutions and their fund managers instead of focusing on one large institution is taken because of the cultures within the firms. This thesis is not aiming at finding results that are generalizable. Nevertheless is the reason for having several fund managers from different companies made in order to find different styles and objectives. There is a risk that fund managers within a fund-family have the same way of thinking and thereby providing similar answers.

One needs to be aware of the risk when choosing a perspective. Eliasson-Lappalainen argues that the perspective of the author leads to conscious and unconscious decisions. This could further lead to threatening of the objectivity. Important is that both the reader and especially the researcher is aware of these perspectives throughout the entire thesis. If the perspective is not enclosed to the reader there is a big risk that the research will be biased (Eliasson-Lappalainen, 1995, pp.27-29). The author has throughout the process of the thesis tried to be as objective and open minded to the problem areas as possible and continuously questioned what has been said and written.

### 3.3 Preconceptions

This section will introduce the author, what his experiences consists of and how this possibly could lead the thesis into different directions. The emphasis will be at the educational background since this is the underlying reason for the choice of topic regarding a behavioral finance perspective of mutual funds, an area that the author still is developing knowledge about.

Because of the importance of preconceptions, it is the authors’ intention to make the reader valuate the objectivity of what is written. The authors’ educational background has taken place in Umeå, Aberdeen, New York, Taiwan and Oslo. This has been completed with working experience in Brussels, Oslo and several places in Sweden. The theoretical preconception in finance has mostly been acquired from the time at the university. The interest of finance and in particular behavioral finance has grown since the first finance course within the International Business Program (IBP). Studying abroad has given the author deeper understanding of important concepts, and a bigger grasp of the importance of the different financial markets.

### 3.4 Scientific Approach

The underlying philosophy is important to be aware of in order to gain and develop knowledge. Saunders et al. argue that for us to be able to understand the reality we are living in the research method is crucial. To be able to answer the questions stated in the problem statement, it is necessary not only to know your own philosophy, but also to be aware of other. With awareness will our own choice of philosophy come naturally and we will be better prepared to answer our problem statement and generate new knowledge. Within the school of research philosophy, ontology and epistemology stands out (Saunders et al. 2009, p.109).
Ontology is defined as the concept regarding the nature of reality and how a person views the reality (see for example Bryman and Bell, 2007, p.25 and Saunders et al. 2009, p.109). The authors’ view of the reality is that the objects of interest are social constructions that can change and be interpreted differently. Epistemology can almost be seen as a succession of ontology and is defined as the concern of what can be regarded as knowledge (Johansson-Lindfors, 1993, p.37). The aim of this study is not to find one truth, which is generalizable. Because of that, there is a need to understand that all the respondents do not perceive the world the same way. Johansson Lindfors (1993, pp.77-79) argues that there are only two main schools within epistemology, positivism and hermeneutics. Because of the difficulties to quantify the results from the empirical part will an interpretive view be used instead as it is more appropriate for the behavioral finance subject. Behavioral finance has a greater deal of interpretation than classical financial theories that is closely tied to positivism.

Both Saunders et al. (2009, p.119) and Bryman and Bell (2007, p.111) highlights the importance for researchers of being aware of the difference between individuals and their different roles in the society as actors. This could mean that in order to form new phenomena’s there is a need to “get the bigger picture”. Qualitative researchers often possess an interpretative view, where the understanding of the bigger society needs to be meet in order to understand the smaller parts. This study will have an interpretavistic approach, as it will try to answer the problem statement and as the objective of the study is not to verify an exact truth. The authors’ own argument is that there are several truths and not one absolute truth in this case. Interpretetivism has less constrains and has been more widely used in social science because of its not so precise claims of causation (Bryman and Bell, 2007, p.17). Instead does the interpreter rely more on individual interpretation of fact, an open mind and a systematic approach to analyze. Nevertheless there is a certain risk, for researcher biases, even if a systematic approach and open mind is used. The interpreter does therefore often have to give up the idea of generalizing the results and only get a “snapshot” at the investigated topic. The advantage of the interpretavistic approach is therefore the possibility to research areas where natural science cannot go (Arksey & Knight, 1999, p.13). Criticism towards the interpretavistic approach is that it lacks strong statistical tools and that is not as controlled or rigor (Bryman and Bell, 2007, p.19-20). However has this been contradicted by Denscombe (2007, p.312-313) who means that by imposing strict systematic research approach it is possible to maintain a rigor study. For this thesis wills no statistical tools be used instead the data will be interpreted with the help of the theoretical framework. Because of the underlying reason of determining and finding behavioral aspects is a interpretavistic approach more suitable.

This study will have a hermeneutic approach, meaning that the data production and data analysis will be made from the authors’ perspective and to a certain degree interpretation. That means that the author will derive understanding from the narrator. This can be further explained in the figure below, where the starting point is in the literature and the knowledge is increasing with more information (Alvesson & Sköldberg, 2008, p.212). Knowledge will be built upon knowledge, and a deeper understanding of the subject that is researched will be reached. The hermeneutic spiral shows that knowledge regarding
this subject will be illusive and not be settled. Interpretation of the theories and interviews will continuously develop the knowledge of the researched subject.

Figure 3: Hermeneutic Spiral (Eriksson and Wiedersheim-Paul, 1997, p.231)

3.5 Research Approach
Neither one of the two main research approaches, deductive nor inductive research method will be used in this thesis, because of the nature of the research, however does it resemble a deductive research approach. Deductive research method is more of a top-down approach with a start in the theory that leads to a hypothesis followed by observation and ending up with confirmation or rejection of the hypotheses. The inductive approach could almost be seen as the opposite to deductive with a bottom-up approach. There is a third school, abduction. Abduction is a combination of inductive and deductive. It resembles more of a deductive approach where the similarities in the extent of research (Kirkeby, 1994, pp.122-123).

The abductive approach starts with the basic research in theories, continues in this study with formulation of interview questions and will throughout the thesis research theories. Kirkeby (1994, pp.122-123) means that abductive approach is ideally in investigating the relationship between concepts within areas where little research has been done, something that is appropriate for this thesis. That means that the theoretical framework is not constant and will throughout the process be built upon. Another argument for the use of abduction instead of both deduction and induction is the possibility of it yielding more. This can be because of a wider possibility of taking advantage of the empirical world and the systemic character of the theories (Dubois & Gadde 2002, p.553). When constructing a abductive study there could be a need for the researcher to clearly differentiate the initial theories with the later ones. This thesis author has with the reader in mind tried to incorporate the new theories and studies into the pre existing theoretical framework. This has been done in order for the reader to understand the concepts of behavioral finance and the function that it plays for the mutual fund manager. The abductive approach has not pleased everybody and among the carpers is Johansson Lindfors (1993, p.55) that argues that important information in relation to the empirical data could be lost. The author has tried to cope with this problem by having an open mind, be aware of the problem and treat the empirical data cautiously.
3.6 Choice of Method
Qualitative and quantitative research strategies are the two main approaches used in academic studies. The research question should guide the researcher to select the more appropriate of the two. For this study a qualitative research method has been used, because of the nature of the problem. Simplified, the difference between qualitative and quantitative research method can be found in the measuring. A quantitative study measures the results while a qualitative study does not and put greater emphasis on interpreting the results (Bryman & Bell, 2007, p.28). This study will use behavioral finance theories and interpret interviews in order to generate knowledge. Because of this would a quantitative method not be perfect. The qualitative research method is better suited for problems where the solution not always can be quantified, as the problem of this thesis.

There are a few drawbacks the researcher needs to be aware of when using a qualitative research method (Bryman & Bell, 2003, pp.298-301). The difficulty of replicating a qualitative study is often due to the respondents selected. Other respondent’s would most likely lead to different results. The author needs to be aware of this and can thus not generalize the results. The object for this thesis has never been to generate results that are generalizable to a bigger group. Subjectivity is another problem that has been dealt with by not asking leading questions to the respondents and giving them the possibility to freely speak around the questions. These precautionary actions have eliminated some of the drawbacks that are related to the qualitative method, however the reader should be aware of these problems and that they have to the furthest extent been dealt with in order to give the thesis higher credibility.

The qualitative research method can take different forms. For this thesis has semi-structured interviews been used with the nature of the problem as the base of the decision. Semi-structured interviews have its advantage that follow up questions can be asked and new angles to attack the problem can be found. This study’s problem would not have benefitted by implementing a stricter interview style, as the need to follow up and go deeper into the topic is necessary. The interview guide (see Appendix 1 & 2) was constructed to help the interviewer to be structured and focused. The questions were not always asked in the same order as the discussion often lead in different directions. There are other forms of interviews except for the semi-structured interview and the result can differ between them. However the semi-structured interview works well in situations like this where the research problem is unique and the knowledge is limited (Bryman & Bell, 2007, pp.212-213). A stricter kind of interview where follow up questions not are allowed, would probably give less of a depth and understanding for the behavioral aspects of the mutual funds.

3.7 Research Design
We have now determined the epistemological approach that this thesis will have and can continue by investigating which research design is most appropriate for this kind of study. The research approach shows the direction the study will take. This study will use the most appropriate research design with the problem statement in mind as well as the time constraint. Easterby-Smith et al. (2002, pp.43-52) presents different choices when
facing different research approaches. They describe different choices between positivist and social construction.

Table 3.1: Key Choices of Research Design. Source Easterby-Smith et al. (2002, p.43)

<table>
<thead>
<tr>
<th>Researcher is independent</th>
<th>vs.</th>
<th>Researcher Involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Samples</td>
<td>vs.</td>
<td>Small Numbers</td>
</tr>
<tr>
<td>Testing Theories</td>
<td>vs.</td>
<td>Generating Theory</td>
</tr>
<tr>
<td>Experimental Design</td>
<td>vs.</td>
<td>Fieldwork Methods</td>
</tr>
<tr>
<td>Universal Theory</td>
<td>vs.</td>
<td>Local Knowledge</td>
</tr>
</tbody>
</table>

The table above presents the different choices a researcher is facing when selecting research approach. The nature of this thesis is to investigate, and interpret empirical material with the help of behavioral finance theories. This research will be involved in the process, something that will occur in the interviews, where involvement is necessary. This is chosen for the reason that the problem that will be researched is not static. The second choice of design comes in the form of the samples. Here is time constraint leading and because of the nature of the problem area, a small sample is chosen. Next step is whether theory or empirical data should come first. For this thesis the theories come before any empirical data. This is in order to adequately design questions for the respondents. The thesis will have more of fieldworks methods with the help of the interviews’. This approach generally allows the researcher to get a more detailed understanding of the topic compared to its counterpart. The last set of approaches is regarding whether the findings of the research have universal validity or not. In a positivist study would there be a requirement for the study to have universal theory. However, this study has as previously described a hermeneutic approach and thus not aspires for universal theory or generalizations.

3.8 Primary Sources
A primary source is defined as the reason for researchers to provide an objective examination of the area studied. A primary source is for instance an original document of scientific articles (Holme & Solvang, 1997, pp.131-132). In this study will the interviews be the primary sources. There has to be a clear and thorough understanding for what relationship the respondent has to the area of research. This will be established when the time of the interview is set. A source can be both first and secondary depending on how it is used. Several authors have stressed the importance of analyzing the origin of the source (see for example Holme and Solvang, 1997:130-132).

The author agrees with Trost (1993, p.73) where he argues that it is of great importance for the conductor of the interviews to have a certain level of knowledge within the subject before the actual interviews. This is elementary in the construction of question and also to be able to respond accurately to the respondent and thereby get a deeper understanding within the research area as well as widening the concept. There have been precautionary
actions taken for this with relevant literature review and by staying updated with the financial news. The interviews were semi-structured where an interview guide was followed and follow up questions were allowed. Bryman and Bell (2007, p.213) argues that the semi structured form of interview is to prefer in situations where the topic in question is relatively new and relevant follow up questions are necessary in order to get a deeper understanding. Semi-structured interview form is suitable for this thesis, where the answers were interpreted and analyzed from a behavioral finance perspective.

3.8.1 Selection of respondents

The selection of respondents within the fund industry in the Swedish market was semi-structurally made. The first respondent was selected due to familiarity and could to a certain extent be seen as a pilot interview. The result was satisfying and thereby included in the study. For other respondents were an initial tailor made e-mail sent out stating the purpose of the study and asking for their participation in a 30-45 minutes long interview. The e-mails further stated why they were of interest for the study and that it could be held either via telephone or face to face. Because of a rather low “hit rate” for other students using the same method, a tailor made e-mail were sent out with different reasons for why they were interesting for this particular study. The table on the next page gives a brief overview of the respondents.

In the first phase twelve e-mails were sent out and there was an immediate response from ten of them, where four declined and six agreed upon being interviewed. The sampling method used was a convenience sampling (Trost, 1993, pp.106-108) mixed with snowball sampling method where the respondents recommended others (Bryman & Bell, 2007, p.200). The respondents were at the end of the interview asked of whether they could recommend someone that did not work at the same organization. This yielded another four fund managers that were included in the study. For the fund managers that declined to participate in the study the influence is non-existing. The non-existing respondents could have led the thesis in another direction with their information. The non-existing respondents were replaced and the thesis did not suffer fewer interviews because of this. The most popular reason for not taking part in the interview was due to time constraint. All of the respondents were asked whether they wanted to familiar themselves with the questions before the interview. Only three out of ten expressed a wish to see the questions before the actual time of the interview. The view of the author is that this should not affect the result, however the reader should be aware of it.

The author hoped for a better diverse group of analysts when it comes to gender. However is the ratio according to the female respondent of the thesis, Julia, close to nine out of ten men and this study is thereby covering the approximate ratio of female/male in the mutual fund industry.
Table 3.2: Overview of Interviews

<table>
<thead>
<tr>
<th>Code Name</th>
<th>Fund Family Size</th>
<th>Position</th>
<th>Established Contact</th>
<th>Q's Before Interview</th>
<th>Date</th>
<th>Location</th>
<th>Length</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adam</td>
<td>Small</td>
<td>Fund Manager</td>
<td>E-mail and telephone.</td>
<td>No</td>
<td>5-Nov-10</td>
<td>In a café</td>
<td>38</td>
</tr>
<tr>
<td>Bertil</td>
<td>Small</td>
<td>Fund Manager</td>
<td>E-mail</td>
<td>No</td>
<td>12-Nov-10</td>
<td>Telephone</td>
<td>37</td>
</tr>
<tr>
<td>Cesar</td>
<td>Medium</td>
<td>Fund Manager</td>
<td>Recommended by Adam. First contact via telephone</td>
<td>Yes</td>
<td>15-Nov-10</td>
<td>Telephone</td>
<td>31</td>
</tr>
<tr>
<td>David</td>
<td>Small</td>
<td>Fund Director</td>
<td>Recommended by Bertil. First contact via telephone</td>
<td>No</td>
<td>17-Nov-10</td>
<td>His Office</td>
<td>27</td>
</tr>
<tr>
<td>Erik</td>
<td>Medium</td>
<td>Fund Director</td>
<td>E-mail</td>
<td>Yes</td>
<td>24-Nov-10</td>
<td>Telephone</td>
<td>33</td>
</tr>
<tr>
<td>Filip</td>
<td>Large</td>
<td>Fund Director</td>
<td>E-mail and telephone</td>
<td>Yes</td>
<td>25-Nov-10</td>
<td>Telephone</td>
<td>31</td>
</tr>
<tr>
<td>Gustaf</td>
<td>Large</td>
<td>Fund Manager</td>
<td>E-mail</td>
<td>No</td>
<td>29-Nov-10</td>
<td>Telephone</td>
<td>30</td>
</tr>
<tr>
<td>Helge</td>
<td>Small</td>
<td>Fund Manager</td>
<td>E-mail</td>
<td>No</td>
<td>2-Dec-10</td>
<td>His Office</td>
<td>40</td>
</tr>
<tr>
<td>Ivar</td>
<td>Large</td>
<td>Fund Manager</td>
<td>Recommended by Erik. First contact via telephone</td>
<td>No</td>
<td>9-Dec-10</td>
<td>His Office</td>
<td>34</td>
</tr>
<tr>
<td>Julia</td>
<td>Large</td>
<td>Fund Manager</td>
<td>Recommended by Gustaf. First contact via telephone</td>
<td>No</td>
<td>13-Dec-10</td>
<td>Telephone</td>
<td>35</td>
</tr>
</tbody>
</table>
The respondents come from a wide array of funds. Both the technical and the fundamental side are represented. There is a wide spread of age and the number of years they have been active as fund managers, something that provides more angles and diversified results. All the respondents were asked if they wanted a hard copy of the thesis after completion. The first interviewee asked for anonymity and this was granted. This could mean that the thesis lack power, however the argument could be made from the opposite perspective. Anonymity could give more truthful answers. The respondents were coded after the order of interview with A as in Adam first.

3.8.2 Conduction of Interviews
The interviews were conducted between November 5, 2010 and December 13, 2010. The respondent had the opportunity to choose between face-to-face interviews or via telephone. The advantage with doing the interviews face-to-face is that the researcher has the possibility to interpret the body language and see the reactions. The non-verbal reactions are not possible to get via telephone (Holme & Solvang, 1997, pp.104-106). Preferable would be to conduct all interviews face-to-face, however a majority of the respondents preferred to do the interviews via telephone. Table 2 provides the reader with the certain method that has been used. The loss of non-verbal reactions due to interview via telephone has been taken into consideration and dealt with in the corresponding transcripts where the respondents had the possibility to add emphasis on the different subjects.

All the interviews started with introduction of the interviewer and what the purpose of the thesis was. It further included small talk in order for the respondent to feel secure and to ensure a more relaxed atmosphere. Kvale (1997, pp.13-14) means that the interviewer should be in control of the interview however is it of great importance that the respondent knows what is going on and for what reason. The interviews that were conducted face-to-face were tape-recorded and the telephone interviews were recorded with the help of Skype. Three of the respondents asked specifically for not being recorded and their interviews were transcribed with the help of extensive notes from the interview. Recording the interviews helped the author to concentrate on what was being said and to get a deeper discussion. For the interviews where notes were taken there is a risk that important information were lost, however has the precautionary actions of taking notes minimized the loss. Bryman and Bell (2007, pp.489-490) argues that interviews that are recorded could possible lead to situations where the respondent feels insecure and thus not answer the questions in a satisfactory way, however was this from the interviewers perspective never felt.

The interviews followed the same pattern, nevertheless the questions were not always asked in the same way as the previous answers often were taken into considerations. The interview guide was divided into six topic themes (see table 3.3) that were touched upon in all interviews. As more information was gathered a need to ask follow up questions to the first respondents was necessary, something that was done via e-mail.
### Table 3: Brief Interview Guide

<table>
<thead>
<tr>
<th>Topic</th>
<th>Type of Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>Background</td>
<td>Age, education &amp; own skills</td>
</tr>
<tr>
<td>Mode of Operation</td>
<td>Briefly describe your way of working</td>
</tr>
<tr>
<td>Practical theories</td>
<td>What is your view of EMH?</td>
</tr>
<tr>
<td>Managerial Objectives</td>
<td>Does a bigger bonus change your way of working?</td>
</tr>
<tr>
<td>Financial Crisis</td>
<td>What blame do the MF managers have?</td>
</tr>
<tr>
<td>Future</td>
<td>What will the importance of mutual funds be?</td>
</tr>
</tbody>
</table>

In the background section one quantified question was asked, where the respondent would grade themselves on a scale of 1-5 where 5 is the best, based on how good he or she perceives themselves in what they are doing. The result from this question will help understanding the importance of overconfidence. The scale 1-5 was used because of its simplicity and to allow the respondents to position themselves in the middle.

### 3.8.3 Transcription and Translation

When the interviews were done, the work task of transcribing the interviews started. The goal was to provide the respondent the transcribed form of the interview within 24 hours. This was done in order for the respondent to remember what had been said and clarify if anything was misunderstood. The transcription of one interview was completed before the next interview was done. Bryman and Bell (2007, pp.489-491) argues that transcribing also helps the researcher to back up his argument and use quotes. The respondents were given the possibility of viewing the transcription in either Swedish or English. The transcripts were translated after approval from the respondents. The quotes are almost exact translations word by word, minor changes had to be made for grammatical reasons. The other parts of the empirical results have been translated and cut with the reader in mind. The author has done the translation.

### 3.9 Criticism of Primary Sources

Saunders et al. (2009, p.272) stresses the importance of having a critical approach, both towards the primary and secondary sources. That includes making sure that the sources make it possible to fulfill the objective of the research and thereby answer the research questions. To have a critical approach gives the study a better credibility.

#### 3.9.1 Interviewer and Interviewee bias

This has by Saunders et al. (2009, pp.326-327) been described as where the interviewer or respondent through comments, non-verbal communication and similar affects the counterpart to answer the question in a certain way. This could possibly be where the authors’ own belief is interpreted into the question. This could arise in situations where either part has a preeminent knowledge within the area. The author has tried to be as neutral as possible during the interviews and let the respondent answer the question before moving on.
3.9.2 Misinterpretation
There are as many stories as there are people. That means that situations and conversations are always given different meaning to individuals. Interviews are no different and in order to avoid misunderstandings of what is communicated it is important that the interviewer and respondent have mutual understanding of what has been said. These mutual understandings can be achieved by confirming what has been discussed with the help of transcribing the interview and confirm the substance with the respondent. During the interviews, the respondents were offered a better explanation of the question if they did not understand it correctly. There is a risk that the fund managers did not understand the questions and answered in a different way than they would have if explained differently. However one of the advantages with letting the respondent read the transcript is to avoid misunderstandings like these.

3.10 Analytical Framework
In the empirical part will interview by interview be presented. This is done with the reader in mind since it makes it easier to follow. The nature of the analysis is that it first is analyzed by itself, to see what could have been done differently during the interview from the authors’ perspective and to analyze what actually was said. The second step was to analyze what was being said and the implication of it and the last step to compare the different interviews with each other and the theoretical framework to get a comprehensive understanding of the mutual fund industry. The analysis has been done from a classical finance and behavioral finance perspective and divided into the different topics. This was done in order make it easier to understand and for future studies to replicate the procedure.

3.11 Secondary Sources
Both qualitative and quantitative data can be considered as secondary sources. Secondary sources in literature are sources that have already been published in primary sources. The advantage with secondary sources is that it is often easier and cheaper to locate (Zikmund, 2003, pp.136-137). The goal of this section is to describe the literature search and provide a better transparency for future replication of this particular part. In this thesis has secondary data been collected from a variety of sources.

There are according to Holme and Solvang (1997, pp.130-137) four different levels that sources need to go through, origin, interpretation, usability and observation. For this thesis all four steps has been considered. The origin is of great importance for the reliability and the relation to other sources. Peer-reviewed sources have to the furthest extent been used. The observation step is concerning where the information has been gathered, something that in this case has occurred at a number of different and well established libraries and their databases. The usability refers to how well the data covers what is being researched. This has for this study been dealt with in mainly two different ways, first by investigating where else the study has been cited and secondly by critically reviewing the procreation. The last step is the interpretation phase, in under what environment previous research has been done. These four phases has all been used in order to increase the trustworthiness of this study.
3.11.1 Information Search
Finding the references for the theoretical framework is an ongoing process throughout this thesis. Internet has been a great source and provided information to a wider audience. However it has to some extent meant that much of the time has been dedicated to searching for something that does not seem to exist. A disadvantage with the secondary sources is that they are not specific to the thesis purpose. Because of it is useful for the reader to be aware of how the information search has been conducted.

Databases such as, Google Scholar, Google Search, Business Source Premier, Emerald Fulltext, Web of Science, Google Books and Album that is provided by Umeå University among others have been used. Besides the previously mentioned has old thesis, dissertations, news articles, and books been practiced. The words in italic below provide the array of the most common words that has been used in the information search.

*Behavioral finance, efficient markets, modern portfolio theory, mutual funds, equity funds, portfolio manager, ETF, financial crisis, bubbles, Sweden, methodology, ontology, epistemological, research approach, abduction,*

Most of these words have been used both alone and in combination with each other. Both English and Swedish words have been used in order to gain the best results. The authors’ own knowledge in the subject before starting the thesis made the information process smoother. The number of hits with Sweden or in Swedish was far less than without. Because of that, it was challenging to find relevant articles and most of the process has been a piece-by-piece puzzle to develop knowledge for the thesis topic. Reference lists of other secondary sources have been used in order to locate supportive articles for the theoretical framework. When researching the different respondents and their companies, Internet has exclusively been used.

3.11.2 Criticism Towards Secondary Data
To make a comprehensive literature review is essential in order to be confident that the literature gives relevant information for the right purpose (Saunders, et al. 2009, pp.69-71). A problem with the secondary sources was that a majority of the studies were made in the U.S. and the applicability to this thesis should not be seen as perfect. Most of the financial research is done in the U.S. and that further entails studies to be carried out in Sweden.

As discussed in the introduction and presented in the theoretical framework has the utter most part of the secondary sources a quantitative approach to their research problem. In many of the secondary sources the initial problem question has been answered with the help of statistical or econometric tools. Nevertheless, they often fail to answer why their investigated evidence behaves in a certain way. The lack of similar studies carried out in a qualitative way made the literature search a tad more difficult. The lack of discussion that naturally arises when writing alone was dealt with by searching more literature. This feedback process should not be compared to having a partner to write with, however it has worked satisfactory.

When searching for relevant literature, published journals and magazines have been preferred. Among the most reliable are:
In order to present the latest research in the area has some unpublished and seminal work papers been included. These could be considered questionable because of its young nature. Nevertheless, most of them come from well-established universities as Harvard Business School, University of Southern California and Yale.

An overwhelming part of the articles and books used for theoretical framework has undergone peer-reviews. A few seminal papers by well renowned professors have been used for highlighting the topicality. In the introduction was information from Fondbolagen (2010) used as well as news article published in New York Times (2009) and Wall Street Journal (2008) for illustrative purpose and to highlight the topicality.

The literature that covers the methodology chapter is considered reliable because of its use as course literature as well as the great number of citations that most of them have. In this section have famous and reliable publishing companies such as Thomson, Wiley-Blackwell, Oxford University Press, Studentlitteratur, etc. been used. Behavioral finance is as pointed out earlier a relatively new area within finance. Nevertheless should the sources be considered trustworthy partly because of its peer-review and that it has a high degree of recognition. Traditional financial theories, for example Markowitz and Keynes, have been around for a long time and are today considered cornerstones within finance. Their contemporaneity is still of great meaning. Some of the newer literature has not been under as rigor investigation, however are they of importance to show what the latest mutual fund research has showed.

### 3.12 Truth Criteria’s

There are a number of different factors that can affect the researcher and the conclusions drawn from the empirical results. This chapter aims at providing the reader with a thorough discussion of the reliability and validity that connects the theoretical framework and the empirical results.

#### 3.12.1 Reliability

Reliability is regarding the subject of consistency of what is being measured (Bryman & Bell, 2007, pp.162-163). This thesis has used semi-structured interviews as data collection method something that according to Denscombe (2007, p.203) is more difficult to rely on. The reason for this is that the answers given by the respondents can be subjective and lack consistency. While Denscombe argues that semi-structured interviews are lacking reliability, Kvale (1997, p.213) is of another view. He means that the interviewer can strengthen the reliability in the research substantially by avoiding leading questions and by ensuring that the transcripts are correct. Throughout the ten interview sessions has the goal been to ask non leading questions. To ensure that the transcripts have been satisfying they have been transcribed and sent out to the respondents for inspection within 24 hours of the interview. This has been done in order to create a high reliability and to ensure that the respondent have the interview fresh in mind.
In this thesis there have been certain patterns that have evolved around the subjects of interest. This does not necessarily mean that the reliability is high, however it indicates consistency. The respondents were all well educated within the subject of interest something that gives reliability to the data collected. There are always things that can be done differently in order to ensure a higher grade of reliability. For this thesis more interviews could have been conducted or the respondents could have been chosen more carefully. Other things that could have ensured a higher quality of reliability are that all interviews would have been performed in a personal meeting that could have given different answers. Nevertheless, precautionary actions were taken to make sure that as reliable results as possible were gained. More interviews could have lead to a different result, however did the output from the last interviews give less than the first, something that can be interpreted as saturation.

Saunders et al. (2009, pp.156-157) argues that there are four different threats to reliability: subject error, participant bias, observer error and observer bias. Subject error can as previously described be diminished with neutral questions. Participant bias is when the respondent answers what he thinks is expected from him and not his actual view of the subject. There is a risk that this happened at some questions, however were no questions perceived as sensitive. The anonymity of participating in this study made it easy to speak for the respondents from their perspective. Following an interview guide and conducting the interviews alone have eliminated observer error. The last threat to reliability, observer bias is the problem of interpreting what has been said differently. This has been dealt with clarification during the interviews and that the respondents could change what they had said when they received the transcript. Other precautionary actions that were taken in order to ensure the reliability of the thesis include being neutral to the subject and presenting the idea for the thesis before the interview started. The interviews started with giving the respondents the opportunity to speak about themselves and make them feel comfortable.

3.12.2 Validity

Validity is by Saunders et al. (2009, p.157) described as the function of whether a study’s finding is what it intends to be. Kvale (1997, p.215) argues that validity in qualitative studies can be valid if they measure what is of interest. Denscombe, (2007, p.202) mean that one of the strengths with qualitative studies is that the validity is often very high because of the nature of the research. This would especially be true in the interviews that were constructed face-to-face. The result from the interviews via telephone was similar to the results from the face-to-face meetings and no significant difference was seen.

The respondents were for this thesis selected for different reasons. To ensure that they had the qualifications a simpler background check was done. For the four respondents that were recommended by other fund managers no background check was made, in this case it easy to assume that they would meet the requirements. The author was alone during the entire process and the result from interpreting the interviews could have been different if another person would have been present. Bryman and Bell (2007, p.168) explains that a study can be reliable and not valid. However it cannot be valid and unreliable. The interview guide has been revised constantly to ensure that the questions measure what they intend to. There is a chance that the respondents misunderstood the
questions that were asked and answered differently than they would. Action were taken against this, however is a possibility that an error occurred. The respondents did all approve of their transcripts that were sent out with minor changes to a few where the respondents asked for clarification. The conclusion from this is that the interview questions were valid and measured what they intended to.

3.13 Summary of Methodology
In order to answer the problem questions the author has used the following architecture:

- Information search and selection of theories
- Selection of respondents and construction of interview questions.
- First interviews and ongoing process of literature research and designing interview questions.
- Continue with interviews and follow up new areas with previous respondents.
- Complete interviews and theoretical research.
- Analyze respondents answers in relation to the theoretical framework
- Discuss and conclude
4. Empirical Data
The result of the ten interviews will be presented in this section of the thesis. The respondents will be presented in the same order as they were interviewed, with the first one being presented first. The reasoning behind this is to for the reader to understand the development throughout the thesis.

4.1 “Adam”

4.1.1 Background
Adam has worked within the financial industry for more than 30 years and is currently setting up a new fund that aims at attracting the interest of the premium pension savers. He has held a number of various positions at different fund companies. Most of his experience has been in the Swedish market. Adam would consider himself as a 4 on a scale from 1-5 of how he skilled he is. His educational background is limited within finance, something that he consider him selves unique with.

In his new fund he works together with one partner and the two of them will decide upon different investment opportunities. He has worked with both monetary incentive schemes as well as monthly salary and the new fund will have a mixed payment scheme.

4.1.2 Mode of Operation
The work task of a fund manager as Adam, specialized in the Swedish market, is to go out and meet the people and companies. This is the biggest difference from the “all world” fund managers that needs to rely on their sources and information. This advantage is according to him, not comparable to anything else. A large investment universe requires much more of your personnel and the downside with that is not only that you need to rely on secondary sources, often incurs a higher fee to cover the costs. Often are the companies they invest in cyclical and that narrows it to only a very few that are interesting.

“We are looking at companies that are interesting for a longer time horizon of 5-7 years and companies that have a solid product and not just the flavor of the month.”

On the question of how investment opportunities arise Adam provides a number of sources; through friends, social gatherings or tipped off by a third party. At other times the company in question approaches the fund directly and present what they do. With experience you will learn how to differentiate tip from each other and be able to screen more efficient, Adam says. He further explains that when he began working every tip was interesting and worth investing in. He has noted that with age fewer companies become interesting. What is important when making the actual investment decisions is to believe in them and follow up on them. It is impossible to follow every interest you have, with every interesting company will maybe three or four competitors follow and you need to be aware of them as well, according to Adam.
The most important for Adam when deciding upon what to invest in are the people that work in the company and that he has the opportunity to talk with them. Smaller companies are often more attractive because of their tendencies to be less aware of their possibilities. Often it is easy just to make research of a company online and see how many languages they offer their homepage in. The bigger and more international a company gets, the harder it is to find the small facets that they are looking for. The downside here is that diversification for an all Swedish fund or Nordic is far from well diversified something that often needs to be explained.

This poor diversification is a bit special since Adam is working for a small fund and cannot offer more diversified funds like Robur or SEB. Adam tells that his core competence is in the Nordic markets, especially Sweden; diversification is something that is secondary. Still there is a need to cope with the rules that funds are tied up to, for instance can they only invest 10% in one company so there is some diversification there.

A problem with large funds is that decision often takes longer time. The fund Adam currently is working on, it will more or less be instantly. For larger funds it often takes more time and effort to diversify, while for smaller funds smaller allocations happen faster, says Adam.

Adam found the question of whether a good or poor start interesting. He develops further:

“First there is a need to define what is poor? Is it compared to OMX30 or is compared to World MSCI or maybe your competitors? When you have an appropriate benchmark you can move on. You always need to believe in the way you are doing your investing. Even if it is possible to suddenly change your way and take another approach you will probably lose some of your investors.”

Adam has seen fund managers that are so afraid of being in the bottom of the lists that they start investing without any thoughts behind it. A good start makes Adam more comfortable and relaxed. He does not know it affects his trading, with success there is a risk that you actually do more trading because of the self-esteem you have from the previous trades. There is a risk in both extremes and as always you need to be aware of how you are coping in these situations, which is key for any fund manager he explains. One common mistake that makes several smaller funds loose and eventually drops out is that they do not maintain their trading strategy.

4.1.3 Managerial Objectives
Adam has as previously described worked under different payment schemes. On the question of whether a bigger bonus or salary would change his way of working Adam answers that it would perhaps make him work more if that is expected. Although he does not believe that more money would make him do a better job. Investment opportunities are not dependent on how much money he makes. Adam doubts that a bigger salary would make him find more companies that are worth investing in.

Adam says that when he was in his mid 20’s a bigger bonus would matter and make him work harder, without a doubt. Now at his age he is not so sure. Adam has seen newly
graduated that are working around the clock just to be able to get that bonus. Whether it means better return for the fund they are working for he is not sure. Adam hopes that harder work leads to better results and more accurate forecast of the companies. What it definitely enables is that you will gain a better understanding for the industry in general and can better follow the competitors.

4.1.4 Practical Theories
Adam finds the question of Efficient Market Hypotheses (EMH) amusing and asks sarcastically if there is any academic paper without Fama and his EMH? Adam’s take is that EMH and random walk is present, largely because there is a big group of uninformed investors that takes opposite trades. There in no way of getting all the decision correct. He likes to compare it to sports betting. In sports betting feelings are often attached to different bets. Investment is similar. People have a feeling towards a company and do not always think rationally. What a mutual fund manager needs to do in those cases is to be aware, always be aware of why things are happening. Then there are times when it does not matter how much information you have, like 9/11 for instance and in those situations you need be able to cope with the result.

“Yes, EMH is to some extent present but I would not be where I am today if it was not for some skills. Luck is not everything.”

On the question whether he attributes some of his skills to luck the answer is that he does and also that you need to remember for what reason you trade. If the reason is because you believe in a product like the Iphone for instance and the product fails but the company stills make profit because of their computers than you need to be humble enough to admit you are wrong and made a bad analyzes, even if the outcome is good.

“My experience is that fund managers are in general bad at contributing success to luck, but keen on telling the world when they are correct. Nevertheless I think that this is a human thing and that it is not unique for the financial industry.”

The function of Markowitz Portfolio Theory (MPT) is according to Adam not present when he constructs a fund. The concept of MPT is great, but he knows of no one that actually tries to use it. Adam thinks that MPT is a great example of how it should be but when you actually see how it is, it is more or less impossible to use it.

4.1.5 The Financial Crisis
Adam explains that a financial crisis like the recent one often works as a wake-up call and is necessary for everyone in the industry. His way of working does not change because there is a bear market. He does admit that it becomes more difficult during these periods. The reason for that is that there is less activity. Large institutional investors are not keen on selling their assets with a great loss and prefer to wait for a bounce back.

Adam does not feel like pointing finger at anyone and repeats that it was a need for a wake-up call and that everyone needs to realize what was wrong and prevent it from happening again. He does however admit that there are some institutional lenders and governmental departments both in Sweden and abroad that have to ask themselves what
just happened. Adam adds that each crisis often means more regulation for the funds and he argues that is not always beneficial for the buyer of the fund.

“There is a need for more transparency in the financial industry, just as there is in other areas as well, like politics. But, people need to know that transparency will not solve all the problems. There are other, bigger, problem that needs to be solved as well.”

Adam mentions regulation that is tied to the fund industry needs to be loosened and that politicians in leading positions should have the competence at least equivalent of the fund industry. He argues that it is not the case.

4.1.6 Future
Adam believes that there is a need for actively managed funds. However an active fund should, in order to maintain the seriousness of the business, offer a return that outperforms its benchmark by 50%. That means if the benchmark has an annual return of 6% the fund should have a return of 9% or better. Another reason for why there is a need for actively managed funds is liquidity. Without the trading that takes place in the funds around the globe the idea of EMH would be true, that everyone would hold a portfolio and keep it that way. However will there never be a situation like this since there will always be people that are willing to take a chance and people have contrarian view. Often people overlook this area and take it for common, but imagine how low the liquidity would be without the funds trading.

When comparing exchange-traded funds (ETF) with actively managed funds is Adam’s experience that ETF’s or index funds are boring. Investors do not want to follow an index, when you can do better than your neighbor. Keeping up with the Joneses should never be underestimated, Adam argues. Another problem with ETF’s has often been that the balance is often skewed. An active fund is not allowed to have more than 10% of its capital in one company. This creates problem for ETF’s and other index funds that often needs to take a disproportionally large share in one or two companies. The function of the ETF’s in the future is not crystal clear. His concern is that people in general will have a desire to do better than their peers. If this is the case, then ETF’s will not be expected to grow. However, if people are satisfied with earning slightly below an index, than the function of ETF’s will grow and the importance of actively managed mutual funds will decline. What ETF’s can offer is easy investing in commodities and similar. Gold for instance is one of the areas where ETF’s offer a simple way of investing. Although there is a need to understand that it is better to have the actual gold in the hand than a gold ETF. Gold is often increasing the Sharpe ratio of the portfolio and thus offering a better diversification.
4.2 “Bertil”

4.2.1 Background
The 37-year-old Bertil has worked as a portfolio manager for less than a decade. He is working for a small fund family that offers one fund to the Swedish investors. The fund was started eight years ago and is based on insider trading. Bertil has a technical engineering education with specialization in mathematics and says that this has helped him in the work. The decision making process in the company is done in two steps, first by a software and than an investment team that makes the final decision. Bertil would consider himself as a 4 on as scale 1-5, on how good he is in his work.

4.2.2 Mode of Operation
Bertil’s fund is slightly different from how the main part of the mutual fund industry is working. It has emerged from research of several different and famous financial professors, such as Eugene Fama, Kenneth French Joseph Stieglitz and more recent research from George Akerlof and Robert Shiller. To briefly explain it would be to say that with the help of algometrical calculations based on insider trading, they are looking at a number of different people and how they with their insider role in different companies trade. The information that they trade on is public and available to everyone.

They get public insider reports from The Swedish Financial Supervisory Authority (Finansinspektionen), which is interpreted by the software and suggests investment ideas. The interest is mostly regarding how a CEO, CFO and other influential people are trading. An example could be in the recent financial crisis when a CFO bought stock in his own company, that is a strong signal of buying, Bertil says. The reason why they are trading like this is because insiders have over the last 17 years been earning a profit that is four times the normal investor. This has been contributed to the superior information among insiders. Bertil does not agree with researchers as Fama and French that all information is incorporated into the price. Bertil’s research and more importantly others research has shown that it is possible to make an abnormal return based on insider information.

The extensive trading that happens in mutual funds is not anything that Bertil think is relevant for his fund:

“I can only talk for us in this case, why other fund managers are trading is something you need to ask them. Our trading is based on insider trading and that is not anything that we control. If there is a lot of insider trading from people that we are following, than subsequently will that mean more trading for us as well.”

The flexibility that this means is something that Bertil informs the investor of in the fund prospect. The question could just as easily be asked from an investor of why there is not more trading done. Often investors are unaware of the cost that trading actually comes with. It is a thin line where both sides need to be pleased.

Bertil does not make a difference with a good or a bad start of the year:
“With the risk of sounding boring, there is no difference. I am aware of as you say these studies where if you perform badly in the beginning you will try to catch up. However is that due to our fund strategy not possible.”

4.2.3 Managerial Objectives
Bertil does not believe that a greater bonus would make him work harder. He would maybe pay more attention to details that he today does not think is important. He explains that they have a bonus system today and his experience is that people work harder. Bertil likes to compare it with a telemarketer that is working harder and pays greater attention to details with a commission; he thinks the same is true for fund managers.

A better salary would not change his way of working. He draws similarities with a bigger bonus. He might pay greater attention to details that you today do not pay too much attention to. Bertil could see that the result would be slightly better for a “normal” fund, which is a fund that is actively managed. But for their part, they get investment opportunities arise from how insiders trade the difference would not be very significant.

On the question of why there is a negative relation between fees and return Bertil thinks the answer is because of fierce competition among mutual funds that an increase in fees simply means that the fund will earn less. Mutual funds are often constrained, and if the investor is looking for extreme positions there are hedge funds that fill that hole. There he thinks there is a “better” relation between fees and return.

4.2.4 Practical Theories
Bertil’s view of EMH is that it primarily is an academic issue that close to nobody in this business believes in. His view is that it is possible to outperform the market and that the strong form of EMH does not hold. Insider traders have proved to be doing better than the market in general. The importance of EMH is not great for Bertil and not for many people in the industry, it is something that is present but nothing that keep him up during the night.

Confidence is something that Bertil says is essential when trading. If you are not comfortable with doing an investment you should always avoid it.

“Preventing overconfidence is, for us an algorithm that predetermines more or less everything; overconfidence is not as present as it is in normal fundamentally based mutual funds.”

Bertil believes that overconfidence plays a greater part in normal mutual funds and his experience is, that fund managers in those funds are too often controlled and that they can have an underlying agenda. With that he means that extensive trading occurs just in order to keep the capital working instead of earning return by having more of a passive approach. As long as individual investors are purchasing these funds it will continue to grow.

4.2.5 The Financial Crisis
The recent financial crisis has not changed their way of doing business. There is a constant fine-tuning that is happening to optimize the software. What the crisis changed for them was that it allowed them to position themselves. There is a need for everyone to
ransack him or herself and see what they could have done different in the period leading up to the financial crisis; fund managers are no exception from that. If there is a need to blame someone, Bertil considers fund managers to be far down that list. Still, there are always things that could have been done different, but as long as supply and demand is deciding what is being sold, then cannot the blame solely be put at the financial industry. He thinks that everyone from regulators to the individual investors themselves need to understand what they are buying and selling. It is too easy to point your finger and put your blame on someone else.

There are a number of things that we can learn from the past financial crisis, according to Bertil. The regulation has been to loose and even if the financial sector is the most regulated of all the sectors it has not been enough. Fund managers have been caught up in this frenzy and the bonus system has often been on wrong premises.

4.2.6 Future
Bertil thinks that some of the regulatory statues need to change in the future. One of those is the tax that is paid for the investors. There are today a great majority of investors that have funds from the 80’s and wants to get out of them because of their poor performance, however is that not possible without paying taxes on them. He thinks that if this tax could be reworked would give a capital inflow.

Except from the tax issue is his belief that fund managers will expand their investment universe and not be as fixated to stocks as they are today. There is a number of interesting investment opportunities out there that in the Swedish market still is under represented. Example of products that he hopes will be found in mutual funds is mini-futures, where it is possible to leverage your position. Leverage has a bad reputation and people are still not comfortable with it. Fund managers and marketers need to inform the investors of all the possibilities that this comes with. There is huge potential in this market. Bertil firmly supports that the function of mutual funds and mutual fund managers will possibly grow stronger as investors learn more, despite poor track records.

ETF’s on the other hand Bertil have a split view of:

“One part of me loves them for their simplicity, that everyone can buy a small part of an index, straight from the stock exchange. The professional part of me is slightly more restricted towards them.”

His personal view is that they will continue to grow, not necessarily on the Swedish side and he explains why:

“The problem with ETF’s is that they follow an index. In order to carry the name fund, a demand is that the fund offers a spread of the risk. With the Swedish ETF’s the risk is still high; the country specific risk is still present.”

The problem is the relatively few companies in each sector, diversification is impossible Bertil argues. There is a Nordic ETF that covers the 120 greatest companies on the stock exchange in the Nordic countries, that one could be worth investing in if diversification is what you are looking for, which often is the primarily the reason for choosing a ETF.
ETF’s can still have a prosperous future because of its simplicity and that it actually attracts a wide audience, from the beginner to more advanced investors.

4.3 “Cesar”

4.3.1 Background
Cesar, a 51-year-old fund manager, is working for a fund company that is offering nine different funds. Cesar is responsible for one of the funds that offer two extreme positions, where the fund is either fully invested in equity or fully invested in bonds. His previous experience comes from various large institutions. Cesar worked closely with regulation of the financial industry in the beginning of 1990’s.

His academic background is equivalent to a bachelor in business administration from Stockholm School of Economics. He founded the company he is working at 10 years ago. Cesar has experience of working with different payment schemes, today are they offering all their employees the opportunity to choose when signing the contract. Cesar considers himself as a 5, the highest on the scale.

4.3.2 Mode of Operation
The fund Cesar is managing takes advantage of the volatility in the market and has two extreme positions. This has according to Cesar a great advantage for the investor because of the simplicity it offers. The decision whether to invest in the equity market or fixed income is decided by a mathematical model that is consistent, opposite of people in many situations.

“We have developed the mathematical model ourselves and it has until now been rather accurate. The advantage that the model has compared to technical analyses is that it has a macro perspective and does not try to forecast each stock. Another advantage that the customers have appreciated is that the fund is rather defensive and it is more about avoiding downturns, like the recent financial crisis."

Cesar further explains that the funds core word is simplicity, and that the return has been good because they managed to avoid the recent financial crisis. When the fund is in the equity market it can be compared to a normal index fund. This requires some demands when the fund is changing positions something that they have dealt with by publishing the prices every day and arguing that transparency is good. There is no leverage in the fund, something that investors often want to see. Cesar recommend their investors that if it is leverage that they are looking for there is a possibility to make a homemade leverage.

Diversification is in Cesar’s case not interesting:

“Our aim is to provide a solid return to each investor and then the case is that you need to sacrifice diversification. However is not the goal for our fund to have an investor’s entire capital in one fund. There are a few other funds that our company is offering that together with this particular fund is offering a good diversification.”
The problem for larger funds is often the bureaucracy. There are a number of interests that needs to be fulfilled and Cesar’s advice is to stay away from large actively managed funds. More passive funds like Vanguard for instance where there is no interest of conflicts provides better diversification in these cases.

4.3.3 Managerial Objectives
Cesar is not sure of whether it would make a difference if he would be paid more on a monthly basis or receive a greater bonus. The fund he is managing is not making decisions as a classical fund. However does he mean that he would probably be able to sell more shares of the fund if he was paid more he would be able to push harder when meeting potential investors. He argues that the payment needs to reflect the job he is doing and not just the title on his business card.

A poor start of the year would in Cesar's case mean that the model that they are working after needs to be changed. The goal is never to present negative numbers. In case of a situation where they expect the market to drop, the fund invests in fixed income instruments like bonds. Their concern has never been to be one of the worst losers in the class since they know that their method is rather conservative and that there are other funds that take on greater risk. The same thing goes with a great start of the year. Since the fund is following an index there will always be funds that perform better than theirs. However are they aware that in a long bull-market will their fund probably be in the middle. Cesar explains that the fund is preferable in situation where the market is volatile and uncertain.

4.3.4 Practical Theories
The role of EMH is overplayed according to Cesar. There are many examples of people that can outperform the market. His own fund is a brilliant example of that where the possibility to sell in the right time and buy in the right time has proved to be correct. Cesar thinks that there will always be people that are willing to take the opposite positions even when the times are bad, at least in the most liquid stocks, where most of the traders are. The traders that take the opposite positions are aware of the risk and know that there is a rather small chance to make a fast profit, Cesar argues. Hedge funds are common among these extreme positions. Often are they looking for very fast investments and are not interested for the long run, they are often selling at a loss. The function of investment strategies like this is often overseen, however are they providing important liquidity to the rest of the markets.

There is a need to accept that there are skilled investors in this industry. To Cesar’s recognition has no theory been able to explain why the stock prices are moving as they are. Cesar tries to follow the research in the area and has yet not heard that any theory has been able to explain the price changes with the help of one theory. He admits that the financial theories has been able to explain a great part of the why the prices are fluctuating but will never be able to explain everything, and he thinks that this is appealing to the work as a fund manager.

“I think that with the recent financial crisis fresh in mind, no serious scholar can say that the markets are efficient. The market price is obviously not always right.”
He continues with mentioning that the markets are prone of speculative bubbles and that this behavior could be seen as chronic inefficiency of the market. Cesar means that there are two kinds of EMH. Where one is that people are not able to beat the market, and the second is that the market price is always right. Neither one of them has satisfactory been explained yet.

Modern portfolio theory is something that Cesar is aware of, nevertheless its use is rather strangled since there is need for so much information in order to be able to use it correctly. Cesar and his colleagues have full confidence in the mathematical model that they have developed themselves. He means that there is no room for not being confident in this industry. Cesar further argues that there is in his case no risk for overconfidence because of the two extremes they always are invested in.

4.3.5 The Financial Crisis
Cesar’s view of the recent financial crisis is that mutual fund managers and hedge fund managers has a great blame, however was the Swedish fund managers function in the crisis rather small. He means that the fund managers were aware that there was a bubble on its way.

“It is so profitable to ride with a bubble and everyone thinks they know when the right time is to move out from the stock market. Nevertheless, more or less everyone was aware of this and people were waiting for the sell signals to show up on their screens.”

For Cesar and his fund the mathematical model that they had developed worked and managed to change to fixed income in time. Other things that they have learned from the financial crisis are that there is no thing as too big to fail and that large does not mean that there are no systematic mistakes. The market place should be able to burst the bubbles when they are occurring. The problem is not the bursting of the bubble; it is that they are allowed to carry on for a long time. That means that there are needs for more regulation of the financial markets, however will this be very difficult to implement. There are a number of issues that needs to be considered.

The financial crisis was a necessary wake-up call. Institutional investors had the opportunity to invest in the U.S. market at a margin of 10%. That meant that investors only needed to have 10% of the stocks and lever the remaining 90%. People argue that this is rational since the market is expected to go up, and the appropriate thing to do that is then to lever the market since they are expected to continue to rise. The risk premium was low and this means that there is a bubble under way. The CEO of the investments banks has a great blame in this just as rating institutions like Standard & Poor and Fitch. They are the ones to blame, at least from an individual’s perspective.

4.3.6 Future
The financial industry has changed tremendously over the last 15 years. The companies have not been able to cope with this growth and a lot of bad products have been put on the market, just in order to sell something. Unfortunately has individual investors been willing to buy these rather poor products that do not offer anything special to the buyer.
Cesar argues that as long as large institutional investors get uninformed customers for free, nothing will happen.

“There will always be a need for actively managed funds, let it be for tax reasons or just because people feel more confident letting an expert in the field make the decisions. Even if not all actively managed funds are creating value for their clients as have been seen in studies, there are fund managers that have proved to do better than average, and this cannot be explained by the coin flipping argument that often is used. Some managers are constantly creating value for their investors and individuals need to be aware of this.”

What Cesar also have noted is that there is a need for more bond funds.

“The Swedish people have overlooked the possibility of bonds because of the stock markets noise. I think that there is a huge potential here for fund managers to realize this.”

ETF’s is a great tool in most markets. Cesar thinks that larger markets than the Swedish is necessary in order to create value. The Swedish market has a high focus on industrial machinery companies like Sandvik, ABB and others. A company like H&M overweight’s the fund and makes ill suited for an investor that is searching for a well-diversified portfolio. There is another financial innovation that they have started to roll out in the U.S. that could be of interest in the future. It is an actively managed ETF. The product is still rather new and has only been around for about a year. Because of a lacking track record has investors yet not taken any interest in it but it looks promising so far according to Cesar. There are a number of interesting things with this kind of fund, one of them that they can short stocks. This innovation might however not be for the everyday investor, Cesar concludes.

4.4 “David”

4.4.1 Background
David is at the age of 61 one of the most experienced managers within the fund industry in Sweden. His experience comes from a number of different companies within the financial sector from the last three decades. His academic background is within macroeconomics from Uppsala University. On a scale of 1-5 David would consider himself to be a 4. David founded the fund company he is working for ten years ago. The fund aims at attracting investments from investors above the age of 55. The company is small and the decision making process consists of himself in collaboration with two colleagues.

4.4.2 Mode of Operation
The Swedish stock market has been David’s work place for more than three decades and his way of working is nothing spectacular according to himself. He is looking for companies to invest in and follows these companies closely. Following one company David says is easy; the problem is to be able to cope with their competitors. The problem with the Swedish stock market is that in order to be able to follow it you need a rather
wide knowledge base, since there is everything from retail, banking, industry and communication. This does according to David put high demand on the fund managers.

Investment opportunities can arise in several ways. Companies that over a long time is doing well get recognized and followed up. This method can often be dangerous and there is a need to evaluate it thoroughly before making the actual decision. Other ways of picking up good investments ideas is through meetings with people and share investment ideas. As a large shareholder of a company you are often in contact with board members. It is not unusual that these board members are members of 5-10 other boards and thereby have information they can share. Often an initial idea is brought up this way and then they follow the normal procedure of investigation that they do at all companies that are of interest.

David’s view is that the brand is not important and that the fund manager is more important. Small funds are often doing better than large funds according to David. This is because good fund managers are starting their own funds. The reason why they are doing this is because of the money they make for themselves. Many fund managers, and David used to be one of them, is doing very well in larger institutions and are making money for them.

4.4.3 Agency Problems
David knows that he is doing a better job today when he is making more money than he was when he worked for one of the big institutions.

“There is a need for a carrot in order to do a better job and be better prepared for different situations. To get recognition for doing a better than average is satisfaction that leads a long way, to get a bonus for doing better than most works even better!”

The last year’s rally to funds has created a situation where there today are more funds in Sweden than there are stocks and the same goes for the U.S. market, David explains. This increasing number of funds has created a pressure on the fees, because there is not many ways the funds can compete and the fees are by far the easiest to compare for the investor. David questions whether this is desirable in all cases:

“My opinion is that there is a need for a certain fee, I cannot understand how serious funds can do a good job when they are offering low fees. We are only a few people hired in our company and have difficulties not charging a higher fee to cover the costs. Nevertheless, the investors need to know what happens with their fees. If it is only a computer making all the decisions, well then the fee can and should be low.”

Another aspect that is closely tied with low fees is that the funds will have hard times contracting the best talent. The reason why almost everyone that graduates today from the top universities is not only the excitement from hedge funds, it is also the fact that people are paid more because they can through their higher fees according to David. There is a risk in a situation like this when the fees are pushed down, that only a few big actors will be able to cope with it because of their economies of scale.
4.4.4 Practical Theories
The function of the efficient market hypothesis must be discussed in two different ways. When Mandelbrot brought this to interest and Fama made it famous everyone seemed overwhelmed and people, mostly professors within quantitative finance seem to have thought that they had found the answer to their prayers. This is not the case. The EMH is according to David two different things and they are closely related but not the same. The first thing is whether the prices of the asset really are correct and the second is whether it is possible to actually profit from mispriced assets.

It has clearly been proved that the markets are not as efficient as they promise, then financial crises should not occur. However, can people profit from these mispricing, David asks. There are a number of professional investors that have strategies that over the long run perform better than average. Big events are not brought in to the efficient markets, something that Nasim Taleb has pointed out. However is the problem that people can in general not profit from these happenings in short time spans and this means that the markets are rather efficient.

Another fact that the markets are efficient is the great number of people that actually loose money. David illustrates this with an example:

“Imagine that you are in the grocery shop and is about to pay. You have three lines to choose from. The shortest line should be the fastest, but there is an elder lady there. The second shortest is a man trying to return something, the one you should choose is the closest one and stick to it. Otherwise would everyone else already be in the other lines”

The example highlights the problem that people do not have the perfect information and does make decisions that seem thought through however are they not always correct. The importance of having a strategy that works is something that David has learned from the first day of work. If there were, it would have been exploited like many of the anomalies.

Modern portfolio theory is for David not important. He instead mentions that a fund cannot be built up like that because of the incomplete information that professionals have. We are of course dependent on the correlation between different assets. David says that he would never considering only be in one industry because of the correlation between these assets.

David describes his way of investing as a typical fund that invests with a specified time horizon, depending on what the markets look like. If there is a good investment opportunity than he will find the cash or sell the assets necessary to invest in it. This way of constructing a fund is not in accordance with the MPT, however it fits the investors view much better. Investors want fund managers to find the best assets that offer a good return. This freedom that it creates, compared to MPT, is an advantage. The downside with this is that the diversification will of course not be perfect and there is a risk with that.
Diversification is often very costly according to David:

“We tried this when I worked for a larger fund, but the cost of maintaining the positions means that the fees will be high. Another problem is that in order to reach perfect correlation of zero, there is often a need to short your positions, which as of today is not possible. The concept of MPT is great, but how many can actually do it? Close to none according to me!”

David further explains that the public needs to be more aware of diversification and that there is often a need to hold more than five funds that are spread out in different markets and at different banks. However, should this not be a problem:

“Most of the investors today has several different forms of funds through their retirement pension, premium pension individual savings etc. This creates a great platform for people to actually invest and diversify away some of the risk.”

David mentions that a fund that is perfectly correlated but still in the equity market will in the case of a market crash still largely be wiped out. There is no way that a market crash would leave you untouched, if you are 100% equity. This is often a mistake that small investors make, they think that just because they have stocks with a correlation of zero that in case of a crash will the returns not change.

4.4.5 The Financial Crisis
A financial crisis does not change the way David is working. His fund has committed to their investors that a majority of the asset must be held in the stock market.

“Because of our prospect we are committed to the equity market. We had to find the most stable companies where the downturn would not be so great. This is a far greater challenge than finding the companies that are doing the best during a boom period.”

David highlights the importance of being prepared for different situations when the financial market has a great volatility. There is a different way of acting when the markets are as volatile, more stable companies are desirable.

4.4.6 Future
The future is bright for actively managed funds according to David. He thinks that the knowledge that some of the funds has is not comparable to what the individual investors or other investors can attain by themselves. The allocation of actively managed funds is often thought through and this is another aspect that should attract people to invest with actively managed funds. However, the investors need more education in the field of the funds because there are according to David to many funds that offer bad products.

Another aspect that David thinks will change, as the interest of funds will continue to grow is the information sharing from the fund company’s side:

“The norm for us is to inform the investor twice a year of what we are doing in the fund and what our outlook for the future is. Other funds are doing it
more sparsely while there are funds that inform more frequently. I think that we will see more interaction from the fund manager’s site and inform the investors of what is going on and so forth.”

ETF’s are nothing that David thinks to highly about. His view is that there will always be people that are more conservative and that these people will chose ETF’s and other index funds. However will there always be people that are looking for more than average and these people will continue to invest in actively managed funds. The reputation of these funds needs to be improved. David finishes the interview with his view of the hedge funds that they will take market shares from actively managed mutual funds; because of the many rules a normal fund needs to follow:

“Hedge funds will increase in importance because of their freedom. They can more or less invest in what they want. The possibility that has been created in the last years when small investors can invest in them will make them a greater player in the market. The Swedish hedge funds have not made the same mistakes as the U.S. and U.K. and this will create inflow of capital.”

4.5 “Erik”

4.5.1 Background
Erik has since he earned his academic degree, a bachelor of art in Economics 14 years ago, been active in the fund industry. He is today a managing director at his own, newly started fund. The focus of the fund is worldwide and he is the head of an investment team of five. The payment scheme at his fund is based on a monthly salary and if the fund is doing well a year-end bonus is paid out. On a scale of 1-5, Erik would consider himself to be a 5. Worth noting is that Erik has been awarded by Dagens Industri and Morningstar “Star Fund Manager” (Stjärnförvaltare).

4.5.2 Mode of Operation
The fund Erik is managing looks at the fundamentals of a company and tries to find companies that have a low value. They are often looking for companies for their fund that the market has beaten and whose value actually is greater than the market value. There are more than 60000 stocks out there that are possible investment opportunities. However most of them are screened in the process of narrowing in down to 30-40 companies. The focus is to find international companies that offer an absolute return. To analyze the companies and its competitors thoroughly and to see what it can earn in different situations and financial states. Often the process of selecting stocks include a lot of waiting, until the stock you are watching reaches the price you are willing to pay for it.

Erik explains how investment opportunities arise:

“Part of my investment strategy has always been to go in another direction than the herd. This is often seen as controversial, however it has helped me to achieve great results. Take a company like British Petroleum (BP) for
instance. Here it is obvious that the market overreact, everybody wanted to sell at the time the news of the failed tests came out. Our position was to wait for the worst fall to happen and then invest and wait for it to bounce back. Markets are in this sense not rational, as they ought to be.”

Other investment opportunities happen from communicating with board members of companies that they have in their fund. Often are these people member of a number of different boards and thereby very aware of what is going on. By meeting and seeing people at different companies you often get a feeling of how solid a company is. There are a number of different ways these opportunities arise, some by sitting behind your desk and steering into the computer and others by being active and actually see the company yourself. Some of the companies that they have in the fund are companies that Erik has followed with interest for the last 10-15 years.

Confidence in your trade is everything. You should never do a trade if you do not have faith in it to a 100%, Erik explains. There is a need to have some distance to the investment and not to buy because you fell in love with it. A number of fund managers make this mistake where they get an emotional attachment to a company and refuse to see what its real potential is. The fund Erik is managing has a price at where they sell. This can minimize the loss in case they would forget why they bought it in the first place. It is important to be objective in every case and to have common sense, Erik explains. In Erik’s case is the risk of overconfidence small. They always aim at having their fund invested to a 100%, which means that there is not much room to do spontaneous trades. It is possible to get hubris and make trades that are made on impulse rather than of fundamental analysis. Erik argues that the extensive trading that is occurring in the funds is just something that we all will need to get used to:

“The reason for people to invest in stocks and funds are not the same as they were a few decades ago. People seek to maximize their wealth and will by that change from fund to fund as funds will change from stocks to stocks, this is just part of the development of mutual funds that we have seen now for a while.”

30-40 years ago people bought stocks and it was meant that they would be owned until you died and then would the inheritor do the same thing and the only interesting was the dividend, Erik explains. The industry is not the same anymore. Dividends are not a sure thing, and Erik argues that people has started to live more for themselves and less for their heirs.

The function of the funds has changed according to Erik. A few years ago you bought a fund for diversification, today you will need more than one fund in order to properly secure yourself from systematic risk. This has contributed to the high frequent trading that happens in the funds. The financial industry and the fund industry in general have a reputation of being complicated, it is not that complicated, Erik argues. What is needed in order to be successful in this industry is to have faith in the way you are acting and to
have common sense. Fund manager often manage to lose that common sense because they get emotionally attached and they have problem of being objective.

On the question whether larger funds often have superior information Erik hesitates. At his previous workplace where there were more funds he would say that was the case. Often is the problem that the larger funds have more cash on hand and thereby greater possibilities to influence the market and take the advantage of the situation. Erik explains that he has seen situations where large funds get the information first but it is not suitable for them to invest and the information is passed on to the next one. Information often comes from people within the management and board members.

For Erik there is no big difference of how the start of a year is influencing the way of working. His fund is looking for a longer time horizon than a few months:

“Our way of working means that we are looking for companies that are on their way up from a tough time. That means that the investment horizon can differ from 6 months up to five years.”

If there would be a negative reaction in the market, the portfolio should be diversified enough to be able to take it in the short run. If there would be a tremendous bull market worldwide there is a chance that Erik’s fund would be among the top performers, but that would not change the way of working. The goal for Erik is not to be best in one year and then drop because it is all due to luck. For them is the goal is to be on top over a longer time horizon than that, say 5-year average.

4.5.3 Practical Theories

Both scholars and other people need to distinguish EMH in the short run and in the long run according to Erik. In the short run EMH does not matter. People often use the example of a coin toss when discussing EMH and Erik argues that is more accurate in the short horizon. Often there is a belief that just because you beat the market in a year that you will do the same thing next year. That is not true. Luck plays a significant part in these markets and you need to be able to contribute part of your success to it.

In the long run Erik firmly believes that the market is right and that it is not always possible to outperform it. Not even an icon like Warren Buffett has been able to that. Sure his method, which is similar to the one Erik adopts, has been proved successful but far from perfect.

“Luck plays a more important part than any investor wants to admit, because admitting it would mean that you are not completely sure of what you are doing.”

Erik and his colleagues are all aware of Modern Portfolio Theory. The fund does not put all eggs in the same baskets, they still try to diversify, however not in the extent that Markowitz intended it to, Erik explains. Markowitz was ground breaking in the mathematical, however has the strategy always been around and is for the most of the funds not usable.
Erik cannot answer on the question of why most actively managed funds are underperforming indexes. He does however have a theory of why:

“My theory is that what a lot of the fund managers do is that they look too much on the index and what is happening. That means that they will in all cases be at least one step behind. If you always are behind there is no way that you can actually beat index.”

Another thing that Erik thought of was that there are a lot of funds out there that has more than 50 companies in their fund. With that it will become a lot harder to stand out and to perform better than average or an index, Erik explains. It is important that buying a share of company is not just a piece of paper, it is a share of a company and with that wills a certain degree of power come. It is possible to change the structure of the company to the better and thereby increase the profits. Many of the funds today, buy the stocks and then expect things to happen. That could be another reason why many of the funds today are doing worse than index Erik argues.

4.5.4 Managerial Objectives
A bigger bonus or salary would not change Erik’s way of doing his work. It would not add anything to how he is analyzing a company. It could make him put bigger emphasis on the competitors of the companies that they are following. In a fund where you have 30 companies, you need to be aware of maybe 100 competitors to those companies, maybe he would expand that universe some, however it is a hypothetical answer. Erik mentions that the bonuses did during the recent crisis get out of hand and that in order to establish the confidence of the public there has to be an adjustment made.

Regarding the negative relation between funds and performance Erik draws parallels with the answer on why actively managed fund are underperforming indexes. He adds that there are a lot of funds that claim in their prospects that their funds are active and has a risk that matches that. However the case is often that the fund is charging a rather hefty fee but is not being active. This in turn creates situations where the fund is steady and does not adjust which means that it will lose more in markets if there is a bear market and gain less in a bull market. This creates situations where the investor’s pays for active risk, but does not get it.

4.5.5 The Financial Crisis
It is different how you invest in a financial crisis and in a bull market according to Erik. It is harder to find good companies that are undervalued in a bull market. There are not too many people that are keen on investing in the midst of a financial meltdown that people compared to the Great Crash of 1929. The last financial crisis is a great example of how the market overreacts.

“Even if it was impossible to actually know what the future would bring, there were some fundamentally wrong things in the market at that time. Looking back now I see what might have been the best opportunity that many
of us ever will find to get a hand on bargain stocks, it was like a smorgasbord.”

From the recent financial crisis there are a number of things that a fund manager could learn according to Erik. There is always a need after a crisis to stand still and think about what has just happened and how did we react. As a fund manager you need to be fast to react in order to cut the losers short. It is important that you can distinguish a company from its stock. This might seem counterintuitive, but often do people forget that a company that is doing everything right, can still be overpriced and thus is not a good buy.

4.5.6 Future
Erik thinks that it is important for mutual funds to distinguish why there is a need for them. Mutual fund managers need to be branded better, as they do in United Kingdom and the US. Today the individual investor is not aware of the fund manager that stands behind the fund. This is something that Erik argues needs to be better. There is a risk with this of course and also possibly the reason of why this has not happened. Institutions in the U.S. have contracts for their fund managers for 10 years often and do then have possibility to create a “buzz” around it. His feeling is that the institutions in Sweden are afraid to create a brand around a fund manager and than running the risk of losing them if they do well.

The function of ETF’s and other passive investments will according to Erik grow in importance as the mutual funds that today are following an index is gone. Hopefully can this happen rather soon, but it could also take a while. Passive investment will overall grow in different shapes.

4.6 “Filip”

4.6.1 Background
Filip has worked for a number of different fund companies in the last four decades. At the time of the interview he was the managing director of a global fund for a well-known investment institution. He has been with the company that he is currently working for since 1985. Filip’s academic background consists of a master degree in science from UCLA, in the United States.

The decision-making in the fund is a bit complex because of its width. The fund consists of an investment team of seven people that all report to Filip. The salary consists of both a monthly payment and a year-end bonus if the fund is doing well. Filip considers himself above the average at his job and could not decide whether he would say he was a four or a five, on a scale of one to five.

4.6.2 Mode of Operation
When Filip and his fund are in the process of looking for investment opportunities they look at a longer time horizon. They try to find companies that can have a long and positive economic development, where it is possible to build profit on profit. Investment opportunities arise in a number of different ways. There is not one answer to this
question. Filip explains that they try to be out and meet companies and through connections get ideas of companies to invest in.

“We have for my fund a universe consisting of more than 66 000 stocks to choose from. However is it in reality a lot smaller. This is not a one-man job and in my case we have a solid team and can benefit from good connections over the globe. Far from all the companies we look at end up with an investment, there is a lot of criteria’s that has to be met.”

The importance of being confident in your trades comes from being secure and avoids any extensive trading in it. You need to stick to your decisions and remember why you made the investment in the first place. However the team Filip’s is directing would never make an investment decision if they were not sure that it would contribute to the portfolio in the long run. In almost all of their decisions all of them agree and believe in the investment.

“I think that during my years as a director of different funds I have been overruled just once because of the others managers convincing me what were the right things to do.”

The team Filip is directing is great at preventing overconfidence. No hasty decisions are taken; everything is analyzed and discussed before actually investing. This creates situations where one fund manager that is overconfident gets a reminder that it needs to be thought through first. Filip further explains that the downside with this approach is that there are no fast decisions taken and that investments have slipped out of their hands because of the rather slow process.

Filip knows that in order to have a well-diversified portfolio there is a need to have about 17-19 stocks. Nevertheless academics often stare themselves blind at these numbers and fixates too much attention to them. Filip’s view is that diversification is good, if that is what you need.

“Even if you have a well-diversified portfolio you need to have more assets than only stocks. Not even bonds can diversify you fully. This is something that the academics often miss. In my fund, we have about 30 companies, all of which are selected carefully. However we do not have any special diversification tool to justify our choices.”

Filip further explains that the fund cannot be entirely invested in for example pharmaceuticals, there still need to be some balance in the way they construct the portfolio. The influence of management is greater if you have fewer stocks. 30 stocks in a portfolio are easier to manage than a hundred. For Filip’s fund they have a better fundament for avoiding big drops that are country-specific. This is something that narrow funds have problem with and is usually why they after a while have to change direction or worst case actually need to shut down the fund.
A good or poor start of the year does not change the way of working according to Filip. The fund has never been a fund that is interested of being in the top or the bottom of the charts. There are funds that are more extreme that you find there. The purpose of Filip’s all-world fund is to invest for a longer horizon and you will merely find those funds in the tables of the newspapers. The fund manager’s looks at cash flow for a longer time horizon and because of the different industries and markets that are represented in the fund will the outcome in general not be extreme in any directions.

Filip argues that people, no matter whether it is academics or non-academic people need to stop thinking of how it was 50 years ago. Back then people was buying stocks for the dividends that were paid every year. You did not buy a stock for the sole purpose that it would raise in value. His view of the investors today is that in their shortsighted view of the market expects a certain return over a predetermined time period. This has lead to a situation where stocks are held for a shorter time, which means that funds will sell and buy more. This is generally the reason why, looking back at his own career he can only say that back in the 80’s the activity in his fund were actually greater than today.

There is certainly an advantage for large funds regarding the information they receive. Large funds often have the best contact with management of the companies they hold. He would not agree that a large fund, for example his own, has an advantage when it comes to information flow within the company. Even if there is information sharing has Filip never seen a situation where the larger funds has taken advantage of its power. However there are from time to time situations where large funds need to take positions, for instance if they are offered a bulk of stocks that requires a large size in order to properly incorporate it to the fund.

4.6.3 Practical Theories
As with all financial theories a great tool in theory, however not in practice, Filip argues when the Efficient Market Hypothesis questions are asked.

“For me is it not relevant how I am doing my job. If you are in the financial industry and actively trading stocks, you need to believe in what you do. And for me it is incredible that a theory like the EMH still is present. There is no way of measuring it because there is no tool that works satisfactory. There is no world market as the fundamental of the hypotheses is based upon. For me EMH is a number of statements that has been proved wrong, but still it is relative, for me that is a puzzle that I cannot understand.”

The role of EMH is less relative today according to Filip. Back in the 80’s everyone was talking about it and there was a bigger awareness in the industry and among the investors at that time, much because of the book “A Random Walk Down Wall Street”. Today both the investors as well as the large number of mutual fund managers has lead to a lower standard of the awareness of the financial markets. Not that everyone knows less today, but the knowledge has shifted towards being more about forecasting a financial statement than the fundamentals of financial markets.
MPT is great, just as EMH, in theory but not in practice Filip explains. It is too complicated; too difficult to gather the numbers that are needed and above all it lead to positions that are impossible for Filip’s fund to take. Even if you can put restrictions on it, the composition of a fund will look ridiculous if you are following it.

Filip thinks that there first is a need to ask whether indexes are the appropriate benchmarks, when questioned of why actively managed funds often are underperforming indexes. If you want to follow an index, than an ETF is by far better than an actively managed fund. Filip questions why actively managed funds want to track an index fund. Looking aside from that, he does not know whether funds actually underperform in general. The knowledge has somewhat diminished with the increase in fund managers according to Filip. There are today too many that wants to make a name for them and thereby take great risks that cannot be explained by anything else than they are only doing this for themselves.

“You need to be aware as an investor of where you put your money and how much risk you are actually taking on. The industry attracts people from different background with different agendas and even if the industry in general is rather regulated it is still possible for some actors to actually slip thorough and create a mess for so many more.”

4.6.4 Managerial Objectives
Filip makes clear from the beginning that salaries and bonuses is a sensitive topic, because of the company he is working for. His view of bonuses is that they generally lead to better results because people work harder. For his team would a higher bonus probably mean that the team would work harder, longer hours and trying to find more companies that could be good contributors to the fund. When it comes to higher salaries his opinion is:

“I am not sure whether a better salary would entitle you to contribute more. Maybe in the beginning, but my experience is that you do it from the start, but after awhile do you get comfortable and settle to a certain routine.”

On the question of why there is a negative relation between fees and performance Filip argues that there has over the last years been a transformation of the holding period and it seems to only get shorter. Naturally shorter holding periods lead to more transactions that lead to higher fees that will influence the performance since fees are affecting the return.

4.6.5 Financial Crisis
For Filip’s fund there is no difference in the investment strategy whether there is a bull or a bear market. His strategy has been to invest in companies that have possibilities to earn money for a number of years. That means they are looking at the company’s cash flows for the next projected five years and try to estimate how close they can be. Often does that mean that they will miss the best stocks of the years, because history has shown that those companies often tend to possess a greater risk and with that high debts. However is the goal of the fund always to outperform the benchmark.
“The recent financial crisis was a reminder that all markets in some peculiar way are tied together. Every major crisis like this one reminds the investment society that in a global downturn is almost every asset correlated to other assets in a different way. There is a need for the market to be reminded about this every once in a while.”

Diversification is not always the answer to these problems, even if it offers the best solution. The crisis taught us to take the warning signals seriously and believe in our own forecasts. There is no quick way to make money without taking on risk and that is something that everyone at all levels needs to be aware of.

4.6.6 Future

The importance of ETF’s will continue to grow; we have only seen the beginning of what it has to offer. Investors will become more aware of them and their low fees. ETF’s will at least for Sweden be something that every serious actor offers. Filip thinks that there will be more marketing in the future where ETF’s will play a passive part of many investors portfolios and that it will be spiced up with active managed funds, just to get some edge and have some excitement. He further explains:

“I am certainly biased in this question but I think there will always be a need for actively managed funds. The private investor should however be more aware of what it is he is investing in and actually paying for.”

Filip’s view of the future for the actively managed funds is that the investor should be more careful when choosing funds and look at funds past performance to ensure that they are in line with their own goals. An actively managed fund should over a few years be able to outperform the market with about 2-3% annually. Past performance is often a good indicator and that it is the same people managing the fund. If the MSCI World is doing 6% annually the goal is that an actively managed fund should be around 8-9%.

The future will bring more products and institutions will have to offer a complete package to the investors. The financial industry has over the last decades moved from being spread out to become more concentrated. The mutual fund manager will face a world that due to regulation will become even more transparent than it is today and this will make the job harder.

4.7 “Gustaf”

4.7.1 Background

Gustaf is a 42-year-old fund manager at one of the largest fund institutions in Sweden. He has been active in the equity industry for the last 18 years, most of these spent at the company he is currently working for. Gustaf has a master of science in business and economics from the Stockholm School of Economics. The fund that Gustaf is co-managing is specialized at the U.S. market and consists of a decision making team of about 8-10 people. Gustaf’s salary is since last year a monthly salary; the bonus system
was abandoned after the financial crisis. Gustaf would grade himself as a 4 on a scale of 1-5.

4.7.2 Mode of Operation
The work is to analyze companies that Gustaf thinks have large possibilities to grow in the future. That means that they are talking to the people that are in and around the company. They are talking to experts in the fields and have a close contact with the management of the company. What they are looking for is that the company has a business idea that is focused and not conglomerates. It is important to understand what the company is doing. There is no reason investing in a high-tech company if you have no idea what they are doing, Gustaf explains. They are looking at how it is placed in the business cycle. In recessions they look at companies that are less sensitive, such as pharmaceuticals. Gustaf is working for one of the largest fund families in Sweden. This offers some opportunities as well as some major drawbacks. Positive for Gustaf is the information sharing that takes place. At least once a week the heads of the funds meets and discusses the global market. Often are ideas changed here and Gustaf does not feel that there is an internal competition within the company.

On the question whether there are favors towards the larger funds Gustaf replies:

"Not that I have noticed. For natural reasons large funds often receive information that only is appropriate to them because of the fund size, however have I never felt that we cannot act on our information because another fund has the advantage of it."

The fund family offers a wide array of funds and Gustaf thinks that the reason funds with a higher fee often performs worse than cheaper funds is because there is for those funds bigger stakes and a different risk profile. Gustaf argues that it is not fair to compare a Swedish equity fund to a fund where the goal is find mispriced assets with a short investment horizon. That higher fee funds would get superior information is not anything that he agrees with. He means that it could maybe happen in the U.S. where there is another culture. The higher fee funds in Sweden could have superior information, however have they not been able to outperform other actively managed funds so the information is in that case not superior.

Diversification is difficult because often do the funds have a prospect of how they have to invest and cannot go outside of that. The same is true for Gustaf’s fund. He argues that in order to make the fund well diversified there is a need to invest half of the money outside of the North American market. Gustaf urges people to complement his fund with another fund that is aiming at Europe and Asia.

4.7.3 Practical Theories
Markowitz portfolio theory is the best tool there is for diversification, Gustaf says. However is the use of it so limited that it is almost impossible to implement in practice. The theory is based on assumptions that very few in the equity markets are using today. Gustaf exemplifies this with:
“The price of the asset today should reflect all future dividends discounted with an appropriate discount rate according to the old theories. This has been seen several times that it is not correct and fund managers of today are not only looking at dividends when trying to value a company.”

The efficient market hypotheses is constantly debated within the walls of the universities, however is it never discussed in the day-to-day work. The reason for that is of course what it implies and that would mean if the markets would be efficient that everyone should have the same portfolio. Gustaf’s view is that there is some truth to the question. The prices of the commodities are in the short run very efficient, otherwise would it be possible to make an arbitrage deal and thereby risk free profit. This is to his knowledge not possible. Gustaf mentions Warren Buffett as an example of a person that has a trading strategy that is to find undervalued companies and hold them for a long time.

“Warren’s time horizon is more or less forever. This strategy has taken him from middle class to among the richest in the world, and to say that this is because of luck or taking high risk is wrong. Warren has a sound investment strategy that he has committed himself to for 50 years or so.”

Gustaf argues that fund managers that are not consistent in their strategy and looking for a fast profit are in the wrong field of work. He mentions that several colleagues of him are often changing strategy in the hope of finding something that works. This is where the efficient market could be working, for those noise traders. Noise traders should not maybe be seen as the academic literature is defining them, with less information, because in that case everyone would be a noise trader in comparison to the insiders. What Gustaf mean with noise traders are the fund managers and individual investors that are not consistent in their buying and selling and trade more than is necessary. These are the ones that create market liquidity and often stand on the losing side.

The numbers of mutual fund managers and other kind of money managers has grown rapidly with the interest of the financial industry. This has meant tougher competition and more extreme funds. Some of these funds are taking on a great risk and hopes that they will be awarded otherwise are they not in the market for long. Gustaf tells that his experience is that even if the competition has grown so has the fees. There are fixed fees, often around 1.5% on top of the high watermark fee. This gives the fund the right to take a fee of 20% of the profit above a watermark. The watermark is often based on last year performance and this creates situations where fund managers are willing to accept more risk. More risk does according to Gustaf mean faster decisions with less analyzes behind. The consequence is lose-lose for the private investor.

4.7.4 Managerial Objectives
Gustaf is working for a company that recently has abandoned the bonus system. This meant for him a greater monthly salary. He cannot say that his way of working has changed.
"There is no difference for me and the way I am working whether it is with a monthly salary and/or there is a bonus in the end of the year. The work is still the same and I could not see that a big bonus would make me work harder or finding better investments. If that would be possible it would mean that I could not do my job as good as I can today, without a bonus."

4.7.5 Financial Crisis
Gustaf have during the recession invested more in companies that are solid and often seen as safer, such as Coca-Cola and Pepsi, companies that have been through these kind of situations before. Almost the entire fund is in large cap stocks, as they will offer the best and most stable return in the near future. There is an ongoing debate within the investment team, where they discuss macro issues and try to forecast what will happen in different situations.

The recent financial crisis is according to Gustaf a good example of why there is a need for actively managed funds. The advising part that an actively managed fund is offering is the biggest difference from a passive fund. Non-financial companies, trust funds and individuals are all in a need of help, with taxes and other services. It is hard to find and often expensive if you are going to an external actor. The service that Gustaf’s company is offering should not only be seen as the funds that they are selling, the surrounding services should be included when deciding. With the recent financial crisis fresh in mind the function of the mutual fund managers has grown and will continue to grow with the complexity of the market.

The financial crisis has meant a record low confidence for fund managers and advisors according to Gustaf. This needs to be restored in order to attract more investing. How this should be done he is not clear with, but insists that there is definitely need for more regulation and that the markets need to become more transparent:

“There is too much covering up and too much secrecy. As a fund manager you need to be able to explain your strategies and also be able to take the blame in bad times”

4.7.6 Future
The tax reform needs to change in Sweden, in order to make it cheaper to own stocks and funds, Gustaf argues. He likes the innovation capital assurance (Kapitalförsäkring) where the investor only needs to pay 1% in tax each year. Compare this to the normal tax of capital gain that is 30%, however this creates problems since you do not actually own the share.

Gustaf says that fund managers are poor at contributing success to luck. He means that everyone needs to be able to be honest and about his or her own investing. Often do fund managers forget who it is they are working for, is it for ourselves or the people that actually invest with us, Gustaf asks.

ETF’s is a safe way of investing, however is it not fair to compare it with actively managed funds since they offer something different. If an investor wants an average
ETF’s like capital assurance is financial innovation that we still are waiting for to really take off. Gustaf means that as a fund manager for an actively managed fund an ETF makes a perfect complement. You get the potential upside with active and still are rather safe and diversified. Gustaf especially points out the advantage with ETF’s in low liquidity markets where investing often is difficult, countries like Bangladesh and Vietnam. According to Gustaf will the greatest threat in the future not come from ETF’s but from investment companies like Investor and Industrivärden. These companies are practically doing the same thing as mutual funds, except that they concentrate only on the equity side. Gustaf again mentions the services that an actively managed fund is doing, something that you will get from neither an ETF nor an investment company.

4.8 “Helge”

4.8.1 Background
The 38-year-old fund manager Helge works for a small mutual fund that invests in Sweden and Norway. His experience as a fund manager is rather limited and his previous positions have been within the company he is working for today. His academic background consists of a master in finance from BI in Oslo. The fund is making the investment decisions based on software with mathematical algorithms and is an all-technical analysis tool. The payment system for Helge is a mix of monthly salary and year-end bonus.

4.8.2 Mode of Operation
The fund that Helge is managing is a new fund that was set up earlier this year. The fund aims at taking advantage of a technical analysis tool that have been researched upon for the last 20 years. They base the decision making on technical analysis and there are a number of different parameters that they are looking at, insider trading, volume it is trading at and trends, Helge mentions. When they find an interesting investment they invest in it for the number of days that is suggested by the software. The idea is to be fully invested all the time and not to leave any cash on the table. The idea is to be invested in about 20 companies in order to take advantage of each company.

On the question how a good or bad start changes the way of working is Helge not sure and gives a hypothetical answer since the fund is still in its infancy. Even if the software provides investment ideas it does not tell the proportions of the investment, for instance how big share of the available cash should be invested. There is some room to take more risk, Helge argues and develops further:

“Since there are a rather large proportion of the private investors that follow different top 10 lists provided by for instance Dagens Industri, the goal is always to be up there. That could mean that if the fund is slightly below the top we can take on more risky positions. As a young and relatively new fund with small possibilities to market ourselves is it difficult to attract new investors, therefore do we wish to be seen in top lists and similar environments.”
In Helge’s case there is always a question of whether one stock is better than one that they already have when it comes to discourage the fund managers from overconfidence. This decision is made by the suggestions they get from the software. However are there situations when the software offers investment opportunities, which for the fund managers would mean that they would need to change a majority of the fund from week to week. Then there is a need to relax and not do anything even if it is difficult he explains. The important thing is to see what the software is suggesting and why the decision to buy the stock in the first place was. Overconfidence is a risk a great risk for the fund manager according to Helge, however do they prevent it from happening by limiting the trading.

Diversification does not have the highest priority for Helge’s fund. He explains why:

“Actually we do not diversify our product. Our goal is not to be one out of a thousand, more like being number one out of a thousand. We are clear with this when facing potential investors. We are not interested in having all of their money for the reason of the high risk. The upside potential is great in a trade like that but people need to be aware of the risks that it comes with, our recommendation is to use our fund as the icing on the cake.”

4.8.3 Practical Theories
The question of EMH is what has bugged the investment society since the 70’s. Helge’s thought, which of course is influenced with the company that he is working at, is that there are ways to outperform the market. Famous investors such as Warren Buffett and Anthony Bolton have proved this. However you often meet private investor that are familiar with EMH and asks about it, Helge says. The software, which is based solely on information that is available for everyone has proved that it is possible to outperform the market on continues basis. He further explains:

“My personal believe is that EMH is present for a few reasons, where one is regarding Fisher Blacks dumb money. There are a number of uninformed investors both professional and private that trade in the dark. There will always be people that are willing to take a chance and carry a high risk that other can take advantage of.”

Helge says that he is still rather new to the fund industry. His previous experience with selling and developing the software is that in those situations you often meet people that have taken a finance course or two at the university that asks about EMH, the random walk and on the impossibility to beat the market without luck. There is a challenge because often are these views that a monkey with a dart can do the job of a fund manager equally well. Nevertheless Helge feels that their track record is so good that it speaks for itself, the difficulty is to convince people that there are ways to do better than average.

Helge is skeptic to whether it is fair to compare actively managed fund to indexes, because of the complexity actively managed funds often has. What index would you compare it to, Helge asks? He develops further:
“The world index is wrong since there are only two markets in our fund. The Nordic index could be more accurate but you are still missing the target. So there is really no accurate benchmark in our case. For funds that are invested in one market only an index is more appropriate but do still not necessarily have to be the best benchmark.”

4.8.4 Managerial Objectives

Much of the work in finance is based on selling, Helge says when the question of whether there would be a difference of how he is working with an increase in salary or larger bonus. A bigger bonus would in most cases lead to more sales. Helge does not think that it would change the way they are selecting stocks for the fund. The standard is already set and the job is more about making small adjustments to the software. A bigger bonus would be nice but it would not change the way the fund is constructed, Helge concludes.

The reason why a part of MFM still is underperforming is because of the extensive trading that is going on according to Helge. Some funds, like his, are based on a rather high trading frequency and thus the fees will be higher compared to a normal fund. It is to some extent up to the private investors to set the standard; they own the funds so they should use some of that power to indicate that is not correct to have a holding period of less than a year. Both institutional and individual investors need to stand up because there is a lot of wasted money to brokerage fees and other fees.

4.8.5 The Financial Crisis

The recent financial crisis has according to Helge been devastating for no particular reason towards mutual fund managers. Mutual fund managers have taken a lot of beating for something that he thinks they did not do. Credit institutes and lenders are the one to blame in this case, Helge says. The trust that people had before needs to be restored. Something good with the recent crisis is that some of the less serious actors have been washed out. Not so good is that the industry has moved towards the larger institutions, people run to the big names because they think they are safer, which is kind or ironic since two of the biggest institutions, Lehman Brothers and Bear Sterns, actually went bankrupt in the process, Helge argues. He further explains that fund managers and other in the industry needs to learn for what reason a financial crisis arises:

“We always need to be aware of the risks that this industry comes with. People, both professional and private individuals never seem to learn. We are at the point today where we were just before the crisis a few years ago, and people are again talking about a new era like we have reached a continues growth era.”

The fund is so new that it has not lived through an economic crisis yet, Helge explains. However the software is not new and Helge explains how the funds changes in those situations. The software gives an indication of when markets are about to drop. The possibility is to short markets or specific stocks. Because of regulation and the funds
rules are they not allowed to short sell stocks. In their case would an economic recession be more about how to minimize losses and try to find the grain of gold that is out there.

An economic recession certainly changes the way of how the fund is constructed according to Helge. In downturns you need to be alert and follow the market more intense than in an up-market. In a financial meltdown like recently experienced there is a need to cut the losers and follow the winners. This is of course true in a market where everything is on the upbeat but not always as severe. Technical analysis is about following trends and finding investment opportunities and is as fundamental analysis not based on names and brands. This makes it easier according to Helge to spot companies that might seem obscure but that actually are doing a lot better than the market in general. Fundamental analysis is more time consuming and the investment universe gets too big, Helge concludes.

4.8.6 Future
Helge believes the trend that has been seen since the introduction of the ETF’s will continue. He is sure that there will be more actors on the market. Helge further develops:

“Investors are not confident in trading with SPDR’s and similar. They want a brand that they know, for instance Robur or SEB. ETF’s are still rather unknown among the common investors and this needs to change and can only be done when one of the major institutions decide to get involved.”

The problem from the institutional perspective is that ETF’s offers a rather modest return compared to their mutual and index funds according to Helge. There will be sort of cannibalism there, where the ETF’s will take market share from other funds in the family. However, if the institutions can live with that, which is something, they have to get used to, than ETF’s will become huge within a few years according to Helge.

The industry in general needs to change in the future means Helge. More than 90% of the funds out there today and their fund managers rely on fundamental information in order to make correct decisions. That does more or less mean that 90% of the professionals in the industry thinks that they have superior information compared to the rest. That is not possible. Funds that are in the bottom of the lists often stay there for a number of years before they eventually vanish. Individual investors need to have solid reasons for investing in a fund according to Helge.

Helge further develops his thoughts of the future for the mutual fund industry:

“I think that there will be more innovation in how the funds are constructed, if the regulation is somewhat eased. Hedge funds popularity has shown that there are people out there that are willing to accept a greater risk for a bigger return, something that hedge funds with their extreme positions can achieve. Mutual funds need a better regulation in order to be able to follow the trends of the market, with derivatives, shorting and leverage. This can only be achieved with loser strings, something that I do not think will happen in the near future because of the recent financial crisis.”
4.9 “Ivar”

4.9.1 Background
The 38-year-old fund manager Ivar currently works for one of the larger financial institutions in Sweden. His previous experience ranges from small fund companies to enormous institutions like Deutsche Bank. The payments have ranged from provision based to monthly salary. Ivar have a monthly salary with possibilities for bonuses. The fund that he manages together with 3 other managers is a small cap fund that is investing in the European Union zone. He holds a master in business and economics from Stockholm School of Economics. Ivar would grade himself as a strong 4 on a scale of 1-5.

4.9.2 Mode of Operation
The fund that Ivar is working for is a small cap fund that aims at finding smaller companies and ride with them to the top. The job that Ivar is doing is to find these companies and analyze them with the help of the investment team. That is done in a few different fashions ranging from talking to the CEO to sitting behind the computer trying to find suitable facts.

Ivar’s fund is looking for companies that have a specific niche and solid balance sheet. He further develops:

“There is nothing spectacular in what we are looking for. We aim at the make or break areas such as debt and cash flow. When that has been sorted out we are trying the results in different scenarios. The companies we are looking at are often not found in the popular areas, as those tend to be overvalued.”

One of the problems working with small cap companies is that the opportunity to buy them is small because of few stocks or few holders of the stock. Therefore is it important to be alert when the opportunity arises and always keep your ears open and talk to people all the time, Ivar argues.

Ivar brings up the problem of overconfidence, and how they work with it in their fund:

“Often is the problem with overconfidence due to a lack of strategy. We try, in our fund to follow the same pattern every time and evaluate from different situations. Most often is the problem that we focus too much on when to enter a trade, this focus is good for this particular reason, however does it make us forget about the role of psychology. We are aware of this, but cannot help from being dragged down and get an emotional attachment to the stock.”

A trading plan is an excellent tool that Ivar’s fund is constantly working on. Anyone should be able to pick up their plan and follow it and make money on it. Ivar means that confidence for the plan is vital, but not overconfidence since it has showed in history that it destroys money.
A poor start of the year would according to Ivar not change the way of how the fund team is working. There needs to be faith in the strategy of the fund. Ivar further develops:

“Changing a successful strategy because of a poor start would be devastating. My investment team is assembled to take advantage of each manager’s strength, changing that in some way would probably mean that the end of the fund.”

Large funds have a few advantages compared to smaller ones according to Ivar, economies of scale for example. However are there some disadvantages that need to be considered. One of these problems and the reason for why large funds have underperformed small funds is due to the restrictions that funds need to follow. Large funds often have an agenda where they invest in companies from a list. The problem, as Ivar explains, is that when the fund gets large is that they are not allowed to invest in the companies on top of the list because of previous commitments; instead do they go further down the list. That means, highly simplified, that investors of large funds invest in their c-listed companies according to Ivar.

Large fund families have to Ivar’s experience often-superior information. However are those situations natural and not always beneficial. The problem with large fund families is according to Ivar’s experience that they can more easily attract investors:

“Brand recognition is just as important in this industry as in other. That does however not mean that a well-known brand offer better products than smaller less known fund companies. Small funds often have better fund managers and better performance but not the capacity to market themselves like large fund families can.”

Diversification is something that Ivar’s fund manager team has discussed thoroughly lately. The discussion has been whether there actually is worth the effort. Ivar explains that much of the research they have done in the market of their investors is that they, the investors, do not care much about diversification:

“A great majority of our funds investors does not care extensively of diversification. The aim has never been to offer perfect diversification since our fund should only be one out of maybe four or five that an investor has. Individual investors should have their funds spread out in different fund families as well to spread the risk.”

4.9.3 Managerial Objectives
There is no doubt in Ivar’s mind that the salary makes a big difference. A greater salary goes hand-in-hand with greater results. The reason for this is according to Ivar because of harder work. He means that there is more effort put in place when fund managers get better paid. However is there a risk that this method of paying more is rather shortsighted. He argues that after a while, when the fund manager is used to the salary will fall back to old habits and not putting in the same effort.
“The best way of making sure that the investment team is doing a great job is to have a payment scheme that is based on the fund’s performance every month. However is the risk with this method that it does not attract the people that it should attract. The highest salary attracts the most talented people; performance based attracts another kind of people.”

Whether a bonus system would change the way of working is Ivar not sure of. He argues that in the long run, for instance a year-end bonus is the difference insignificant:

“I cannot see how a year-end bonus would change my way of working for the first ten months. It is ridiculous to believe that someone would be willing to work those extra hours in the beginning of the year for money that might in a best case scenario been seen on the account a year later. It is different when you are in November and the goal is within reach, than I would work 24/7 to make it happen.”

The reason why higher fees do not give a better result is rather obvious according to Ivar. There are funds that charge up to eight percent in fees, this is not sustainable with the results they are delivering and there are no funds that need to charge more than a few percentages. There are good fund managers and bad fund managers, the bad fund managers are often charging these ridiculous fees and perform the worst because of the risk they take on, Ivar concludes.

4.9.4 Practical Theories
The efficient market hypothesis is in Ivar’s view dead. The discussion has according to him not changed since the 70’s even if evidence has been laid out. It is of course relevant to discuss the topic and it ought to be because of the nature of the industry Ivar say. He develops the concept of efficient markets in relation to financial crisis further:

“The interesting thing is that efficient market hypothesis is often hot after a financial crisis. But should it not be the other way around? The hypothesis argues that market prices are always right, this I cannot agree with. There should never be a bubble like the one we are recovering from now. Financial markets are keen to speculative bubbles and that can never be efficient, at least not to me.”

Ivar explains that the market is not perfectly efficient since news, obviously is processed differently. However this does not mean that the market is inefficient. The measure of risk is not correct and therefore is the hypothesis not interesting. Until there is a general model where the risk factors are properly taken care of there is no great need for the hypothesis. There are some economists who argue that a more regulated financial industry would make it possible to let the markets be truly efficient and burst bubbles in their infancy. This argument does Ivar not agree with and says that if there is something the financial market does not need is more regulation.

4.9.5 The Financial Crisis
Ivar explains that the role of the trading plan is essential and needs to be followed in bad periods as well. In his case, the financial crisis highlighted the importance of the
fundamentals of the financial plan, including a solid balance sheet and future cash flows. Financial crisis like the recent offer a wakeup call to those that needs it and great opportunities to those that have made their homework. Mutual fund managers did just like every other actor in the financial market have part of the recent financial crisis according to Ivar. However he is not sure of what could have been done differently from the fund manager’s perspective. The regulation is strict, there is no way that we could have influenced the American bankers says Ivar.

A crisis does however not change the way of how the fund was constructed because it is based on fundamental points that are built to last for a financial crisis. Funds that are built on opportunistic fundamentals will be wiped out from the market, where the IT crash in the beginning of the millennium offers a great example, Ivar says.

The recent financial crisis is a good case where actively managed funds have had great opportunities to do better than index according to Ivar. He means that it will be interesting to see how the actively managed funds have done in comparison with index funds.

“A good fund manager should have some skills to identify a financial crisis and thereby have some market timing and through that do better than index funds. Hopefully will there be some studies that can show that has been the case in the recent crisis.”

4.9.6 Future
When the question of ETF’s function in the future is mentioned Ivar’s laughs and says that people tend to believe that this is something new and wonderful. According to Ivar is this old news and that the only new thing with a EFT is that it is traded priced continuously during the day, in contrast to a regular fund that is traded and priced once a day. Ivar is skeptical to the future of the ETF’s:

“A vast majority of the ETF’s are plain index funds. Most of them are illiquid and hard to trade. The ones that are liquid are traded to frequently because of the inexperience the holders of them have. All ETF’s are mutual funds but not all mutual funds are ETF’s.”

Another interesting thing that Ivar has noted is that active investors primarily hold ETF’s and not passive investors. This is because of the risk reducing and not about the return they offer. Ivar is more optimistic about the future for mutual fund managers, because of the possibilities they offer:

“Mutual fund managers are needed and the industry needs the individuals. Both institutional and individuals investors will learn that the brand is not important, what is important is the person behind the fund. If a fund manager is leaving, there is a need to see why and whether it makes sense to withdraw the money and follow him to the new place.”

Mutual fund managers will always have a certain place because of the complexity of the markets and the expertise they have. It is harder than it looks and people are careless
about their hard earned money. Ivar develops this and resembles the mutual fund manager to a car mechanic:

“If your car breaks down and you need to repair it, you do some research to find someone that can fix the problem. The same does not go for your own money. Today there is a belief among many individuals that they can invest and protect the money as good as or better than the ones actually working with it. This will hopefully change in the future.”

Another thing that Ivar brings up is the fact that history repeats itself. People are asking themselves the same question today as they have done over the last 60 years. We are not in a new phase, the answer is that we live in real time, says Ivar. We have the same problem today as we had during the 60’s with unemployment and recession for instance.

4.10 “Julia”

4.10.1 Background
Julia has been with the company that she is working for her entire career. That means more than 25 years of experience within one of the larger financial institutions in Sweden. She is today fund manager for a fund that has a global approach and her responsibility is for the U.S. market. She has a monthly salary scheme and bonuses if the fund and company is performing well. However is this still under debate and might according to Julia change any day. Her academic background is equivalent to a bachelor in history. She would consider herself as a 4 on a scale of 1-5.

4.10.2 Mode of Operation
Julia describes her way of working as a classic fund manager in the spirit of Benjamin Graham. She classifies herself as a value investor that is looking for companies that are undervalued and companies that can be held for a long time period. She describes her selection method as a top-down approach where the search for undervalued companies often happens behind her desk in the first phase and after that try to talk to people within the company and their competitors to see what they are doing.

The job as a fund manager for this particular fund means that she is responsible for the U.S. market and there are other fund managers that are responsible for other parts of the fund. Many of the investment ideas come from other managers of the fund. There is a list that they are working from, where most of the companies are valued too high at the time. Julia describes the funds trading strategy almost as a contrarian view of the markets. She says that in order to create wealth and stand out in the highly competitive fund market there is a need to do the opposite. She clarifies that this does not mean that she always is found on the other side of the trade:

“Fundamentals need to be in order before buying. Balance sheet is extremely important. The golden rule is often to be fearful when others are greedy and greedy when others are fearful, as a wise man said.”

There is a great advantage of being part of a larger fund family Julia says. Much of the research that people from other departments of the company is doing is not available to
anyone else. Working closely with other fund managers creates information that would be impossible to obtain if you were not a part of a larger fund company. However she does not feel that there is a favor towards the funds with higher fees in the company. Julia says that there are too much trading happening within the funds. Some of the blame should be put at the fund managers. However she argues that there is a pressure today from the investors in the funds that they want to see that something is happening. She sees a need here for better communication between the actors involved.

4.10.3 Practical Theory

The markets are very competitive according to Julia and she cannot compare it to anything else. She further develops:

“The market is close to always right. The only way to actually be able to do well is to have a long time horizon and look for undervalued companies. Speculating in the short run will mean that you have the same chance as in Las Vegas, which is rather small.”

According to Julia are half of all decisions in the market incorrect. That means that in order to have any success as a fund manager is the importance of pride extremely important. The most dangerous thing as a fund manager is pride and that it affects your investments. She says that she has seen a number of funds that have gone out of business simply because there is too much pride in the decisions taken. Julia explains:

“A lot of the people in this industry have a phenomenal ego that has been built up for some time. When they face challenges they often take a superior stand and refuse to admit that they have done wrong and hold on to their loosing stocks. It is not possible to be prideful and you need to be able to admit mistakes.”

Julia further develops her thoughts and says that no one can predict the future and make correct decisions all the time. The most successful investors that are active today, Warren Buffett, Bruce Berkowitz and David Herro all have a very humble approach and are aware of what is going on and can admit wrongdoing according to Julia.

“In order to protect yourself from overconfidence you need to be able to take a step back, look at the situation and reevaluate it. Often I see fund managers that think that just because they are in the zone that they cannot fail. Nothing could be more wrong.”

Markowitz Portfolio Theory is a theory that the fund Julia is working for is not trying to follow. She says the complexity of the correlations and covariance makes it more or less impossible to follow. However is the idea of diversification somewhat taken into consideration in the fund:

“We try to be as diversified as we can in the fund and collaborate over investments ideas that fit well. One of the problems with diversification is that the individual investor often seems to think that diversification is the same as profit. Another problem from our perspective is that the cost of diversifying is often very high and not always lucrative.”
4.10.4 Managerial Objectives
On the question of why there is a negative relation between fees and return Julia means that it is because of the competition among the actors in the industry. She argues that the funds that charge a higher fee often does the same job and provides the same service as the lower fees funds. Higher fees funds often aim at wealthier clients and their presence is greater in those areas. Julia mentions that in funds where fees are based partly or entirely on performance there is greater risk taking. This she says is because these funds still get a certain percentage independent of results, but with a good result will the fund manager make more money.

Julia argues that a larger salary would not make a fund manager perform better. She further develops of why that is:

“I could not see how it would change your work. If you are a fund manager whose main task in to sell the fund to the customers than I could see that you would sell more, but I cannot see that a fund manager would select better investments.”

Julia is restricted to discuss bonuses because of her current employer. However does she mention that she thinks that a good bonus system can be rewarding for all actors, including the end consumer of the fund. However, the bonuses need to be in relation to the results and not as it was during the financial crisis, Julia argues.

4.10.5 The Financial Crisis
A financial crisis does not change the way Julia is working. She explains that since her trading style can in many cases resemble a contrarian trading style the financial crisis offered a great deal of investment opportunities. When the common investor was selling Julia was buying. The top-down approach made it possible to find bargains almost in every sector. However she admits that the last century has been difficult and that it has been easy to lose money and not so easy to make money.

“The last decade, has been a lost decade. It is more difficult to attract people to invest with us than it was a few years ago. People are still not confident in the markets and that spills over at the mutual fund industry.”

The recent financial crisis showed that the responsible could not be put on one person or institution. There is a need for everyone in this business to see what he or she could have done differently. Julia argues that even if her role is peripheral she could still have done more to avoid the downturn.

4.10.6 Future
The function of the mutual fund managers and subsequently mutual funds will be great in the future according to Julia. She continues to say that the function will change and that mutual funds will not only be plain vanilla as it is today:

“I am sure that the forms of mutual funds will change soon, and that there will be more freedom in the funds. There are too many rules that need to be followed and too many restrictions. I think that the fund will move towards
more of the extreme, such as allowing other investment vehicles that today are not allowed.”

The awareness of finance will grow in the future, as more people will realize the importance of being knowledgeable in this subject. With that Julia believes that the fund manager’s function will increase and that people will to a greater extent follow fund managers where they are going. The performance of a fund is closely tied to the management of the fund Julia argues.

When the question of how the function of ETF’s will change in comparison with ETF´s is Julia exhaling and explains that she is tired of the discussion that ETF’s would be a new magical investment.

“There is nothing new with ETF’s. What they have done is that they have marketed it well. Fee’s of ETF’s which is supposed to be the real benefit have lately gone through the rough and there is a myth that they would be good and cheap”

Julia concluded the discussion regarding the ETF’s that they do not pay any dividends and that the tax benefits are very similar to normal mutual funds. The active investor could still have a need for ETF’s in his or her portfolio, however would she think twice before actually recommending it to anyone.
5. **Analyses and Discussion**

In this chapter is the empirical result analyzed in relation to the theoretical framework. One purpose with this chapter is to position the different concepts and see what influence the financial theories have. The respondent’s answers will be interpreted and compared to each other. The authors’ thoughts and discussion will be incorporated into this chapter.

5.1 **Analytical Disposition**

The analytical part of the thesis will follow a similar pattern as the theoretical framework chapter. The respondent’s answers will be compared to the theories in order to clarify its importance. The respondents will be analyzed together in contrast to how they were presented in the empirical part. There is a need to mention that each question from the interview guide will not be analyzed separately, as the interviews were not identical and did not carry the same importance for everyone. The respondents were during their interviews given the possibility to speak freely around the questions and the result therefore differs.

5.2 **Classic Financial Theories**

Several of the respondents referred to the mutual fund industry to be a continuously developing industry. The function of classic financial theories have during the last decades been heavily debated and questioned. Much of the criticism has been that classic financial theories do not encounter human behavior (DeBondt & Thaler, 1995, p.385). Almost all of the respondents have a mode of operation where human behavior is essential. Is it still possible to argue that the function of human behavior is not important, and not present when financial decision-making is done? The answer among the respondents is a clear no and the importance of the human interaction is in many of the interviews highlighted.

5.2.1 **Efficient Market Hypothesis**

Several respondents, Adam and Erik, to mention two, argue that they have a great advantage when they have the possibility to meet the companies and their employees on site. Both Adam and Erik, mentions in their interviews that they have done better than average. This is not in line with the Efficient Market Hypothesis (EMH) that states that it is not possible to outperform the market, unless extra risk is taken on (Fama 1965, pp.90-91). The question of whether these companies that they have met are more risky than an average company was never asked, however is easy to assume that is not the case. The implications of that would mean that it is possible to outperform the market if thorough research is done as suggested by Erik and Adam.

The function of EMH was one of the questions that the respondents found most interesting and yielded the greatest reactions. A majority of the interviewees have a skeptical view of the subject. This did not come as a surprise since believing in the EMH and working as a fund manager are two opposites. The different forms of EMH are interesting to discuss in relation to the answers given and the respondents mode of operation. The weak form of EMH states that all historical information is already priced into the stock (Fama, 1970 p.383). If that argument would hold, technical analyses would
According to Helge, that is managing a fund based on technical analyses, it is possible to outperform the market with technical analyses. Technical analysis is not the same today as it was in 1965. The advancement with computers has made it possible for everyone to take advantage of trends, support and resistance. The fund that Helge is managing is new and there is still not enough data to determine whether they can make abnormal profit. There are other areas in investment, called flash trades, which are highly debated today where mispricing is taken advantage. This can be related to technical analyses and historical information and would mean that it is possible to make excess return.

The semi-strong form of EMH states that all historical information and all public information are already in the price of the stock (Fama, 1970, p. 383). This implies that there is a way to earn excess return, via insider information. All of the respondent’s answer that they are better than average at their work. The result from this question should not be taken as a true answer, however does it give an idea of the historical results that they have had. Several of the respondents highlight that they have better than average results from different schools of investing. Erik’s approach to perform better than average is by finding companies that are undervalued while Cesar follows an index in good times and switch to bonds when the market is uncertain. This highlights that there are numerous anomalies that a fund manager can take advantage of due to markets not being efficient.

The most extreme way of EMH is the strong form that states that all public and private information is incorporated into the price of the asset (Fama, 1970, p.383). This would if true, mean that there is no way to outperform the market, regardless of the information the investor have about the company. The second respondent Bertil’s mode of operation is a good example that by following how insiders buy and sell, it is possible to outperform the market. This together with the above mentioned anomalies does not make it possible to generalize and say that the markets are inefficient, however it provides evidence that the markets are not as efficient as Fama (1970) argues.

David argues that the EMH should not only be seen as whether it is possible to continuously outperform the market. His view of the hypotheses is that one part is regarding earning excess return in a longer term. The other part is whether the prices actually are correct. Julia brought up the argument that the market is always right, however does Cesar, who argues that the recent financial crisis is a great example of how the market is not always correct, contradict this and says that there is a need for correction. Friedman (1970, p.19) argued that even if it is not possible to precisely predict the market outcome there is still the “as if” defense of the simplification of the theory. The same can be used from a fund manager’s perspective. That even if the prediction for the future is uncertain, it is still possible for fund managers to earn excess return. The discussion could be seen from a different perspective. A great deal of the academic discussion is regarding whether it is possible to continuously outperform the market. This thesis is no exclusion, however is there a clear need to move on. Over a long time horizon it has been proved that certain solid strategies perform better that average. The discussion regarding EMH should instead, as suggested by David, be regarding the prices of the markets and if they were always correct how come markets crash?
The markets are in most of the respondents view not efficient. However is the question of whether the fund managers can profit from the inefficiency. From the interviews has several trading strategies been brought up that claims that they can do better than average. None of the funds, except for Helge’s can be seen as more risky than any other fund. Cesar and Filip’s fund is regarded less volatile than the average fund. That highlights the weakness in Fama’s (1970, pp.413-416) argument that in order to be able to make excess return there is a need to take on additional risk. Fama’s (1998, p.304) argument that there are no ways to outperform the market with behavioral anomalies should be seen as outdated. In the short run the markets are rather efficient as suggested by Erik, however have investors proved that over a long time the markets are not efficient and have been able to benefit from it.

5.2.2 Modern Portfolio Theory
The importance of the modern portfolio theory is among the respondents diverse. No one is using it according to how Markowitz (1952) intended it. The understanding of the concept is all aware of, however several mention that the complexity with correlation and covariance’s makes it close to impossible to use. Much of the criticism that has been aimed at MPT is the difficulty to gather the necessary data and the problem with measuring risk with volatility (Murphy, 1977). In the interviews have these arguments been highlighted and confirmed by the respondents. The core idea behind the theory, not to put all eggs in one basket, is understood, nevertheless is diversification not of great interest for the fund managers.

Mutual funds development has among many things meant that the function of diversification has changed. Erik and Gustaf mention that diversification used to mean that one fund was enough. However has the climate for mutual funds changed with the interest of the saving and investment sector and as it was pointed out that by Helge and Filip, it is today necessary to have several funds from different fund families in order to spread the risk. Much of the diversification that used to be done by the financial institutions has changed and there is today more for the end consumer of the product to consider. This creates a pressure on the legislator and the financial industry to make sure that the end-consumer is aware of the risks when purchasing a mutual fund or other financial products.

Benartzi and Thaler (2001, pp.79-80) mean that the poor diversification among the investors in U.S. pension plans is evidence that the markets are not rational. This thesis cannot and does not aim at confirming or rejecting that. However do the answers from the respondents give an idea that diversification is no longer the goal for the individual fund and that the responsibility is today put at the individual investors. The naïve diversification can be seen as financial illiteracy. However is there a need to keep this discussion on the mutual fund level as well. From the interviews a clear tendency that fund manager overlook diversification emerges. If this were true, it would implicitly mean that the responsibility on the individual investor is greater than it ought to be. This does not suggest that all mutual funds should be well diversified and accordingly resemble each other. However is it debatable whether the individual investor, both from the institutional and retail side take on greater risk than they often are aware of.
Spreading the risk is a concept that all of the respondents work with in different shapes. The regulation of mutual funds gives an effective form of diversification that the fund managers need to follow. This was surely the intention behind the regulation of owning less than 10% of the shares in one company. The rationality behind this concept is easy to understand, however it could be a problem for the fund and negative on the performance. If a company is rising in value and the rest of the fund is stable or declining, the fund could face a situation where they have to sell. This exemplifies the problem that mutual funds have faced in the past where former winners have been sold and losers kept in the fund (Shefrin & Statman, 1985, p777). Erik who wants to take advantage of each stock, something that we will later see supports the theory of behavioral portfolio theory, mentioned the function of each assets value to the fund.

It is easier for smaller funds to diversify than it is for larger funds, something that have been confirmed by the respondents. This is because of the bigger and often more illiquid assets that the larger funds need to trade with. An argument laid forward by one of the respondents that large mutual funds does not always give good diversification, however does it provide economies of scale, when it comes to research and information gathering. This should mean that the larger funds are often performing better than small funds because of superior information, something that has not been proved and is contradicted by David. To conclude that one is better than the others are not possible and will probably never be. However should it be noticed that the advantage with small funds is faster reactions and easier to reallocate and take advantage of current economic circumstances. Large funds have an advantage when it comes to research and information sharing.

Frieder and Subrahmanyam’s (2005, pp.57-58) study concluded that financial crisis leads to worse diversification because of brand recognition. In uncertain times do mutual fund managers rely more heavily on brands that are considered safe. These safe companies are distinguished by the fact that they have been through rough periods before. Gustaf, who explicitly said that the financial crisis had made his fund invest in safer companies like Coca-Cola and Pepsi, mentioned this. This exemplifies the problem that diversification does not work properly and also herding is present in these kinds of situations. One could argue that herding leads to bubbles and that bubbles in turn leads to herding.

Murphy (1977, p.5-6) argues that the idea of measuring risk in the form of volatility is wrong and that risk in relation to reward could at best be seen as weak. David that illustrates it with the example of Nasim Taleb, a criticizer of how risk is measured, also pointed this out the fallacy of volatility as a measure. However it is necessary to argue that as long nothing better is presented, volatility will continue to be the norm of how mutual fund measures risk.

5.3 Behavioral Portfolio Construction
MPT suggests that a portfolio should be constructed with regard to the correlations between assets. This is according to the respondents not the normal way of building a portfolio and other factors have emerged as more important. If MPT is the classic financial theories way of constructing a fund the behavioral portfolio theory (BPT) could be seen as the counter part that has emerged from behavioral finance. Shefrin and
Statman (2000, pp. 3-4) argue that MPT is not realistic in today’s investment environment and that there is no room for individual assets. The interviews have confirmed that MPT should be seen as a theory and is not considered practical. Both Helge and Filip says that large funds are more difficult to manage and that in order to take advantage of each stock there is a need to keep the fund’s assets limited. Helge mentions that his fund is always fully invested and that means somewhere around 20 stocks in a fund. Filip mentions in relation to this the complexity of following more than 30 companies makes it difficult, because of the large number of competitors that needs to be followed.

The methods regarding how a mutual fund is constructed has differed significantly from respondent to respondent. The common denominator has been the function of each asset. The layer-by-layer idea that was brought up by Shefrin and Statman (2000, p. 28) seem to have some relevance in the reality as it intends. One of the reasons for this theory was to explain that assets are individually selected in order to protect the downside (Shefrin & Statman, 2000, pp.7-9). Whether that is true for the respondents in not explained in their answers, however is the potential for upside clearly described by several such as Erik, Julia and Helge.

The idea with a downside protection is to safeguard in a worst-case scenario. The respondents do not seem to have this kind of protection that according to Shefrin and Statman (2000, p.26) entails bonds or cash, with the exception of Cesar. Both Helge and Erik even declare that their aim is always to be fully invested in stocks. This kind of statement contradicts the idea of BPT. However Shefrin and Statman (2000, p.8 & 17) leave room for interpretation when arguing there are possibilities for the end consumer to create their own downside protection. This argument can hardly be contradicted, however it weakens the idea of BPT and the idea that there always is downside protection can be seen as a weakness of the theory. BPT manage to get closer to the truth than MPT of how funds and portfolios are created. The two has been seen as each other’s opposites, however a more accurate way would be to not compare the two and instead see what they bring to the table. There is no exact way of describing fund construction. Nevertheless is the problem still that there is no theory that enables to cooperate the function of the wide diversity that funds offer today. A unified theory will probably never emerge because of the complexity among funds diversity that we see today. This would mean that we are moving towards the death of behavioral and other financial theories as suggested by Thaler (1999, p.12).

The function of home bias in the mutual fund industry is difficult to deny with the empirical results that have been presented by Strong and Xu (2003). Graham et al. (2009, pp.2-3) found evidence that investors with greater results are more interested in investing abroad. The respondents have had a wide array of investment objectives, from worldwide to the Swedish market. Adam mentioned that he invests in Sweden because his competence is greatest in this area and he has built up a solid network that he gets investment opportunities from. The idea that better investors are keen on investing abroad is both appealing and contradictive. The appealing part of the argument is that with confidence will the investment horizon probably grow. It is easy to see a resemblance with overconfidence and extensive trading as explained by Glaser and Weber (2004,
Home bias among mutual funds should however be seen in a different light from individual investors. Mutual fund managers have more time and often more competence to specialize and thereby acquiring a deeper network that provides better information than the individual investor can acquire. This creates natural situations that will lead to a certain bias towards the home market.

The contradictive analyses of the relation between skill and willingness to invest abroad are documented well by Adam. His core competence is the Swedish market and even if he has performed above average he sticks with it, for the reason that his competence is not transferable to another market. Several of the respondents mention the famous investor Warren Buffett and how he has become successful by sticking to his strategy. This has lead us into the next segment of the analyses, the function of confidence and overconfidence for mutual fund managers.

5.4 Confidence and Overconfidence

The purpose with the question where the fund managers got to grade themselves was to see how confident they were. The conclusion from the result was that all thought that they were better than average. Two respondents Erik and Cesar, considered themselves as 5. The results from this simplified question should not be generalized to the fund industry, however does it indicate that the fund managers could be in line with what Griffin and Tversky presents (1992, pp.412-413). They argue that individuals in jobs where there is a great deal of uncertainty often tend to be overconfident. Whether that is the result in this study cannot be answered since there could be a chance that all of the respondents perform better than average. Nevertheless is the result debatable and could be in line with what Odean (1998, pp.1910-1912) argues that the overconfidence might not always stem from the historical results. An individual that are confident in one area that resembles investment is the person most likely to start working there. That could in this case mean that the overconfidence might not come from the actual performance of their fund, there could be other factors behind.

The function of confidence was mentioned by several of the respondents as a main factor in their strategy. The interviewees’ provided different ideas of how they balance between confidence and overconfidence. Some of the respondents, Helge, Cesar and Bertil, follow a predetermined strategy, which is not based on their own behaviors. This highlights in a good way the fear that seems to be present in the mutual fund industry of overconfidence and the fallacies of human behavior. Filip credits his investment team that they are the ones that make sure that no unnecessary trades are made while Erik tries to be fully invested and thereby prevent him from redundant trading. Erik’s argument to not have any cash on hand is in this purpose clear however there could be investment situations that will be missed for the same reason.

The key to success is according to Erik confidence. Overconfidence on the other hand can be devastating. He argues that there is a need not to get emotionally attached to a stock and to maintain distance to it. The problem when not keeping the distance is that the fund managers get too close to a company collects more information and thereby has a stronger opinion regarding the company. This is in line with what Barber and Odean (2002, pp.456-457) concludes in their article, that more information leads to
overconfidence for an investor when forecasting returns. Erik argues that the best way of cutting the losers is to remember for what underlying reason the asset were bought and to include a level in the analyses where they sell. Ivar argues that overconfidence does not necessarily emerge from only doing well. His view is that overconfidence happens because of a lack of strategy and this allows the investor to get emotionally attached to the stock. Following a predetermined trading plan and sticking to the investment strategy is key for avoiding overconfidence according to our respondents. Adam ads that many of the fund managers that are performing below average often tend to shift strategy which is a safe sign of no confidence and that the fund soon disappears.

The result from the answers around overconfidence has been relatively one-dimensional and there is a certain pattern that has evolved. The function of overconfidence in trading is disastrous and should be avoided. Having a clear strategy and remember for what reason the assets were bought in the first place is essential in order to prevent overconfidence. This can be closely linked to being able to attribute success to luck, something that fund managers according to Adam and Erik are rather poor at. Admitting that you made a mistake can as we all know be rather difficult in certain situations. One of the great problems in the mutual fund industry is the difficulty with measuring the performance of the fund managers and the preceding problems this creates. Chen et al. (2000, pp.343-345) attributes performance of mutual funds to luck or chance. Adam agrees to a certain extent with this and means that fund managers are in general bad at contributing success to luck. Ivar agrees with Adam and thinks that it is important to be able to remember for what reason the investment was made in the first place. This makes it easier to attribute outcomes to skills, luck or chance. There is a certain pattern that the respondents through the interviews revealed. Strategy and trading plans are vital to follow in order to gain success. There is certain disdainfulness towards acting on your own and follow the gut feeling. This should from an investor’s point of view be seen as positive and also reassure the confidence that have been lacking after the financial crisis. The importance of a trading plan has been established and this leads us into the next section regarding stock selection.

5.5 Stock Selection

Does actively managed fund earn the fees that they are charging? This has been one of the most fiercely debated questions within the mutual fund industry. Supporters of efficient markets have said they do not believe that mutual fund managers create value (see Jensen, 1968 and Chen et al., 2000 for examples). Consensus among the respondents is that mutual fund managers should be able to outperform the market and thereby create additional value for their customers. Both Filip and Adam argue that the fund manager should be able to perform a few percentages better than an index. Both claim that they are doing this, however Adam points out that this is not obtainable every year and should not be expected. The mutual fund manager should accordingly over a longer period of time perform significantly better than an index or appropriate benchmark. However can it, as Adam mentioned not be expected to occur every year because of fierce competition.

There is according to Alexander et al. (2007, pp19-20) evidence that fund managers have ability to value stocks better than average investors and that these fund managers perform better than other forms of investment vehicles. According to theory, funds that are based
on other forms than value investing should perform worse. This can be read into some of the respondent’s argument of investing when they prefer solid companies in uncertain times and are staying away from the hot area companies. Julia and Erik are two value investors that prefer stocks that have been beaten by the market as Erik puts it. This investment strategy could be seen as contrarian to a certain extent where believing in shares that few other considers. There are in these kind of trades arguably a greater deal of risk involved and with that a bigger upside.

Barras et al. (2010, pp.179-181) provides evidence that the number of skilled fund managers have declined as the fund industry has grown, for what reason has however never been determined. Bertil thinks that the fierce competition has made the fund industry more efficient, which would mean less investment opportunities. Other reasons that were mentioned by the respondents were that the fundamentals of the industry have changed, development of Internet, and that newer fund manager’s has a different mindset. Whether the last is true or not is difficult to determine, however could there be argued that the shorter holding period of the assets within the funds could be a reason for the diminishing returns. Shorter holding periods create higher fees that “eat up” the profit fast and make it difficult to perform better than average.

5.5.1 Herding

The diverse trading styles among the respondents lead to different answers regarding their investing strategy. The function of herding between the interviewee’s was discussed in different fashions. Cesar, who’s trading style is either fully invested in bonds or equity argues that herding is common and that it is too profitable to run with a herd, at least for a while. He argues that it is this kind of mentality that leads to financial crises in line with Shiller (2000, pp.148-149). Cesar thinks that stronger regulation will make it possible to “burst” the bubbles before they occur. The problem with these kinds of situations is not the bubbles in themselves. The problem is that the fundamental aspect of the situation is not defendable. The mutual fund industry has a great part in this, and Wermers (1999, pp.582-585) provides evidence of substantial herding among mutual fund managers and its impact on stock prices. That would mean prices lead prices and this is a viscous spiral. This creates situations where bubbles occur because of the profitability that it often comes with.

Among the respondents the trading styles could be divided into two groups. One is the contrarian view that is implemented by Erik and Julia, which we will return to shortly. The other one includes Helge, Bertil and Cesar, even if the three of them represents extremes of trading. Helge’s technical analysis is a good example of how to trade with the herd. Technical analyses are based at historical information and indicate how the investment community is investing. Trends are very important in this trading style and are constructed from trading patterns. Cesar’s macroeconomic fund is similar in the sense that it tries to take advantage of the business cycles and thereby follow the trend. Bertil’s fund is together with Helge’s fund most extreme and could be seen almost as pure herding funds. The difficulties with these kinds of funds are when to stop following the trend. In Bertil’s case there is no stopping. Helge has precautionary actions that can be included in order to prevent large losses and that are what Erik argues for, stop-losses. However could mutual funds face great problem with selling large bulks of shares fast
because of illiquidity and thereby loose money. This could be an argument where the situation of selling past winners is done because of the nature of the situation where it is assumed to be easier to sell past winners and stick to past losers.

The trading styles of the participants could not be determined for everyone. Some of the respondents possess a mixed trading style where herding and contrarian both are included. This can from an outside perspective be seen as lacking a clear strategy and decision making are based on other premises. Acting upon information that stem from other sources, for example information from board members and similar creates funds with a mixed strategy. Bickchandani et al. (1992, pp.994-995) finds evidence that information sharing creates situations with trading in the same direction. Adam and David argue that investment opportunities often arise from interaction with other managers and board members. This information should rarely be seen as exclusive and could create situations with unintentional herding. David mentions that assets that have risen in value often makes it to the radar and thereby are interesting for investment. The last example is a good illustration of how investment opportunities arise according to Keynes (1936, pp.136-137). His argument is that herding is largely due to lack of trading strategy, or in the case of Bertil and Helge how investment strategies are based on other peoples trading. Whether the information sharing creates herding is difficult to distinguish and Adam points out that the function of experience is extremely important when it comes to differentiate a tip from another something that Sharfstein and Stein (1990, pp. 465-466) argues against. According to them are fund managers afraid of losing out, however could this with the respectable experience that the respondents have be discussable. The argument that Kacperczyk and Seru (2007, p.486) brings to the table is regarding the fact that unskilled fund managers are more likely to herd and more likely to follow external information. Whether there is a relation between experience and skills is difficult to measure, however not unrealistic to assume, which would make Adam’s argument truthful.

The question of whether fund managers herd in the same direction as analysts, as suggested by Brown et al. (2009, p.1), cannot be rejected, however should it be questioned. None of the respondents said that they followed or traded on information from financial analysts. The question was never asked directly with the risk of being to leading. However, there was room for the respondent to include analysts in several of the questions among them of how investment opportunities arise. There could be a certain kind of “pride” and difficulties to admit that you trade on someone else’s information. There could also be that the respondents forgot about the analysts however that just as the hypothesis regarding pride occurs unlikely. The fact that downgrading has a stronger impact (Brown et al. 2009, p.2) than buy signals could explain why it was not important. The function of analysts for fund managers seems at the best to be peripheral.

5.5.2 Contrarian Strategies
Contrarian strategies can take different shapes and does not necessarily mean to move in the opposite direction of the herd. Warren Buffett is one investor that was labeled contrarian by one of the respondents. Whether that is true can be debated because of the difficulty of quantifying a contrarian trader. Both Julia and Erik can be labeled contrarian. Erik’s trading strategy explicitly states that he is investing with companies
that have been beaten by the market. The debate whether this kind of strategy is more risky often comes down to looking at firm specifics and cannot be determined by the strategies name alone. The close ties to value investing are difficult to surpass. Erik’s strategy has been proved successful and relies on a sound investment strategy where several scenarios are tested. This is not in line with the EMH and the fact that it should not be possible to make excess return if no additional risk is taken on (Fama 1965, pp.90-91). There is a chance that Erik have taken on additional risk and thereby been lucky in his past. Nevertheless, if this for the time being is overseen there is a great chance that Erik’s sound investment style can be evidence that the markets are not efficient.

Erik and Julia’s trading style does not only highlight the importance of remembering for what reasons the investments were made. It also shows the importance of sticking to the plan and believing in it. Their trading style can compared to what DeBondt and Thaler (1985, pp.793-795) tried to prove in their study, that past losers perform better than past winners. Erik’s trading plan reminds of that from the perspective that he is actively looking for companies that possess a great upside and small downside. A sound strategy like this should have less risk than the general market. The strategy that both Julia and Erik have can be compared to Buffett in the sense that they are both looking for undervalued companies, however should no further resemblances be made because of their different exit strategies. Erik explains that they for every asset they hold have a price of where they want to sell. Buffett does not have this, as his holding period is not determined by one specific price or time.

5.6 Managerial Objectives

The results regarding managerial objectives revealed that the decision making process does not seem to evolve around the future prospects of the fund manager as suggested by Kempf et al. (2009, pp.93-94). Because of the subtle way of researching the subject the results should not be seen as definite. Another aspect of the results is that the respondents of the study were all in an upper management position and might because of that not consider the future when making investment decisions. Other reasons could be because a predetermined trading style.

Massa and Patgiri (2009, p.1778) find evidence that monetary incentives makes a fund manager take on additional risk. The respondents were not in agreement over the question of whether a higher salary or bonus would make a fund manager perform better. Ivar means that a better salary would in the short run implicitly mean that a fund manager is performing better. This he contributes to the fact that more work will be put in. He also mentions that there could be problem with payment schemes that are based on performance, as it would attract people that are willing to take a chance and incur greater risk for the investor in line with Massa and Patgiri (2009, p.1778). Ivar’s argument is contradicted by several among them Filip who argues that a greater salary would only make a peripheral change in how the work is done. The views among the respondents are dispersed and there is not unified argument. The respondents that think there is a difference mainly argues that there would be more attention on small details that otherwise are overlooked. This would from an EMH perspective not be possible, where the effort laid down does not matter, unless extra risk is taken on. More research should
however mean that less risk is taken on and if that means better performance, it would make evidence that the markets are not efficient.

The function of whether a bonus system changes the way of working resulted in similar answers as the question of how salary influences a fund manager’s way of working. Again smaller details were mentioned. Ivar argued that a year-end bonus would not change his way of working for the first ten months. The bonus does in his view need to be within reach in order to attract the special attention. Helge mean that a bonus would make him work harder, however would it be to sell more of the fund to external investors and thereby make money, the fund managing would not change. There is an obvious danger when monetary incentives are closely tied to performance. This entails investors to take on additional risk and enact in more trading. The financial system has because of its disproportionate bonus systems lost much of its reputation and confidence. This need to be restored in the future and one way of doing this is to regulate the payment schemes, something that was mentioned by several. Much of the attraction for the financial industry is because of the big money that it attracts. Mutual fund industry should not be one of these actors that collaborate with hedge funds and other extreme funds. As long as there is demand for hedge funds, there is an even greater need for a fund industry that is built on trust and confidence.

There is from the respondents view no difference whether their fund performs well or poorly during the first half of the year as suggested by Brown et al. (1996, pp.85-86). The only respondent that could see a difference in the way of working was Helge that admitted there could be more risk taken on if necessary. His argument is not in line with what Brown suggests, it is more in order to attract investors. Cesar who have a somewhat similar trading strategy as Helge admits that there could in case of a poor start mean that the model needs to change. However is Cesar’s goal not to be in top of the lists for shorter time periods. The same pattern erodes here, as with previous questions that no one seems to be concerned by his or her job situation when performing poorly. This can be because of different cultures in Sweden and U.S. where a great majority of the previous studies have been made. The work climate is probably more result oriented in U.S. than it is in Sweden, which makes Swedish fund managers more secure in their work. This can be connected to the previous discussion. If there is less focus on results in Sweden than it is in U.S. could help explaining some of the results from the interviews. This assumption would probably explain why there is less of a focus on branding managers and a greater safety among the fund managers when it comes to job security in Sweden.

Dass et al. (2007, pp.51-52) found evidence that the best performing funds in economic crises have often been funds that have high monetary incentive funds and have a contrarian strategy. This fits well with Erik that mentioned that the problem he suffered during the most recent financial crisis was that he did not have enough capital to invest. High monetary incentive funds tend to have a different view and not participating in riding the bubble and herd as other funds. This does not prove that higher fees are the same as safer investments. On the contrary, many funds should be investigated thoroughly. However these funds can be of interest for investors that are willing to take on more risk and want to diversify their portfolio. The reason for why high fee funds often have a contrarian view is probably because of the need to stand out and thereby
“create value” for their investors. No sane investor should be willing to accept the higher fees for the work that can be done by lower fees.

5.7 Fund Size Behavior
We have briefly discussed the matter concerning whether there is a difference of performance depending on the fund size. The subject of fund size gave good response from the respondents and some things need to be analyzed. Ivar underscores the importance of superior information that he consider they have. He means that the fund size makes it more difficult for larger funds to actually enact on trades because of limitations. This hypothesis, that large funds would have superior information would implicitly mean that they should perform better than small funds something that is contradicted by David. David argues that small funds often have superior fund managers and thereby perform better. There is no academic evidence that indicates that either of them is right. However is there evidence that larger European funds have advantages with economies of scale (Otten and Bams, 2002, pp.98-99). There are in several instances important to be large and visible. Information sharing happens at all levels, no matter whether you are at a large financial institution or a minor player.

5.8 The Financial Crisis
One of the objectives with this thesis was to incorporate the lessons learned from the recent financial crisis. The respondents shared their ideas and gave different views of what could have been done differently. Shiller (2003, pp.94-95) argued that the IT crash at the beginning of the millennium was because of price-to-price feedback. The same can from the answers of the respondents to a certain extent be said about the recent crisis. Cesar meant prices were going out of their fundamentally based range and that investors knew there was a bubble under rising. Nevertheless, the argument is the problem of awareness and the profitability of riding the bubble. The solution is accordingly to be able to burst the bubble in its infancy. However would this be difficult to implement and there is a need for regulators to identify bubbles that are under way.

The view of regulation in relation to the financial crisis is double-edged among the respondents, where a few like Bertil means that there is a need for more regulation. This is contradicted by Helge, who means that there is too much regulation and there needs to be a relaxation. Common for several of the respondents is the need for understanding and awareness of what actually is being sold and bought. One of the major reasons for the recent financial crisis was that both retail and institutional investors bought assets that were complex and difficult to understand. There is a need for more transparency in the financial industry. Much of the lack of trust and confidence that we have seen is because of the secrecy that has been around the financial industry. This need to change in the future and the only way of doing this is with more regulation and harder punishment for the responsible actors, as suggested by Gustaf.

The financial crisis meant different things for the respondents. Filip mentions the importance of bubbles and how they work as a reminder for everyone that the financial markets are highly correlated and the difficulties this creates with diversification. Dass et al. (2008, p.95-96) blames the recent financial crisis at mutual funds and meant that their short-term investment horizon created the bubble. The shorter time periods has lead to
more trading and there could for regulators be possible to demand a certain time period on the individual holdings. This would if possible speak in the favor of the already long holding period funds for example pension funds. Other funds with shorter fund periods would not benefit from this. There is however a need for the holding periods to be longer and create stabilization in the funds. Unfortunately is the trend, as indicated by Erik, that more trading will occur in the funds in the future. There seems to be as Julia described it during the interview and as Dow and Gorton (1997, pp.1-2) found in their study that the end consumer wants to see something being done. This creates problem for the fund managers when they have to trade instead of doing nothing, which often is more beneficial. The problem again comes down to financial illiteracy and poor communication. Another problem is that the investors want to see fast results and this is not always obtainable. Better communication as suggested by David, between the seller and the buyer of the funds would eliminate this problem. Hedge funds have another solution to the problem with fast results and that is lock up periods of the invested capital, however would this be a step in the wrong direction as the financial industry is in need of more transparency not less as this would support.

Helge contradicts that the mutual fund managers had any blame for the financial crises and instead mean that the credit institutes and lenders are the one to point fingers at. The questions regarding the financial crisis showed two different sides, one where the fund managers like Helge for instance, does not admit any wrongdoing. Ivar argues that the mutual fund managers did like many other actors in the financial industry let this happen. Helge’s approach to the financial crisis is rather naïve and it can be concluded that mutual funds did play an active part in the recent crisis. Nevertheless the function of Swedish mutual funds is diminishing in the globalized financial industry. Everyone that took part of the speculation and sold or bought assets that they did not fully understand have blame in this.

One of the positive effects of a financial crisis of the recent magnitude is according to Ivar that speculative funds are wiped out. This is obviously negative for their investors, however is there a need for these kinds of corrections and reminders to happen. Individuals, both professionals and non-professionals, seem to posses difficulties in learning about risk and how the markets are correlated in extreme times like a global recession. It is therefore necessary for markets to correct themselves, even if the consequences can for individuals be devastating. There are in these situations necessary to see beyond the individual investors and see what is best for the financial system for a longer time horizon. If the trust ever will be restored for the financial industry it can be necessary to “sacrifice” a few for a greater interest. Mutual funds did participate in the recent financial crisis and the majority of the respondents seem to agree on this. More could have been done in order to prevent a financial crisis. More regulation could have stopped a situation in Sweden. Nevertheless, because of the high correlation between the financial markets would it be impossible to regulate other markets that would prevent this from happening. There is as previously discussed a need for more regulation however the globalization makes it difficult for the regulators. More standardization between financial actors in different countries could make it easier to regulate and prevent future bubbles. The lack of discipline in the U.S. market created a chain reaction that eventually spilled over to Sweden.
5.9 Exchange Traded Funds and the Future

The future function of mutual funds and subsequently their managers was questions that gave different responses. Not surprisingly do the fund managers argue for a function of mutual funds, however it differs to a great extent of how the future will play out. The view of ETF’s in the future was divided among the respondents. A few, for example Julia, argued that ETF’s is not anything that will revolutionize the financial industry. This contradicts Poterba and Shoven (2002, pp. 422-423) who argues that ETF’s will with its low management fees be a threat to mutual funds. Julia does not agree that all ETF’s have low fees and that they will be a threat to regular mutual funds. That ETF’s with low fees is an interesting investment opportunity is difficult to argue against. However is there a need to have the same procedure when investigating ETF’s as mutual funds.

The respondents have highlighted that ETF’s in Sweden are still rather undeveloped and that the diversification benefit that they often claim to have needs to be researched. The respondents agree on that ETF’s should not be seen as a threat to mutual funds and that it could at best be seen as a complement. Interesting to note is that ETF’s were constructed to attract passive investors (Tufano, 2003, p.325), however has it been most successful at attracting active investors that are looking to hedge. The idea of ETF’s is great and there is definitely a future for them. However is the difficulty of attracting passive investors to them difficult because of the nature of passive investors. Only a few actors’ offers ETF’s in the Swedish market today. This is probably because the low fees do not generate profit that can be comparable to an index fund that is actively managed from the institutional point of view. However will this need to change as the products becomes more known and all large institutions will have to offer them in the future. The problem that was established by Adam that there is often no diversification benefit will need to change and there will be necessary to offer greater investment horizons than only specialized in Swedish markets. One of the benefits that ETF’s has and something that should be marketed better is the possibility of investing in markets that is difficult to invest in otherwise as Vietnam and Bangladesh as mentioned by Gustaf.

The importance of the mutual fund manager was highlighted by several of the respondents. Some of them argue that the performance of a fund is determined of who is running it and not of the company they represent. This does to a certain extent confirm what Baks (2003, pp.1-2) find in his study that examines the importance of the fund manager. With this in mind have several of the respondents argued for a better branding of the fund managers. The conclusion drawn from this is that the fund manager stands above the company when it comes to earning profit. The fund companies should invest more time and money to promote their best and most successful fund managers. There is however a risk with this, something that is mentioned by Erik, that when fund managers are performing well is there a greater chance that they move on and start their own fund. Nevertheless could there be argued that the institution should bear this risk because of an expected spillover effect that is assumed to happen as suggested by Nanda et al. (2009, pp.329-330). Erik suggests another solution with longer contracts for managers that are performing well. However this could create problems that performance drop when there is a long-term security as a contract entails.
The future will bring more financial innovation, which is necessary for continues growth in the mutual fund industry. Tufano (2003, p.325) mean that with financial innovation will agency problems disappear. This could go in the other direction and innovation can actually lead to further agency problems, something that we have seen from Ponzi-schemes and complicated derivative products. There is according to the respondents a continues need for the fund industry to adapt new products and develop through this. One problem with the fund industry where mutual funds play a vital part is that several of the new innovations that are introduced are often constructed for the seller and not for the buyer. An industry where both the demand and supply is determined by the selling side is not optimal. These industries often dig their own grave. The same is at the moment not present for the mutual funds, however is there a need for the industry to ransack itself and see what is the need and actual demand from the buyer. The different views of the respondents gave different directions of the future for the industry. Gustaf meant that the more complicated products that are offered today creates a greater need for fund managers to offer complete service while Helge argues that there needs to be a diversification not only in markets but also among fund companies. The views of are dispersed, however it has been established that fund managers need to create value for the customers through their expertise in order to survive in the future.

5.10 Summary of Analyze
Thaler (1999, p.12) argues that behavioral finance is the first step towards the death of all financial theories. That is a strong statement, however there is some truth to it. Behavioral finance has as Cochrane (1991, p.480) argues made it easier to explains certain anomalies. Behavioral finance has proved necessary in order to explain certain events that cannot be explained by classic financial theories. The truth is probably in between, there is a need for both views. Behavioral finance will continue to challenge the classical views even if it lacks the strictness that classical financial theories possess. This concludes the analytical chapter and the preceding chapter will conclude the thesis and answer the research questions.
6. Conclusion

This final chapter of the thesis will string the findings together and answer the problem questions. It will start with a review of the purpose of the thesis and the research question. In the end of the chapter, suggestions for further research will be given.

6.1 Recap of Purpose of the Study and Research Question

Based on the theory of efficient markets all investors should be rational when they are making their investment decision. The recent financial economic crisis is an example of how irrational the markets behave under certain circumstances. With these mixed results as a base, the following research questions were proposed, where the first one can be seen as more theoretical and the second as more practical:

- How present are behavioral aspects in the mutual fund industry?
- What have been the greatest eruditions from the recent financial crisis and what will it lead to in the future?

6.2 Answer to the First Research Question

The research questions are complex and impossible to answer in only one sentence, therefore will a summary of the answer first be provided followed by a more detailed explanation of the findings. This study has highlighted the presence of human behavior in the mutual fund industry and that there is a need to better incorporate these behavioral aspects. Overconfidence, herding and irrationality are all behavioral aspects are greater than previously thought. There is a need to incorporate this better in the financial theories, something that is suggested from the results of the study.

The first question has been answered in two fashions, first by incorporate classic financial theories and illustrate how they cannot integrate human behavior. The second step has been by showing the function of behavioral finance with several anomalies and theories. The theoretical value of this thesis is that there is a need to constantly rethink and develop theories that are based on both the theoretical and practical side.

Efficient Market Hypothesis has been fiercely debated over the years. This study has indicated that there is a need to approach the problem of efficient markets from a different perspective. The idea that no one over a long time can beat the market has been rejected by most of the respondents, which exemplifies with themselves and famous investors as Warren Buffett. According to classic financial theories the market price is always correct, something that could be considered false because of the possibility to outperform the market over a long time. The markets could be seen as efficient in the short run and not efficient over a longer time period. The fact that the respondents are not supporters of the EMH should be considered. However is the result of their answers interesting as it suggests further research with a different approach.

The construction of funds highlighted a few different aspects that can be taken from this study. All respondents rejected the function of Modern Portfolio Theory (MPT) and the use of it can at best be seen as peripheral. Nevertheless the concept behind the theory
should be regarded as essential in the financial market with the importance of diversification. This study has recognized that diversification is no longer the goal for the fund manager and that there is a need for the investor to diversify by holding several funds from several fund families. This has been argued to put a great responsibility at the end consumer, a responsibility that he or she often is not aware of. This creates situations that lead to crises. There is a clear need for the mutual fund industry to educate not only the end consumer but also the fund managers themselves of the risks that they are taking on.

The Behavioral Portfolio Theory (BPT) can be seen as closer to the reality compared to MPT. However, BPT cannot be seen as perfect because of the downside protection that is argued for. This highlights another behavioral aspect where the lack of downside protection in many funds is not rational and thus not efficient. Construction of funds and investment opportunities happens in a number of different fashions and there is no unified theory that manages to incorporate it all. Again this shows the fallacies with the argument of the rational actors in fund construction.

This study has indicated that there are different ways of working with overconfidence in the mutual fund industry. It has been indicated that having a clear strategy and sticking to it makes it easier to prevent from overconfidence. Overconfidence is seen as a human fallacy and the impact of the human behavior is in this situation obvious.

Stock selection and trading style has differed greatly among the respondents. This has allowed the researcher to illustrate different behavioral aspects that indicates the importance of human interaction. Investment opportunities have been recognized that they arise from a number of different sources and there is no common denominator among them. Herding and contrarian styles are both present among the respondents mode of operation indicating further behavioral aspects that affects the fund managers. This thesis has indicated that behavioral finance theories that have been aimed at other groups within the financial sector could be applied to mutual funds. Examples of that is the function of overconfidence and herding. The thesis has not been able to establish a common pattern among the respondents of the significance of different payment schemes. That does however not necessarily have to mean that there is no difference regarding the monetary incentive schemes. Some of the respondents argue that there is a difference while some contradict this; the conclusion is that there is no clear pattern that has emerged except that the bonuses should be in line to the contribution to the fund performance in order to restore the public confidence.

This concludes the answer to the first problem question regarding the importance and presence of behavioral aspects in the mutual fund industry. The answer to the second question regarding what have been the greatest erudition from the financial crisis and what will it lead to in the future will follow.

6.3 Answer to the Second Research Question
This thesis has concluded that a financial crisis is not only negative. There is a need for these crises to occur from time to time, in order to remind the entire industry of the fundamentals it is built on and to remove speculators. It is still, however to profitable to
ride a bubble and thereby create a price-to-price feedback loop that leads to bubbles. This can be prevented with better regulation.

One of the biggest problems that the mutual fund industry and the financial industry in large experiences from the recent financial crisis is the lack of confidence. This has been highlighted by several of the respondents and there is a clear need for change. There is a need for more transparency in the market and this need to be established in regulations that everyone follows. Better transparency and stricter regulation could make it possible to burst bubbles in their infancies. This together with a regulation where it is made sure that both the buyer and the seller are aware of all the risks of the assets within a fund would contribute to better stability and higher confidence for the fund managers.

The function of the fund manager will according to the respondents change in the future and the industry will move towards more emphasis on the fund managers instead of the institution they represent. This will create possibilities for the institutions to better profit from their best fund managers. There is a need in the mutual fund industry for new products in order to attract more investors. However this thesis has indicated that these new products need to be easy to understand and not possess a great risk. ETF’s will play an important part in the future, however there are still a few shortcomings that need to be dealt with. This includes the problem of cannibalization where the ETF’s low fees will take business and thereby profit from the institution selling them.

6.4 Suggestion on Further Studies
With the conclusion in mind a few ideas for future research is presented. The functions of behavioral finance in mutual funds have been indicated in this thesis, however it would be interesting to focus more on a few aspects that were mentioned in this thesis. This could for instance be the function of overconfidence and establish a deeper understanding of the consequences. Using the same methods as this research has incorporated could be suitable.

Another topic that is closely connected to the conclusion of this thesis would be to research whether there would be possible to allow regulators to burst bubbles. This study has highlighted the importance of better regulation in order to prevent financial crisis and to stabilize the confidence of the mutual fund industry. This is a daunting task and would require sufficient data and knowledge, however it is a study that the financial sector needs.

A last topic of suggestion for further studies that would be interesting to research is the consequences of poor diversification in the funds and what it means for the end consumer. As it has been indicated in this thesis, there is a great risk that the end consumer’s portfolios are riskier than they ought to be because of the intentional poor diversification in the funds. What impact could this have for the individual investor and what are the consequences of it?
7. Reference List


Appendices
Appendix 1: Interview guide (Swedish)

Bakgrundsfrågor

- Ålder:
- Akademisk Bakgrund:
- Arbetstitel:
- Hur länge har du varit verksam som mutual fund manager?
- Är organisationen ni jobbar för med i en större fondfamilj?
- Hur tas besluten?
- Hur ser er kontraktssituation ut, är den baserad på bonus eller liknande?
- Hur skulle ni klassa er själv på en skala 1-5, där 5 är högst.

Arbetssätt

- Beskriv kort ert eget sätt att arbeta som mutual fund manager
- Hur motiverar ni den stora andelen handel som sker inom fonderna?
- Beskriv hur samarbetet inom er fondfamilj
- Hur påverkar en bra/dålig start ert sätt att jobba?
- Hur jobbar ni med att diversifiera er fond?
- Varför har större fonder problem med att diversifiera sig?
- Hur viktigt är det att ha tro på de investeringar man gör?
- Vad är er syn på övertro och hur kan man motverka det?

Praktiska Teorier

- Vad är er tanke om EMH?
- Vilken roll spelar MPT för ert sätt att bygga fonder?
- Antalet MFM som kan ”vinna” över sitt benchmark har sjunkit trots att antalet fonder har stigit. Varför?

Managerial Obejtives

- Skulle en större bonus ändra ditt sätt att arbeta? Hur? Varför inte?
- Skulle mer grundlön få er att arbeta annorlunda? Hur? Varför inte?
- Varför finns det en negativ relation mellan avgifter och avkastning?

Framtiden

- Vilken roll kommer ETF’s att spela i framtiden?
- Vad tror ni MF kommer ha för betydelse i framtiden?
• Kommer det alltid finnas behov för aktivt investerade fonder?

Finansiell Kris
• Efter en ekonomisk kris, förändrar sig ert sätt att arbeta?
• Vilken skuld har MFM för den senaste finansiella krisen?
• Vad har vi lärt oss från den senaste finansiella krisen?

Appendix 2: Interview guide (English)
Background questions

• Age
• Academic background
• Work title
• For how long have you worked as a MFM?
• Is your organization part of a greater fund family?
• How are the decisions taken?
• How is your contract situation, is there a bonus or similar?
• How would you grade yourself on a scale of 1-5? 5 being the best.

Mode of Operation

• Briefly describe your way of working as fund manager
• How do you motivate the great deal of trading in the mutual funds?
• Describe the co-operation within your fund family.
• Are there favours towards higher fee funds?
• How does a good/poor start affect your way of working?
• How come large funds have problem with diversification?
• How important is confidence in your investments?
• What is your view of overconfidence and how do you prevent it?

Practical Theories

• What is your thought regarding efficient market hypothesis (EMH)
• How great is the importance of Modern Portfolio Theory?
• How come the numbers of MFM that can beat their benchmarks have dropped?

Managerial Objectives

• Would a greater salary change your way of working? How? Why/why not?
• Would a bonus/greater bonus change your way of working? How? Why/why not?
• How come there is a negative relation between fees and return?

Financial Crisis

• Does an economic crises change your way of working?
• What have been learned from the recent financial crisis?
• What part did MFM in the recent financial crisis?

Future

• What function will MFM have in the future?
• What function will ETF’s have in the future?
• Will there always be a need for actively managed funds?