

# THE MUTUAL FUNDS – NATURE, CHARACTERISTIC AND APPLICATION IN THE REPUBLIC OF BULGARIA

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***Abstract:** The industry of mutual funds is a means of financing the economic development of a country as the net assets of the mutual funds amount to 76% of the market capitalization of the Bulgarian Stock Exchange as of the end of 2013. The purpose of the current article is to make a review of the activity of the mutual funds in the Republic of Bulgaria for the period 2005 – 2012. The methods used for the comparative analysis of the characteristics of the mutual funds are financial and economic analysis. The competitiveness of the mutual funds is proved in comparison with the market indices, voluntary additional pension funds, bank deposits, and real estate investment trusts. The development of the mutual funds sector is compared to other members of the European Union - the Czech Republic and Hungary.*

***Key words:** mutual funds, investment intermediary, competitiveness*

## 1. Introduction

The mutual funds are a wide-spread method for investment, under one or another format they are present actively at all capital markets. The capital market in Bulgaria is a second in size and importance channel for financial mediation after the bank sector as the market capitalization of the Bulgarian stock exchange – Sofia amounts to 12,5% of the GDP as of 2013. The industry of the mutual funds is a means of financing the economic development and exerts a substantial

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influence on the national economy in several directions – income distribution, aggregate demand and the restructuring of the mutual funds portfolios can serve as an indicator regarding the appearance of new trends. On the basis of the above mentioned the author considers that the object of the current elaboration and namely the specific character of the mutual funds and their functioning is actual and significant. The subject of study of the current article is the comparative analysis of the mutual funds characteristics and their application as an investment mediator. With the increase of the popularity of the mutual funds in Bulgaria the importance of measuring their effectiveness and a comparison of their results with alternative forms also increase. The working hypothesis in the current article refers to the high level of competitiveness of the mutual funds in comparison with alternative forms of investment. With a view to testing this hypothesis the analysis lays stress on the changes in the activity of the mutual funds in a chronological order. The purpose of the article is to analyze the mutual funds industry for the period 2005 – 2012 while analyzing basic characterizations, trends and problems. The choice of the analyzed period is based on the start date of the actual development of the industry in Bulgaria as three periods are covered – before the financial crisis, the crisis period, and the period after the crisis. This fact allows basic trends to be defined. The methods used are financial and economic analysis as the source of the empirical material official information published on the internet sites of the Financial securities commission, Bulgarian national bank, and the respective competent institutions, organizations and companies is used.

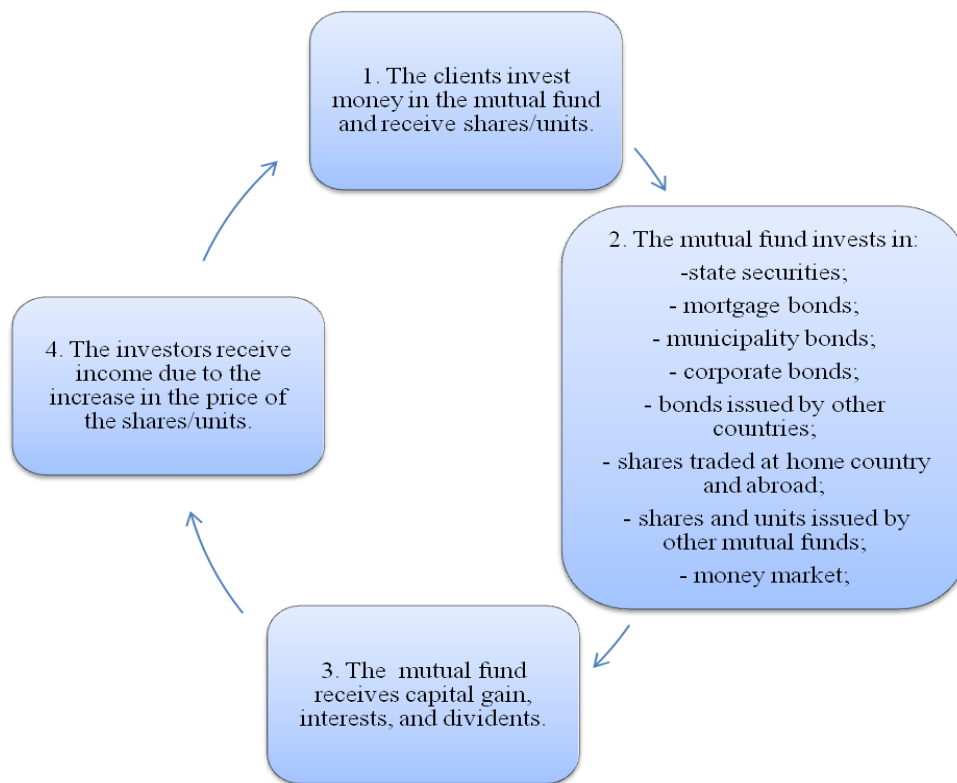
## **2. Development, characteristic and application of the mutual funds**

The industry of the mutual funds comes into being approximately 240 years ago. It is thought that the appearance of the mutual funds known as collective

investment schemes as well dates from the distant 1774<sup>2</sup> when the Dutch trader Abraham van Ketvih establishes an investment trust with state bonds issued by the Netherlands as basic trade object. In the Bulgarian practice the notion collective investment schemes is accepted and it includes the investment companies, mutual funds, and foreign mutual funds. The mutual funds in Bulgaria appear in the beginning of the 90s when the privatization funds appear as well. The stronger development of the mutual funds sector in Bulgaria starts in 2005 when this registration form is settled by law. In 2005 the management company TBI asset management establishes the first mutual fund in Bulgaria – TBI Dinamic. The mutual funds are an investment form where the resources of a large number of investors are collected in a fund where the investors can be physical persons, companies and institutions. The first place where an investor can find information about a fund is the prospectus where the investment purposes, risk profile, portfolio manager, expenses and commissions and the way of buying, selling and substituting units are described. It is the Financial and securities commission which approves the prospectus in Bulgaria. The way of functioning of the mutual funds is presented with scheme 1.

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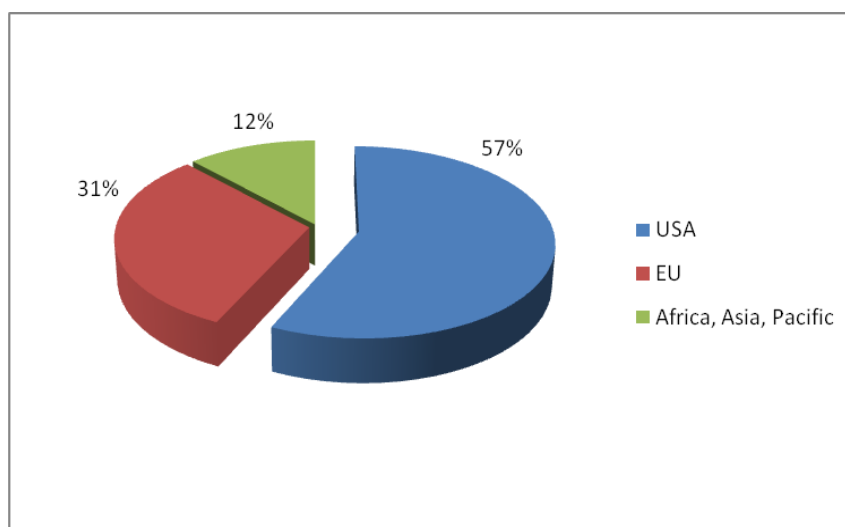
<sup>2</sup>Tanushev, Khr. Marketing and planning in the investment companies. S, UNWE, “Property”, 2004, p. 41.



Source: [www.tbiam.bg/funds/fundsworkprocess/](http://www.tbiam.bg/funds/fundsworkprocess/)

### **Scheme 1. Functioning of the mutual funds**

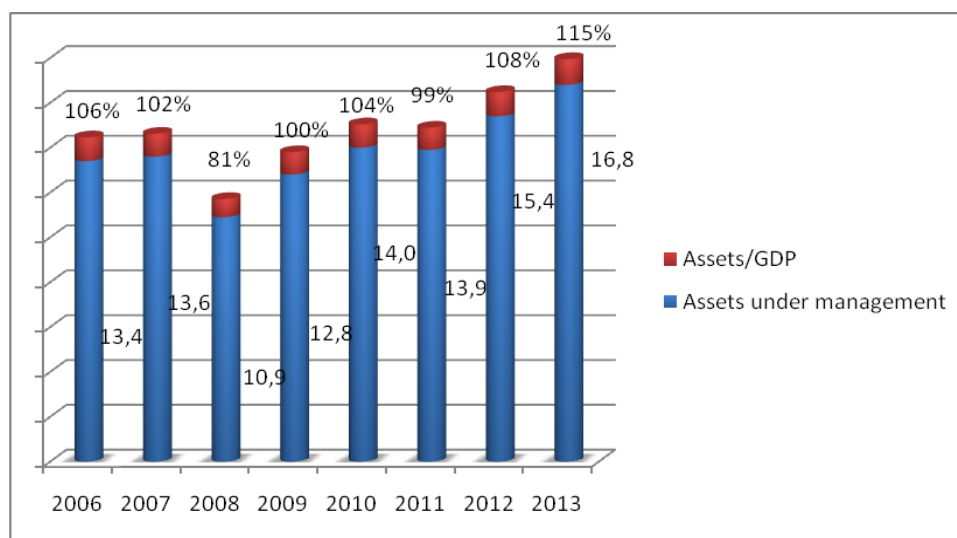
The collective investment schemes have a substantial share in the total volume of savings in the developed economies. Europe is the second largest market in the world asset management industry and traditionally manages approximately one third of the assets in the world. The world distribution of the mutual funds industry is presented with diagram 1.



Source: [www.ici.org/research/stats/worldwide/ww\\_03\\_14](http://www.ici.org/research/stats/worldwide/ww_03_14)

**Diagram 1. World mutual funds assets distribution as of 03.2014**

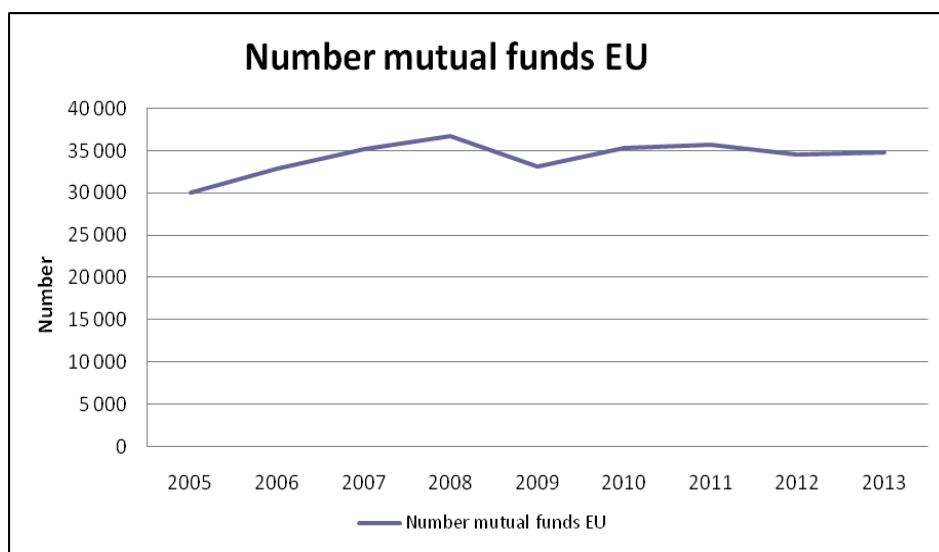
There is a trend towards an increase in the demand of mutual funds in the EU where the high quality of servicing, convenience and effectiveness also explain this growth (see diagram 2).



Source: [www.efama.org](http://www.efama.org)

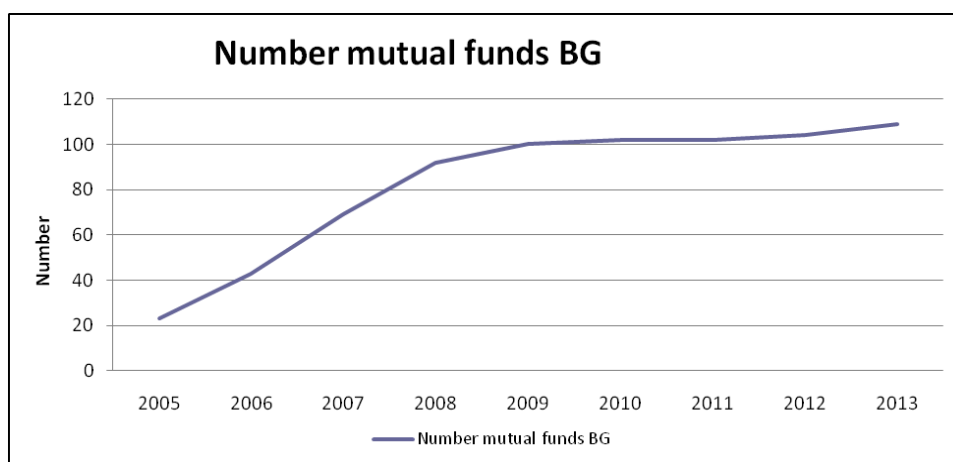
**Diagram 2. Dynamics of assets under management (bln. EUR) and assets/GDP (%) in the European Union for the period 2006 – 2013**

The development of the mutual funds in Bulgaria is in harmony with the dynamics of the oldest index on the Bulgarian stock exchange - SOFIX . The crisis slows down the development of the mutual funds industry sector which is the result of a decrease in the free cash of the population. In spite the delay in the development the growth rate of the number of mutual funds in Bulgaria compared with the EU is bigger (see diagrams 3, 4).



Source: [www.efama.org](http://www.efama.org)

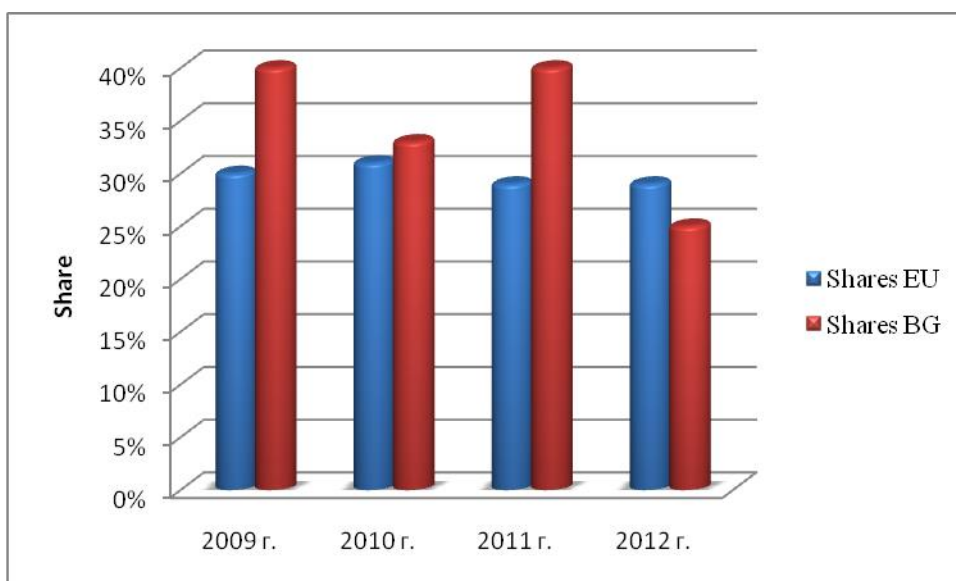
**Diagram 3. Dynamics in the number of mutual funds in the EU for the period 2005 – 2013**



Source: [www.efama.org](http://www.efama.org)

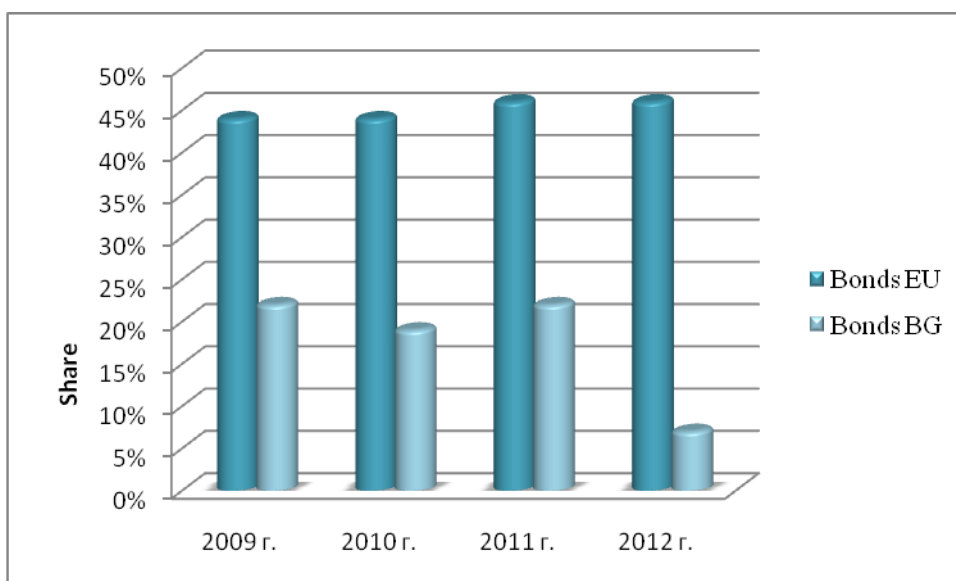
**Diagram 4. Dynamics in the number of mutual funds in the Republic of Bulgaria for the period 2005 – 2013**

For a comparison during the analyzed period a growth of 352% in the number of mutual funds in Bulgaria is reported towards 15% for the EU. The growth rate of the volume of assets under management in Bulgaria is also impressive – 480% towards 69% for the EU. Having in mind the growth rate and the fact that the investments of the mutual funds are directed mainly toward Bulgaria the significant role of the industry for the economic development of the country can be seen. The dynamics of the portfolio structure of the mutual funds in Bulgaria is illustrated with diagrams 5, 6 and 7.



Source: [www.efama.org](http://www.efama.org)

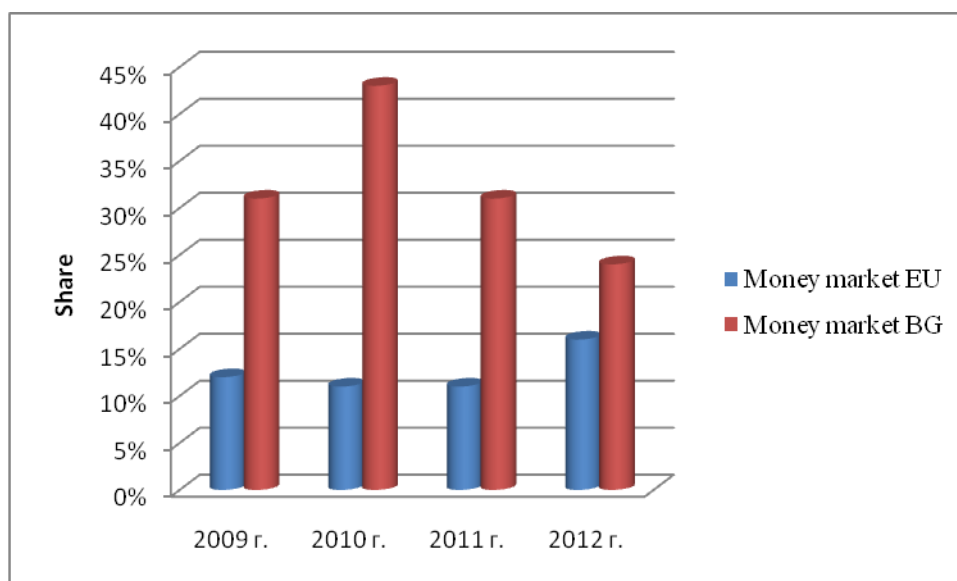
**Diagram 5. Dynamics in the share of stocks in the portfolio of the mutual funds in the EU and Bulgaria for the period 2009 – 2012**



Source: [www.efama.org](http://www.efama.org)

**Diagram 6. Dynamics in the share of bonds in the portfolio of the mutual funds in the EU and Bulgaria for the period 2009 – 2012**





Source: [www.efama.org](http://www.efama.org)

**Diagram 7. Dynamics in the share of the money market instruments in the portfolio of the mutual funds in the EU and Bulgaria for the period 2009 – 2012**

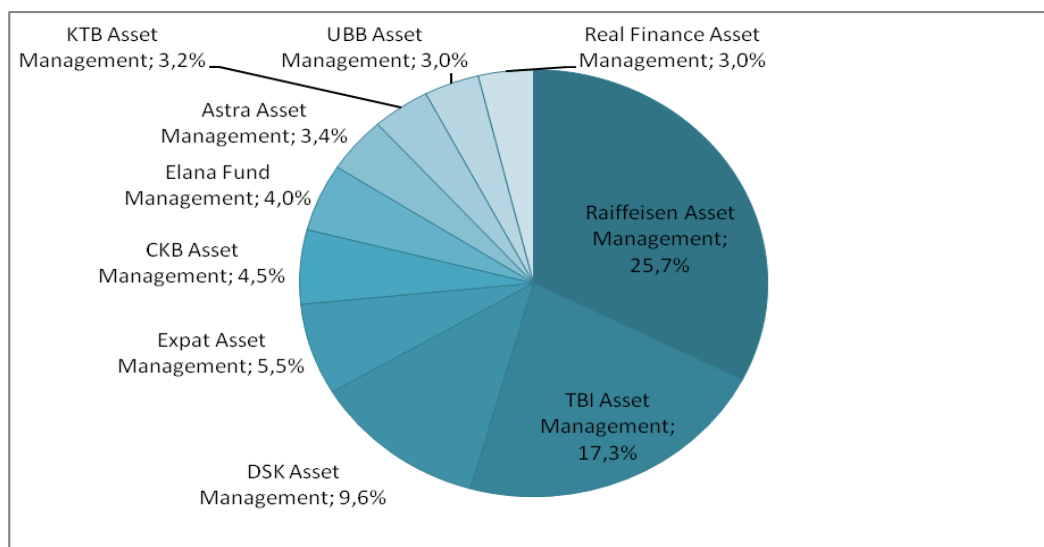
As can be seen from the above diagrams 5 and 6 the industry of mutual funds plays a key role for financing the economy where the preferred asset classes in the EU are shares and bonds. According to information from the Financial securities commission as of 14.09.2014<sup>3</sup> 31 management companies are given a license in Bulgaria.

In spite the great number of the management companies in Bulgaria this sector is characterized with an oligopoly structure - as of 31.12.2012<sup>4</sup> the biggest three companies share more than 50% of the sector. The EU countries in which as of 2011 the first five management companies control less than 50% of the industry are only the UK and France. This fact is significant for their higher level of competitiveness, diversification and progress. According to the

<sup>3</sup> [www3.fsc.bg/ERiK/runner?backId=0&tplId=Tpl\\_6&act=DISPLAY&docId=0](http://www3.fsc.bg/ERiK/runner?backId=0&tplId=Tpl_6&act=DISPLAY&docId=0), 11.09.2014

<sup>4</sup> [www.fsc.bg/Kapitalov-pazar-bg-107](http://www.fsc.bg/Kapitalov-pazar-bg-107), 17.09.2014

information of the Financial securities commission 31.12.2012 <sup>5</sup> 50% of the first ten management companies in Bulgaria ranked according to the size of their managed assets have the names of commercial banks. (see diagram 8).

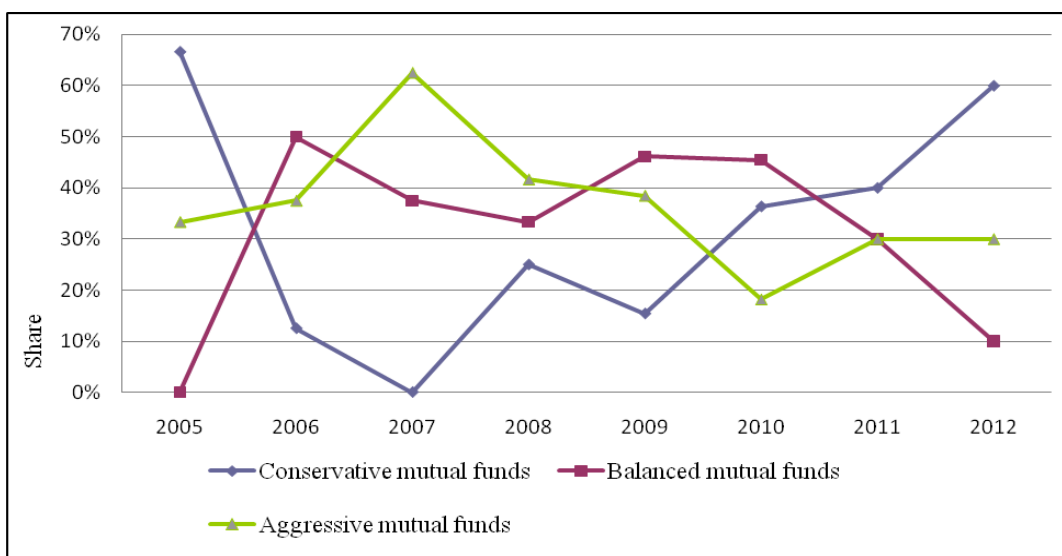


Source: [www.fsc.bg/2012-bg-947](http://www.fsc.bg/2012-bg-947)

**Diagram 8. The first ten management companies in Bulgaria according to the volume of assets under management as of 31.12.2012**

The bank groups dominate the mutual funds industry in the EU. The countries in the EU except for Bulgaria where these groups manage more than 50% of the mutual funds assets are Hungary, Germany, Portugal, Greece, and Austria. The change in the share of the mutual funds with different risk profile in the share of the mutual funds which form more than 50% of the total market share in the mutual funds industry in the Republic of Bulgaria is presented with diagram 9.

<sup>5</sup> Ibi-dem.



Source: Financial securities commission, author's calculations

**Diagram 9. Dynamics of the risk structure of the mutual funds which form more than 50% of the industry in Republic of Bulgaria for the period 2005 – 2012**

The result shows negative growth rates of the aggressive and conservative mutual funds during the analyzed period (-9%) and (-10%) respectively and a positive growth rate for the balanced mutual funds (10%). This carriage of a share from the conservative and aggressive mutual funds to the balanced ones is significant for the attitude of the investors in Bulgaria who want a higher rate of return offered by the conservative funds but are not ready to take the risk of the aggressive ones. The behavior of the investors points to the presence of a perspective for development of the mutual funds industry in Bulgaria.

### 3. Legislation framework

The basic legislation acts which define the law aspects of the regulation of the mutual funds in Republic of Bulgaria are The law on securities, stock exchanges and investment companies, The law on public offering of securities, The law on markets of financial instruments, The law on collective investment

schemes and other companies for a collective investment and Regulation 44 of the Financial securities commission. Other laws related indirectly to the functioning of the mutual funds are The trade law, The law on credit institutions and The law on the liabilities and contracts. Having in mind the above mentioned acts regulating the functioning of the mutual funds on domestic and international level a strict control on the activity of all microeconomic subjects, ascendant gradation of the level of the level of investor protection and gradual synchrony of the legislation in Bulgaria with the respective competent structures in the EU are apparent. Considering the globalised world the presence of common basic principles is apparent upon which the legislation in the USA, EU and Bulgaria is built up. All Bulgarian laws contain texts concerning the foreign participants and a participation of Bulgarian participants in the international market. As it appears from the latest wording of normative acts regarding the mutual funds there is a trend the legislation to be supplemented and edited due to cases similar to the scheme Bernard Madoff<sup>6</sup>.

#### **4. Advantages and disadvantages of the mutual funds**

The basic advantages in case of investing in mutual funds are the following:

- protection of the investors interests, security and transparency;
- possibility for the individual investor to gain access to the international markets;
- possibility for a high profitableness;
- possibility for small investments;
- economies of scale – the investment company diversification where the expenses on 1 monetary unit investment are lower;
- professional fund management.

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<sup>6</sup>Proposal for a Directive of the EP and the Council from 2012 about change in the Directive 2009/65/EU, [eur-lex.europa.eu/legalcontent/BG/TXT/PDF/?uri=CELEX:52012PC0350&from=EN](http://eur-lex.europa.eu/legalcontent/BG/TXT/PDF/?uri=CELEX:52012PC0350&from=EN), p. 2, 22.09.2014

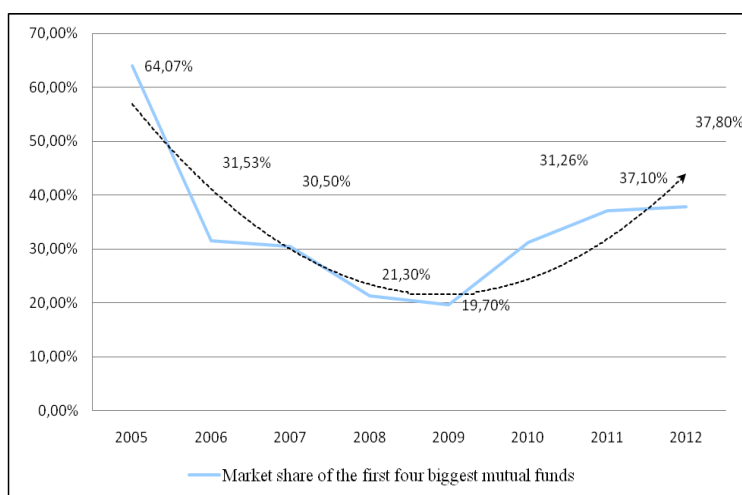
Having in mind the above mentioned advantages it is necessary their disadvantages to be outlined, and namely:

- buying and selling units take time;
  - the profitability is not guaranteed;
  - it is more difficult for the ordinary investor to understand the activity of the mutual funds because an increase in the financial knowledge is needed.
- According to a research 64% of the participants in Bulgaria prefer to invest in a mutual fund with the help of an investment mediator.<sup>7</sup>

## 5. Inferences

### The industry of the mutual funds in Bulgaria

During the period before the financial crisis there is a trend of market deconcentration where after the crisis there is a trend in the opposite direction (see diagram 10).



Source: Statistics of the Financial securities commission, author's calculations

**Diagram 10. Dynamics of the concentration of the mutual funds market in Republic of Bulgaria for the period 2005 – 2012**

<sup>7</sup>Tanushev, Khr. Survey of the nonprofessional investors, current and potential clients of the collective investment schemes. S., UNWE, "Property", 2012, p. 186.

The analysis shows a dynamic fluctuation in the risk structure of the analyzed excerpt which is significant for the fact that the mutual funds are a clear indicator for the attitude of the investors and the economic condition. Two leading management companies are clearly outlined having in mind their results and market share – Raiffeisen asset management and DSK asset management.

### **The mutual funds compared with the market indices**

A gradual trend of a better performance by the mutual funds is present compared with the market indices. There is a positive correlation between the return of the mutual funds and the index SOFIX which indicates that a large portion of shares in the mutual funds portfolios are traded on the Bulgarian stock exchange. (see table 1).

**Table 1**

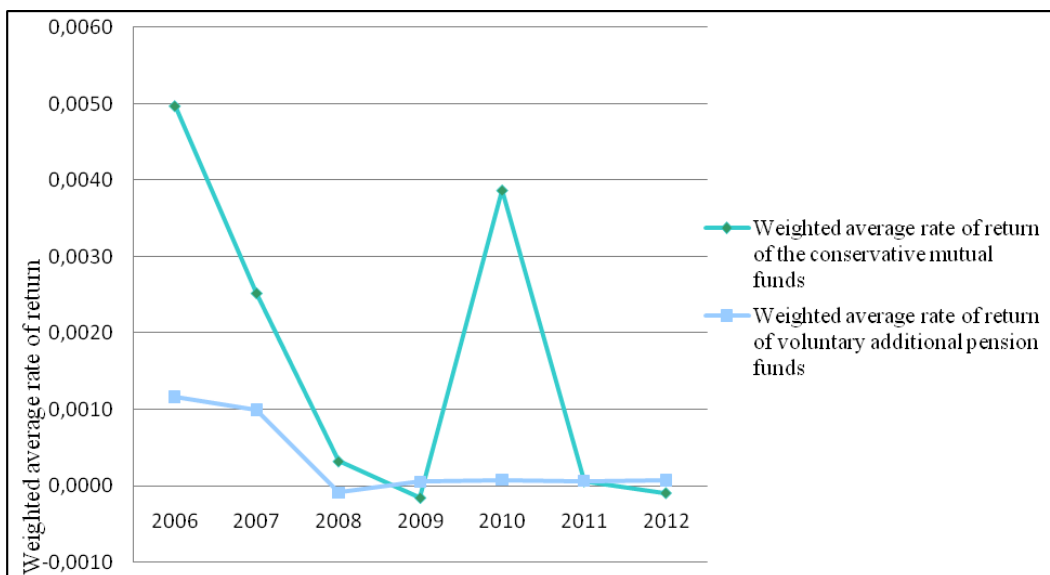
**Correlation coefficient between the rate of return of the mutual funds with best performance and index SOFIX**

	Raiffeisen– 30.06.2010 – 31.12.2012	Elana balanced dollar - 31.12.2005- 31.12. 2009	DSK euro activ - 30.09.2008- 31.12.2011	CKB activ - 30.06.2007- 31.12.2012	Kapman max - 31.12.2006- 31.12.2009	Advance invest - 30.06.2004- 31.12.2008	DSK growth - 31.03.2006- 31.12.2011
A	1	2	3	4	5	6	7
SOFIX	-0,4422	0,9193	-0,3481	0,7653	0,1671	0,8105	0,9664

*Source: Author's calculations*

### **The mutual funds compared with the voluntary additional pension funds**

Having in mind the risk level and the recommended investment horizon it can be said that the rate of return of the mutual funds is higher compared with the voluntary additional pension funds (see diagram 11).



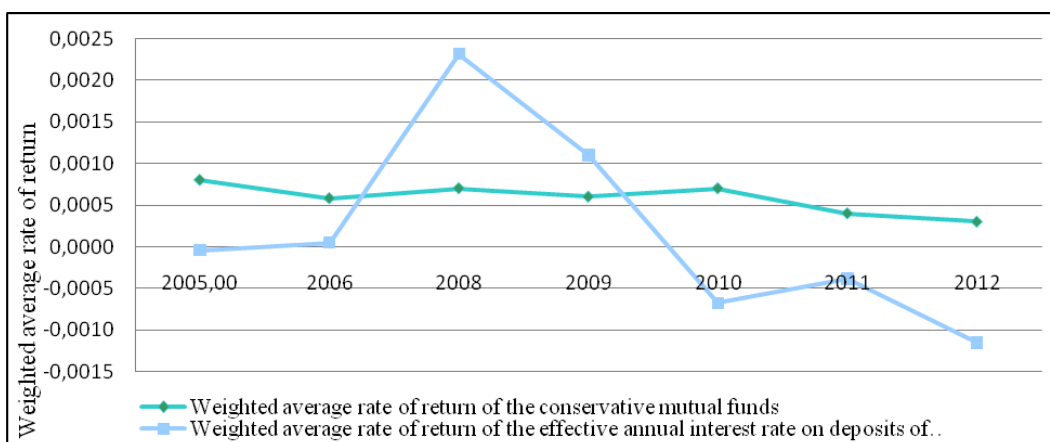
Source: Statistics of the Financial securities commission, author's calculations

**Diagram 11. Dynamics of the average rate of return of the balanced mutual funds and the voluntary additional pension funds for the period 2006 – 2012**

There is a trend toward a gradual decrease of the balanced mutual funds in the analyzed excerpt where a decrease of 40% is reported for the period 2006 – 2012. The higher fluctuations of the rate of return of the balanced mutual funds compared with the voluntary additional pension funds indicate the presence of a bigger share of stocks and bonds in the portfolios of the mutual funds. Having in mind the state regulation and the defined quantitative limits of the investment in certain instruments the profitableness of the voluntary additional pension funds is in fact limited unlike the mutual funds.

#### **The mutual funds compared with the bank deposits**

In spite the gradual decrease of the rate of return of the conservative mutual funds the analysis indicates that the investment in a conservative fund is more profitable than the bank deposit (see diagram 12).



Source: [www.bnb.bg](http://www.bnb.bg), Statistics of the Financial securities commission, author's calculations

### **Diagram 12. Dynamics of the rate of return of the conservative mutual funds and the effective annual interest rate on annual bank deposits for individuals for the period 2005 – 2012**

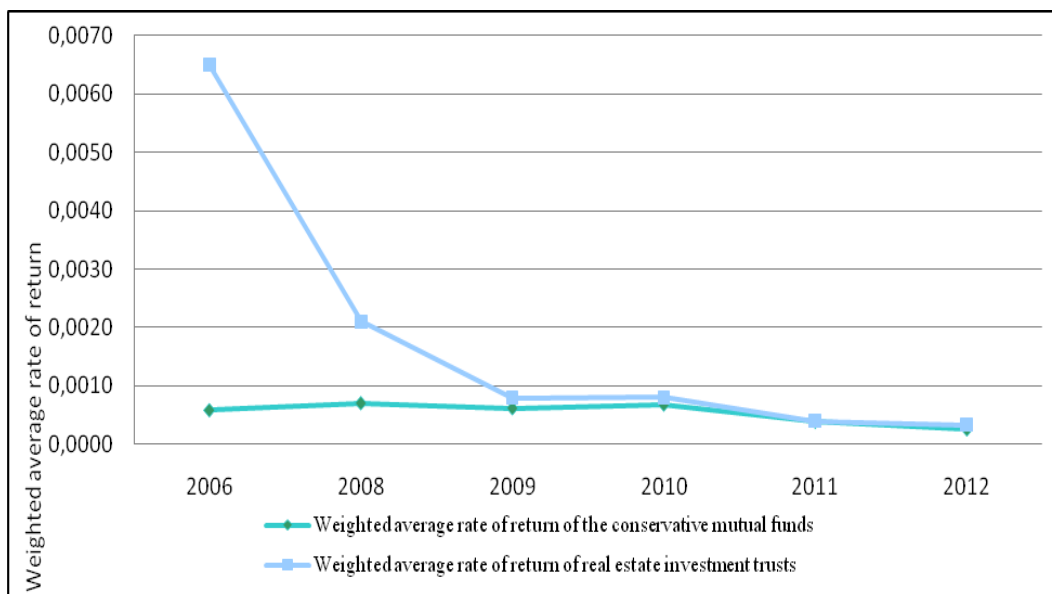
It can be summarized that for the whole period the decrease of the return of the effective annual interest rate is higher compared with the one of the mutual funds. Having in mind the recommended investment period of 1 year (for some mutual funds 100 days) there is no permanent trend regarding the dynamics of the number of the conservative funds in the analyzed excerpt and short-term fluctuations are present.

#### **The mutual funds compared with the real estate investment trusts (REITs)**

Most of the time during the analyzed period the average rate of return of the real estate investment trusts is higher than the average rate of return of the mutual funds. Considering the fact that the minimum investment in the real estate investment trusts allows the participation of investors with average income it can be summarized that for the conservative investors the most profitable is the investment in the real estate investment trusts. Having in mind the trend of



equalizing the rate of returns of the mutual funds and the real estate investment trusts during 2011 and 2012 it can be said that the mutual funds are gathering speed as a worthy competitor to the real estate investment trusts (see diagram 13).



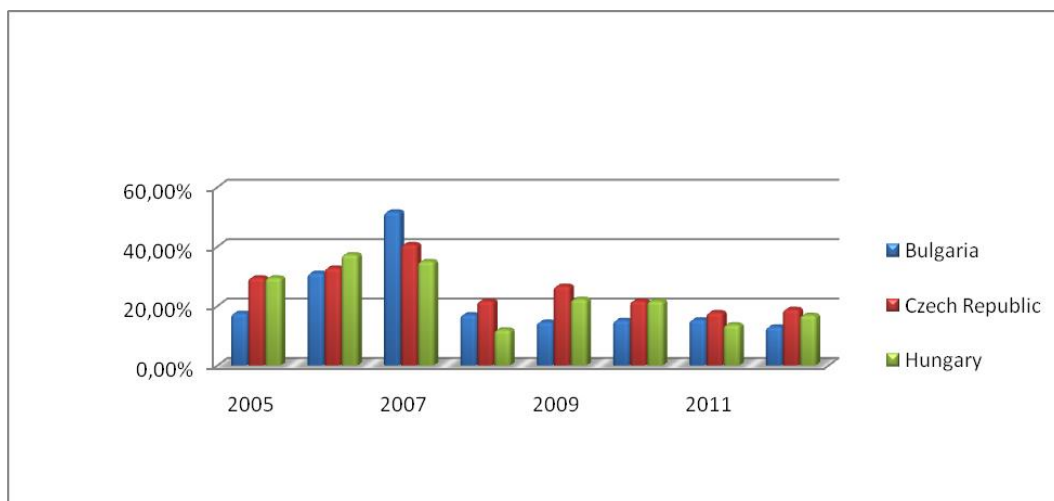
Source: [www.bnb.bg](http://www.bnb.bg), Statistics of the Financial securities commission, author's calculations

### **Diagram 13. Dynamics of the rate of return of the conservative mutual funds and the real estate investment trusts for the period 2006 – 2012**

#### **Analysis of the mutual funds in Bulgaria compared with the mutual funds in Czech Republic and Hungary**

The better economic development in the Czech Republic and Hungary is in favour of the development of their capital markets compared with the capital market in Bulgaria. По-високият икономически растеж на Чехия и Унгария облагодетелства и развитието на капиталовите им пазари в сравнение с този на България. The fact that the indicator total capitalization of the stock exchange

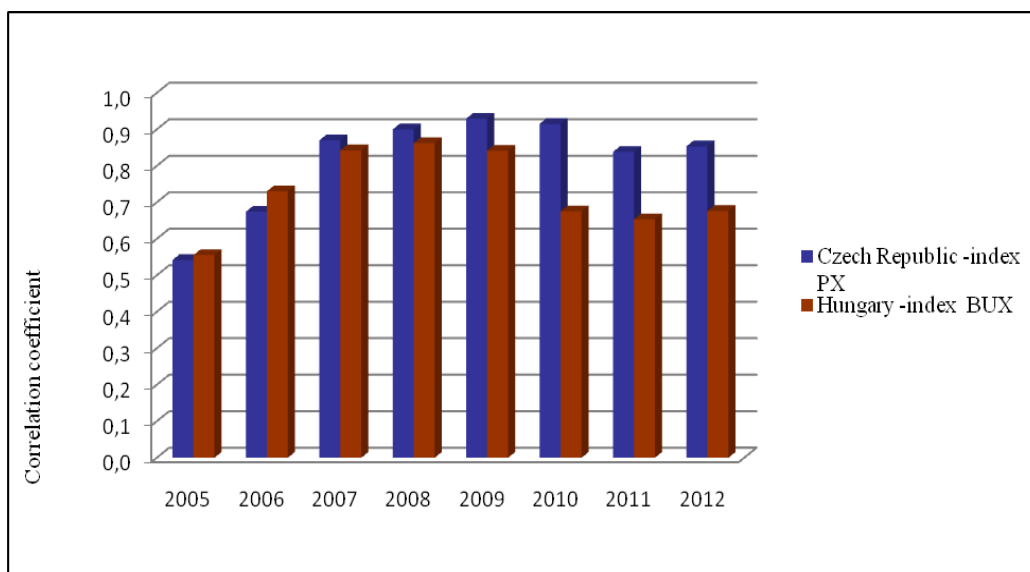
as a share of the GDP is lower for Bulgaria in comparison with the other countries supports the above mentioned statement (see diagram 14).



*Source:* data.worldbank.org

**Diagram 14. Dynamics of the indicator rate of capitalization of the stock exchanges of Bulgaria, Czech Republic and Hungary for the period 2005 – 2012**

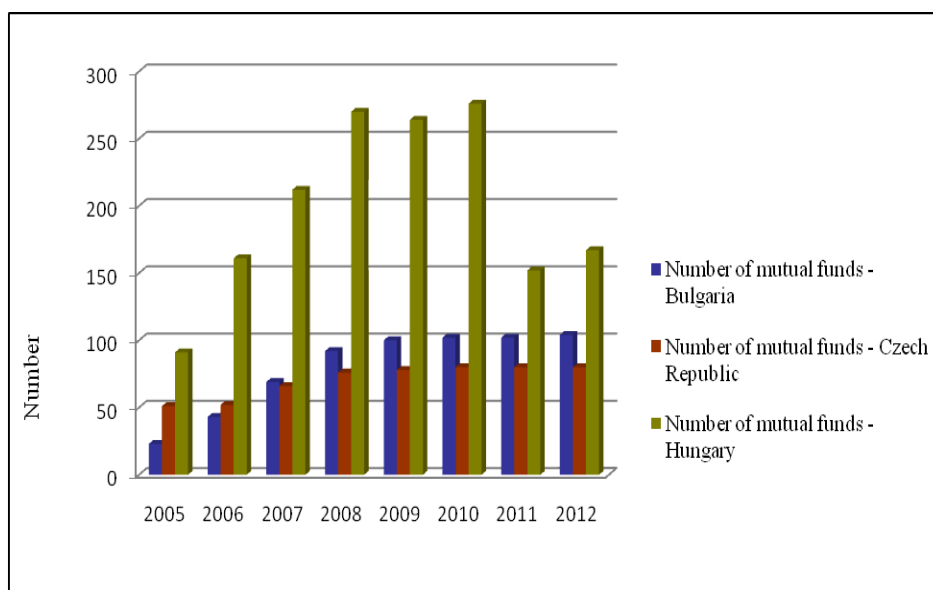
The analysis of the relation of the capital market in Bulgaria with the capital markets in the Czech Republic and Hungary indicates an ascendant trend of a strong positive correlation where the relation with the market in the Czech Republic is stronger (see diagram 15).



Source: [www.pse.cz](http://www.pse.cz), [www.bse.hu](http://www.bse.hu), [www.investor.bg](http://www.investor.bg), author's calculations

**Diagram 15. Dynamics of the correlation of the indices SOFIX, PX and BUX for the period 2005 – 2012**

The strong positive correlation is a proof about the strong connection between the Bulgarian market of securities and the foreign investors in the Czech Republic and Hungary. The number and volume of assets under management are significant for the development of the mutual funds in each country. Indisputably as of 2012 Hungary is a leader in the number of mutual funds followed by Bulgaria and the Czech Republic (see diagram 16).



Source: Financial securities commission, [www.ici.org](http://www.ici.org)

**Diagram 16. Dynamics of the number of the mutual funds in the Republic of Bulgaria, the Czech Republic and Hungary for the period 2005 – 2012**

The presence of the higher number of the mutual funds in Hungary compared with Bulgaria and the Czech Republic indicates a higher level of market competition. There is a great fluctuation in the number of the mutual funds in Hungary compared with Bulgaria and the Czech Republic. In spite the higher absolute number and volume of assets under management in Hungary and the Czech Republic the highest growth rate as of 2012 compared with 2005 is reported in Bulgaria - number (352%), followed by Hungary (84%) and the Czech Republic (57%), and respectively volume (480%), followed by Hungary (26%), and the Czech Republic reports a decrease of 16%. It is important to indicate that Bulgaria is also a leader regarding the growth rate of the net assets of the mutual funds as a share of the GDP – (2,47%) followed by Hungary (0,16%) where the Czech Republic reports a decrease of 0,43%.

On the basis of the analysis it can be summarized that the fact of the domination of the low risk mutual funds in Bulgaria is significant for the risk preferences of the investors having in mind the macroeconomic environment. The risk tolerance of the investors in Bulgaria is lower compared with the investors in the EU. There is a tendency in Bulgaria towards searching for the “golden mean”. The high level of competitiveness of the mutual funds in Bulgaria is proven in comparison with alternative investments. Regardless of the lower level of development of the capital market in Bulgaria in comparison with the Czech Republic and Hungary it can be inferred that Bulgaria is a leader in the growth rate of the mutual funds industry.

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13. [www.tbiam.bg](http://www.tbiam.bg)