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Mutual fund advertisements

Abstract

This study provides an extensive examination of equity mutual fund advertisements that were published in a popular personal finance magazine. Rule 482 of the 1933 Securities Act allows mutual funds to advertise selected information as long as it is derived from the prospectus filed with the SEC. We find that sixty-four percent of the funds advertised highlight historical performance, all but one reporting positive one-, five-, and ten-year returns. The vast majority of the funds that report past performance beat the S&P 500 index. Around one-fifth of the funds reveal Morningstar ratings, which are either five or four stars. Less than 5% disclose that they have sales charges, 54% indicate that they are no-load funds, and the rest of the funds do not reveal any information in this regard. Around 30% of the equity funds advertised show their availability for Individual Retirement Account (IRA), and those available for IRAs report significantly higher past performance.

Keywords: mutual funds, advertisements, personal finance, 12b-1 fees.

JEL Classification: G20.

Introduction

The mutual fund industry experienced extraordinary growth during the 1990s. The Investment Company Institute (ICI) estimated that at the end of 2003 the combined assets of U.S. mutual funds were around \$7.4 trillion, up from just over one trillion in 1990. Seventy-seven percent of the mutual fund assets are owned by 91 million individuals in 53.3 million U.S. households while the rest are held by institutional investors.

Despite the rapid growth in mutual fund assets, it is often said that mutual funds are sold, not bought. Traditionally, mutual fund investors purchase through financial advisors. According to the ICI, 81 percent of all long-term mutual fund sales were transacted with the assistance of investment advisers in 1975. By 2001, 52 percent of the mutual fund assets were purchased either through sales forces (37%) or direct purchases from investment companies (10%) or discount brokers (5%), while the rest were funded through employer-sponsored defined contribution retirement vehicles such as 401(k) plans.

With the rising demand for mutual funds in the 1990s, funds and fund distributors have cultivated new ways to reach investors and expanded traditional sales channels. To be sure, given the universe of 8,000 plus individual funds representing various investment policies and management styles, it is tough for ordinary investors to choose the right ones. It is, therefore, not surprising that investment companies and their distributors employ various means of marketing channels to attract potential investors. According to the National Association of Securities Dealers (NASD), these marketing tools are classified into four broad categories: 1) communications to a broad audience, 2) sales literature for

communications to a targeted audience, 3) correspondence to a single customer; and 4) communications in a live forum such as conversations with clients. The first category is reserved for communications targeted toward a broad and anonymous audience, and the NASD defines these communications as “advertisements”.

Like any other advertisers, mutual funds and their distributors tend to advertise some features of the fund that are appealing to potential investors under certain circumstances. This selected disclosure of information in an advertisement is allowed under Rule 482 of the 1933 Securities Act as long as it is derived from the prospectus filed with the Securities and Exchange Commission (SEC). Highlighting past performance or Morningstar ratings is one obvious way to make funds attractive to potential investors. Even the popular press has alerted that readers cannot open a newspaper or magazine without seeing advertisements promoting the stellar performance of hot mutual funds (see, for example, “You may get burned by ‘hot’ funds” in the November 20, 2001 issue of the Wall Street Journal).

The proliferation of advertisements touting recent performance of hot funds has also caught the attention of regulators. An officer at the SEC’s division of investment management made the following comments in a speech before the general membership meeting of the Investment Company Institute (on May 18, 2001):

“Fund advertising is another important area that I believe firms need to navigate very carefully. In the year 2000, it is reported that mutual fund companies spent \$515 million on advertising, 22 percent more than they spent in 1999. That surprised industry observers because fund advertising usually declines in market downturns. Another trend that these observers noted is that more advertisements relied on performance claims.”

This study provides an extensive scrutiny of mutual fund advertisements. Specifically, we examine various aspects of mutual fund advertisements that were published in a popular personal finance magazine between 1995 and 1997. This is an important and timely research for several reasons. First, though a large body of academic research has been devoted to assessing various aspects of mutual funds such as performance, structure and fees, few have focused on how mutual funds are advertised. The one that is closest to this study is Jain and Wu (2000), who examine a sample of 294 mutual funds that were advertised in *Barron's* or *Money* magazine during the 1994-1996 period. They focus on whether mutual fund advertisements are used to signal superior management skills or they use the past performance to attract more money into the funds. They find that there is no superior performance in the post-advertisement period. Rather, they find that the advertised funds attract significantly more money in comparison with a group of control funds. Barber, Odean and Zheng (2005) examine how the fee structure affects mutual fund flows. They find that investors are averse to funds that charge front-end loads. They also find that mutual fund advertising works in terms of attracting fund flows. Our study differs from previous works in that we provide an in-depth look at how mutual funds are advertised.

Second, an empirical investigation of mutual fund advertisements is of interest to potential investors in choosing mutual funds. It is hoped that such a study will help investors make better investment decisions.

Finally, a study of mutual fund advertising behavior will have policy implications that can be used by regulators. Despite the complicated regulatory structure surrounding mutual fund advertising, the existing guidelines are either too general or vague, leaving mutual funds to decide by themselves what to advertise and the format of advertisements.

The rest of the paper proceeds as follows. The next section discusses and summarizes the basic regulatory framework surrounding mutual fund advertising. Section 2 describes the data and sample. Section 3 presents the results. The last section summarizes and concludes.

1. U.S. regulations on mutual fund advertising

This section discusses and summarizes the basic regulatory structure surrounding mutual fund advertising. This summary will be helpful because the regulation of mutual fund advertising is scattered haphazardly throughout the 1933 Securities Act and the Conduct Rules of the National Association of Securities Dealers (NASD). The Securities Act of

1933 covers mutual fund advertising in its usual strict manner. The NASD has taken the lead among Self-Regulatory Organizations (SROs) in adding regulations to this area. We begin with the four most popular types of fund advertising allowed under the 1933 Securities Act and the manner in which funds have advertised under each area. We then discuss the NASD conduct rules concerning fund advertising and the corresponding types of advertisements falling under each category.

1.1. The 1933 Securities Act regulations. The Securities and Exchange Commission (SEC) regulates mutual fund advertising primarily through the 1933 Securities Act and its restrictions on written communications offering securities to the public. As mutual fund sales are considered as new securities, a mutual fund cannot advertise its shares to the public until it has filed a registration statement with the SEC. In fact, a mutual fund can only advertise before its registration statement becomes effective if it employs a prospectus that meets the SEC requirements. However, a mutual fund can advertise more freely after its registration statement becomes effective. But, under all circumstances, the mutual fund must deliver a statutory prospectus to the purchaser of its shares no later than the delivery of the security or the confirmation of the sale, whichever occurs first. This prospectus delivery requirement, coupled with the fact that most advertisements will be considered prospectuses with their corresponding content requirements, places a tremendous burden on mutual funds desiring to advertise their products.

The SEC has recognized that funds have a legitimate interest in advertising their shares and that it is impractical to expect advertisements to include all of the information required in the statutory prospectus. The SEC allows mutual funds to have four different advertising options to market their shares and not have the advertisement considered a prospectus with its corresponding content requirements. These options are 1) generic advertisements, 2) supplemental sales literature, 3) tombstone advertisements, and 4) Rule 482 advertisements. These options are discussed below.

Generic advertisements (Rule 135A)

SEC Rule 135A permits a generic communication on behalf of investment company products. The rule permits a general discussion of product attributes as long as the presentation does not include the name of a specific product or any information relating solely to a specific product. These advertisements may refer in general terms to securities as a method of investment but must neither refer to any specific security nor contain any performance information. Generic advertisements speak generally to the bene-

fits of investing in mutual funds and may contain invitations to inquire for further information. While this rule does not allow the advertisement to identify a specific security, it does require that the advertisement identifies its sponsor, which may provide a clue as to the identity of the fund. These advertisements may be published and distributed by fund underwriters, broker-dealers, and sponsors of no-load funds, and do not need to be accompanied or preceded by a statutory prospectus.

Supplemental sales literature

The only restriction for supplemental sales literature is that this information must be accompanied or preceded by a statutory prospectus. The SEC staff holds the view that the prospectus delivery requirement implies that the prospectus will be delivered in a manner reasonably assured to make the intended recipient conscious of the fact that he or she has received a statutory prospectus.

Tombstone advertisements (Rule 134)

A mutual fund can create a tombstone advertisement under Rule 134. These tombstones may incorporate almost any type of information about the fund except for performance information, yet the absence of performance data greatly hinders their effectiveness as an advertising tool. There is no requirement that these advertisements contain any of the substance of the statutory prospectus and they need not be accompanied or preceded by a statutory prospectus. A tombstone advertisement is not required to include all the categories of information prescribed by Rule 134 and need not present this information in the same sequence as set forth in the rule. The rule generally limits tombstone advertisements to information that has little risk of being misleading or of causing tombstone advertisements to become selling vehicles for fund shares.

Omitting prospectuses (Rule 482)

A mutual fund can advertise, without being considered a statutory prospectus, under Rule 482 – the “omitting prospectus” rule. This rule permits investment companies to advertise any information the substance of which is included in the statutory prospectus. The essence of this rule is as follows: if the advertisement omits information from the statutory prospectus, all of the information in the advertisement must be derived from the statutory prospectus. A Rule 482 advertisement is not intended to replace the statutory prospectus, which must be delivered to an investor prior to or at the time of delivery of fund shares. The most important aspect of this rule is that it allows funds to include standardized performance data in their advertisements.

The majority of mutual fund advertisements follow Rule 482 of the 1933 Securities Act. The attractiveness of this rule is that it permits funds to advertise their performance, without first having to provide investors with a copy of their prospectus, if they comply with the conditions of the rule.

1.2. The NASD conduct rules. The NASD is also an important player in the regulation of mutual fund advertising through its conduct rules. The NASD creates four categories, under Conduct Rule 2210, under which mutual fund advertisements are regulated. The first category includes communications to a broad and anonymous audience. The NASD defines these communications as “advertisements” under Rule 2210(a)(1). Each “advertisement” must be filed and approved by a NASD official signature within ten days of first use.

The second category refers to communications to a targeted and restricted audience and it falls under the NASD’s definition of “sales literature” under Rule 2210(a)(2). The third category is reserved for correspondence that is prepared for a single customer and it falls under NASD definitions as “correspondence” under Rule 2210(a)(3). The last category includes situations in a live forum that do not fall under any of the above-mentioned NASD definitions.

All advertisements falling under the “advertisements” or “sales literature” categories must be approved, by signature or initial of a registered principal of the NASD member, prior to use or filing with the NASD. The NASD also requires that a separate file of all advertisements and sales literature be maintained for a period of three years from the date of each use. Sales materials constituting “correspondence” under the NASD rules are governed by a separate NASD Conduct Rule and are not as heavily regulated. Advertisements fitting within the “communications” in a live forum category are unregulated by the NASD.

Although these NASD rules are not as intimidating or complicated as the SEC rules, their importance in creating a valid mutual fund advertisement cannot be understated. In fact, both the SEC and the NASD have the power to force a mutual fund to discontinue an advertisement found violating their rules.

2. Data and sample

We manually collect all mutual fund advertisements that were published in Kiplinger’s *Personal Finance* magazine between January 1995 and December 1997. We also look at the advertisements published by the same magazine beyond the sample period as well as those published by other popular personal

finance magazines such as *Money* and *Smart Money*. We find that the same funds tend to advertise in different magazines at the same time. The format and style are amazingly similar, and some are identical. Consequently, we believe that adding more magazines or extending the sample period will not materially affect the results of this study.

Each monthly issue of the *Personal Finance* magazine contains an eclectic mix of advertisements for equity funds, bond funds, money-market funds, and other investment vehicles such as individual retirement accounts (IRA), variable annuities, life insurance, and college savings plans. This study is limited to equity funds only.

For each advertisement, we gather information such as fund name, past performance, Morningstar rating or ranking by other institutions, availability for IRAs, sales charges, and the theme of the advertisement. In this study we do not intend to verify the truthfulness of the materials being advertised. In other words, we presume that information disclosed in the advertisement is truthful.

Table 1. Frequency distribution of mutual fund advertisements: 1995-1997

Panel A. Number of advertisements by mutual fund families		
Mutual fund family	Number of advertisements	Mean per issue
T. Rowe Price	140	3.9
Warburg Pincus	79	2.2
Strong	76	2.1
Franklin Templeton	57	1.6
Scudder	54	1.5
Robertson Stephens	50	1.4
Fidelity	40	1.1
Kaufmann	36	1.0
Janus	34	0.9
Vanguard	33	0.9
Berger F	32	0.9
Neuberger	28	0.8
Founders	27	0.8
Twentieth Century	25	0.7
Dreyfus	23	0.6
Gabelli	22	0.6
Invesco	21	0.6
Montgomery	21	0.6
Lexington	18	0.5
CGM	16	0.4
Ivy Funds	15	0.4
Stein Roe	14	0.4

American Century	9	0.3
Jones & Babson	8	0.2
Transamerica	8	0.2
Payden & Rygel	8	0.2
Guinness Flight	7	0.2
Benham Group	7	0.2
Others	54	N/A
Total	962	26.7
Panel B. Average number of equity fund advertisements over calendar month		
January	89	
February	83	
March	84	
April	86	
May	78	
June	69	
July	79	
August	73	
September	83	
October	89	
November	74	
December	73	

Table 1 presents the number of advertisements placed by mutual fund families. The total number of advertisements for equity funds over the sample period is 962, of which 851 promote one fund only and the rest advertise multiple funds. The total number of mutual funds advertised is 1,175. The average number of equity fund advertisements is 26.7 in each monthly issue of the magazine. The biggest advertiser is T. Rowe Price, which placed 140 advertisements over the three-year sample period, with an average of four in each monthly issue. The second biggest advertiser is Warburg Pincus, which had 79 advertisements for its equity funds, about two in each monthly issue.

The second panel presents the number of advertisements in each month. The results seem to indicate the first four months of the year have the most advertisements.

3. Results

3.1. Promoting past performance. Like any other advertisers, mutual funds tend to advertise what they have that others do not. Our strong suspicion, however, is that mutual fund advertisements provide selected disclosure or tilt towards some features of the fund that are appealing to potential investors under certain circumstances. This is allowed under Rule 482 of the 1933 Securities Act. The majority of mutual funds when advertising follow this rule. Its

attractiveness is that it permits funds to highlight selected information that may appeal to potential investor, without first having to provide investors with a copy of their prospectus.

Highlighting past performance is one obvious way to make funds attractive to potential investors. There is no doubt that investors chase past performance (Gruber, 1996). On July 12, 1994, the Securities and Exchange Commission approved mutual fund advertising guidelines proposed by the National Association of Securities Dealers (NASD). These guidelines require funds to report performance over one, five, and ten years if the fund has been in existence for that time period. Furthermore, the time period must be at least one year long and must end with the latest calendar quarter and not with any arbitrary

chosen time period. Prior to establishment of the guidelines any arbitrary chosen time period could potentially be used.

The results for past performance are presented in Table 2. Out of the 1,175 funds advertised, 757 (or 64%) report past performance. All of them, except one, report positive one-year returns. The mean and median one-year returns are, respectively, 26.93% and 25.70%, with a standard deviation of 11.92%. The biggest one-year return is 81.92% (Dreyfus Aggressive Growth Fund). The only advertisement that reveals negative returns is CGM, which shows its one-year return of -6.25% up to September 30, 1994. This advertisement, however, also reports its five- and ten-year returns of 10.81% and 16.03%, respectively.

Table 2. Past performance reported in the advertisements

	Raw return				Relative return		
	One-year	Five-year	Ten-year	Since inception	One-year	Five-year	Ten-year
Number	757	460	289	520	757	460	289
Mean	26.93	17.13	14.95	20.66	3.84	4.92	3.85
Median	25.70	16.92	14.47	18.33	2.39	4.24	3.45
Minimum	-6.25	-3.50	7.37	0.81	-26.29	-9.30	-4.14
Maximum	81.92	35.10	22.86	64.86	64.32	24.29	12.41
Std. dev	11.92	4.68	2.34	8.14	10.91	4.30	2.27
% positive	99.9% (756/757)	99.8% (459/460)	100% (289/289)	100% (520/520)	65.5% (496/757)	92.0% (423/460)	96.9% (280/289)

Notes: This table presents the raw and relative returns for the one-, five- and ten-year periods. Raw returns are taken from the advertisements. Relative return is calculated as the difference between the raw return and the S&P 500 index return during the same reported period. Returns are expressed in percentage.

Of those that reveal the one-year performance, 460 (or 60.5%) also report the past five-year returns and only 289 (38%) report ten-year returns. Since the SEC requires funds to report performance over one, five, and ten years if the funds have been in existence for that time period, this result implies that the majority of the funds that advertise are relatively young. All but one reveal positive five-year returns, with an average of 17.13% and a median of 16.92%. The mean and median ten-year returns are, respectively, 14.95% and 14.47%.

Most of the advertisements that present performance data do not provide comparable market returns during the reported periods. We thus calculate the relative return as the raw return in excess of the S&P 500 index, which is the most popular benchmark used in the mutual fund industry. The results, also reported in Table 2, indicate that the majority of the funds that report past performance beat the S&P 500 index. The percentage of mutual funds that outperform the market index over the preceding one-, five- and ten-year periods are, respectively, 65.5%, 92%,

and 96.9%. On average, they beat the index by 3.84%, 4.92%, and 3.85% during the one-, five-, and ten-year periods. This result is amazing given the well-accepted fact that the overwhelming majority of mutual funds underperform the market.

In this paper, we do not examine the post-advertisement performance of these funds. The mutual fund literature suggests that past performance as a predictor of future performance is, at best, controversial. A number of studies have attempted to identify the existence of skill for superior performance by selecting a sample of mutual funds based on past performance, with mixed results. Hendricks, Patel and Zeckhauser (1993), Goetzmann and Ibbotson (1994), Brown and Goetzmann (1995) and Elton, Gruber and Blake (1996) find persistence in mutual fund performance over short-term horizons of one to three years. They attribute the persistence to "hot hands" or common investment strategies. Grinblatt and Titman (1992) and Elton, Gruber, Das and Blake (1996) present evidence of mutual fund predictability over longer horizons of five to ten years,

and attribute this to manager differential information or stock-picking talent.

Contrary evidence comes from Jensen (1969), who does not find continuity of good past performance. Brown, Goetzmann, Ibbotson and Ross (1992) and Malkiel (1995) question the persistence results on the grounds of survivorship biases. Carhart (1998) shows that common factors in stock returns and investment expenses almost completely explain persistence in equity mutual funds' mean and risk-adjusted return.

Jain and Wu (2000) show that there is no superior performance in the post advertisement period. On the other hand, they find that the advertised funds attract significantly more money in comparison with a group of control funds.

3.2. Morningstar ratings. The Morningstar rating system ranks mutual funds based on their risk-adjusted performance over various periods. The system compares mutual funds with others in the

same category. The firm rates mutual funds according to a five-star scale, with five stars as the highest possible rating and one star as the lowest, based on relative percentiles within each fund category. Ratings are calculated monthly, and funds must have at least three years of historical performance to be considered.

Anecdotal evidence suggests that mutual fund advertisements are often an exercise in star gazing, with many advertisements featuring Morningstar's star ratings of funds. It is possible that a fund may have a five-star rating for the most recent one-year period but only have three stars for the 10-year period. In that case, the advertisement is likely to highlight the former and either fail to mention the latter or put it in footnotes in fine prints. Similarly, if a fund is rated with five stars for the ten-year period but fewer stars for other periods, it will likely highlight the former and either ignore the latter or put it in fine prints. If a fund has fewer shining stars to brag for any periods, it will opt not to mention it at all.

Table 3. Morningstar rating and performance

Reporting period		Five stars [N=139]	Four stars [N=70]	All others [N=966]	T-test of difference in means between five- and four-star funds	T-test of difference in means between five-star funds and those not reporting stars
One-year	Raw return	25.09	29.0	27.16		
	Relative return	2.33	3.87	4.13	-1.59	-1.78*
	Number	[N=118]	[N=37]	[N=602]	-0.69	-1.71*
Five-year	Raw return	19.51	18.84	16.37		
	Relative return	7.46	5.90	4.30	0.56	5.94***
	Number	[N=89]	[N=29]	[N=342]	1.26	7.02***
Ten-year	Raw return	15.98	14.53	14.69		
	Relative return	5.03	3.37	3.55	2.05**	3.84***
	Number	[N=60]	[N=11]	[N=218]	2.43**	4.54***
% Reporting past performance		84.9% (118/139)	52.9% (37/70)	62.3% (602/966)	χ^2 -test of same proportions p-value=0.000	χ^2 -test of same proportions p-value =0.000

Notes: This table reports Morningstar ratings and the average raw and relative returns for the one-, five- and ten-year periods. Raw returns are taken from the advertisements. Relative return is calculated as the difference between the raw return and the S&P 500 index return during the same reported period. Returns are expressed in percentage. The * and *** indicate statistical significance levels of 10% and 1%, respectively.

The results, reported in Table 3, show that only 241 (less than one-fourth) of the 1,175 mutual funds advertised disclose Morningstar ratings. Two hundreds and nine of these 241 funds are advertised in single-fund advertisements, of which 139 have five stars, 70 have four stars, and none reports three stars or lower. In addition, thirty-two funds with Morningstar ratings ranging from 2 to 5 stars are advertised in multiple-fund advertisements.

We then calculate the average past performance as reported in the advertisements for each of the three subsamples: five-star funds, four-star funds, and all

others including the 32 funds that reveal stars but are advertised in multiple-fund advertisements. Eighty five percent of the funds that disclose their five-star ratings also reveal their historical return data. The proportion of the funds with four-star ratings reporting past performance is only 53%. Not surprisingly, the five-star funds have significantly higher past ten-year returns, in both raw and relative terms, than the four-star funds. However, the difference in the one- and five-periods is not significant statistically.

Of those 966 funds that do not reveal Morningstar ratings, 602 (or 62.3%) report past return data. Their

average one-year raw return and relative return are actually higher than those of five-star funds. However, they have lower five- and ten-year returns than the five-star funds.

In sum, less than one-fifth of the funds advertised reveal Morningstar ratings. Funds promoted in single-fund advertisement have ratings no lower than four stars. Those that brag about their five-star ratings are more likely to disclose their historical performance, which on average is better than other funds in the five- and ten-year periods.

3.3. Load vs. no-load funds. Mutual funds come in two broad categories based on whether or not they have sales charges. Those that have a sales charge are called load funds and those that do not are called no-load funds. The sales charges allow a fund to pay a commission to the broker/dealer or registered representative selling the fund. A front-end load is an initial sales charge, which may range from 2% to 8% of the amount invested depending upon the fund family and the size of the investment. A back-end load is assessed when fund shares are redeemed. This deferred sales charge decreases each year, typically from 5% in year 1 to 0% in year 6 and thereafter. This is to encourage investors to hold their shares longer. In general, a loaded fund either assesses a front-end load or a back-end load. Some funds carry a combination of front- and back-end loads. Generally, these loads are smaller and the back-end load is only assessed on redemptions made within the first year or two.

No-load funds generally are sold directly by the mutual fund company, without a broker or salesperson as intermediary. In 1980 the SEC adopted Rule 12b-1 to allow no-load funds to charge fees for marketing and distribution costs. These charges are known as 12b-1 fees. Very quickly, however, 12b-1 fees came to be used for other reasons. Most notably, they became substitute for front-end loads. In this way, more substantial sales loads could be collected while the fund could still advertise itself to investors as “no load.” The Investment Company

Institute (2008) reports that 12b-1 fees had grown to \$13.4 billion in 2007. Of this amount, only 2% was used for advertising, the rest went to financial advisors for initial investor assistance (40%), for continuing shareholder services (52%), and for fund distributor (underwriter) expenses (6%).

Barber, Odean and Zheng (2005) find a strong negative relationship between mutual fund flows and front-end loads. In contrast, they find a positive relationship between fund flows and expenses that is confined only to 12b-1 fees. While ordinary investors maintain a strong aversion to front-end loads, they value advertising and marketing in mutual fund selection. However, as pointed out by Haslem (2009), investors are paying a great deal more for 12b-1 fees (and operating expenses) than needed to value advertising in selection of funds.

With this caveat in mind, we now turn to the results reported in Table 4. In our sample, only 54 funds reveal that they charge front-end loads while 636 clearly indicate that they are no-load funds. The rest of the funds do not reveal any information in this regard. Since no-load funds tend to use part of the 12b-1 fees for advertising, we can speculate that those that do not reveal this information are primarily no-load funds. In the table, however, they are reported separately as others.

Ninety six percent of the load funds also report past performance, compared to only 63.8% for no-load funds and 61.5% for all other funds. Based on the reported figures, load funds have higher historical performance than no-load funds. For example, the reported 1-year performance for load funds is, on average, 26.89%, which is 4.19% higher than S&P 500 index during the same time. In comparison, the average reported 1-year performance for no-load funds is 22.41%, which is 0.10% below the index. The performance difference between the two types of funds is statistically significant for the one- and five-year periods. In other words, despite the fact that investors are averse to front-end loads, the load funds advertised are touted for their high past performance.

Table 4. Sales charges and performance

Reporting period		No-load [N=636]	Load [N=54]	All others [N=485]	T-test of difference in means between no-load and load funds
One-year	Raw return	26.89	22.41	27.78	
	Relative return	4.19	-0.10	4.05	2.59**
	Number	[N=406]	[N=52]	[N=299]	2.72***
Five-year	Raw return	17.01	15.80	17.61	
	Relative return	4.86	3.07	5.42	1.64*
	Number	[N=241]	[N=41]	[N=178]	2.81***

Table 4 (cont.). Sales charges and performance

Reporting period		No-load [N=636]	Load [N=54]	All others [N=485]	T-test of difference in means between no-load and load funds
Ten-year	Raw return	14.82	14.37	15.27	1.02
	Relative return	3.72	3.19	4.20	
	Number	[N=156]	[N=25]	[N=108]	
% Reporting past performance		63.8% (406/636)	96.3% (52/54)	61.6% (299/485)	χ^2 -test of same proportions p-value= 0.00

Notes: This table reports the average raw and relative returns for the one-, five-, and ten-year periods for three groups of funds: no-load, load, and others. Raw returns are taken from the advertisements. Relative return is calculated as the difference between the raw return and the S&P 500 index return during the same reported period. Returns are expressed in percentage. The * and *** indicate statistical significance levels of 10% and 1%, respectively.

3.4. IRA availability. Table 5 shows that 358 (or around 30%) of the equity funds advertised indicate that they are available for Individual Retirement Account (IRA). Since the deadline for IRA contributions for the previous year is April 15, the majority of those mentioning IRA availability appear in the first four months of the calendar year.

About 65% of the funds indicating IRA availability also reveal past performance. There is not much difference for other funds in this regard. However, funds available for IRAs have lower one-year past returns, but higher five- and ten-year past returns than others.

Table 5. IRA availability and performance

Reporting period		Available for IRA [N=358]	All others [N=817]	T-test of difference in means
One-year	Raw return	25.70	27.48	-1.91*
	Relative return	3.23	4.11	
	Number	[N=234]	[N=523]	
Five-year	Raw return	18.03	16.66	3.00***
	Relative return	6.24	4.21	
	Number	[N=159]	[N=301]	
Ten-year	Raw return	15.51	14.64	3.09***
	Relative return	4.28	3.62	
	Number	[N=103]	[N=186]	
% Reporting past performance		65.4% (234/358)	64.0% (523/817)	χ^2 -test of same proportions p-value = 0.645

Notes: This table reports Morningstar ratings and the average raw and relative returns for the one-, five-, and ten-year periods. Raw returns are taken from the advertisements. Relative return is calculated as the difference between the raw return and the S&P 500 index return during the same reported period. Returns are expressed in percentage. The *, ** and *** indicate statistical significance levels of 10%, 5% and 1%, respectively.

Summary

This study provides an extensive scrutiny of mutual fund advertisements that were published in Kiplinger's *Personal Finance* magazine between January 1995 and December 1997. Our strong suspicion is that mutual fund advertisements provide selected disclosure or tilt towards some features of the fund that are appealing to potential investors under certain circumstances. This practice is legal under Rule 482 of the 1933 Securities Act, which allows mutual funds to advertise, without being considered a statutory prospectus, any information as long as it is derived from the prospectus filed with the SEC. The majority of mutual funds when advertising follow

this rule. Its attractiveness is that it permits funds to highlight selected information that may appeal to potential investor, without first having to provide investors with a copy of their prospectus.

The results can be summarized as follows:

1. Sixty-four percent of the equity funds advertised highlight historical performance. All but one report positive one-year or five-year raw returns and all report positive ten-year raw returns. The percentage of mutual funds that outperform the S&P 500 index over the preceding one-, five-, and ten-year periods are, respectively, 65.5%, 92%, and 96.9%. On average, they beat the

market index by 3.84%, 4.92%, and 3.85% during the corresponding periods.

2. Less than one-fifth of the funds advertised reveal Morningstar ratings. Their ratings are no lower than four stars. Those that brag about their five-star ratings are more willing to report their historical performance, which on average is better than other funds in the five- and ten-year periods.
3. Only 54 funds in the sample reveal that they have sales charges, while 636 indicate that they are no-load funds, and the rest of the funds do not reveal any information in this regard. The percentage of load funds also reporting past performance is 96.3%, much higher than 63.8% for no-load funds and 61.5% for all other funds. Based on the reported figures, load funds have higher historical performance than no-load funds. The performance difference is statistically significant for the one- and five-year periods.
4. Around 30% of the equity funds advertised over the sample period indicate that they are

available for Individual Retirement Account (IRA). Since the deadline for IRA contributions for the previous year is April 15, the majority of those mentioning IRA availability appear in the first four months of the calendar year. The percentage of funds with IRA availability also revealing past performance is 65.4%, not much different than that for other funds. However, funds available for IRAs have significantly higher five- and ten-year past returns than others.

Our results concerning mutual fund advertisements should be of interest to potential investors in choosing mutual funds. It is hoped that such a study will help investors make more informed investment decisions. A study of mutual fund advertising behavior should also have policy implications that can be used by regulators. Despite the complicated regulatory structure surrounding mutual fund advertising, the existing guidelines are either too general or vague, leaving mutual funds to decide by themselves what to advertise and the format of advertisements.

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