



INVESTMENT FUND INDUSTRY IN TURKEY: A DESCRIPTIVE STUDY

Arman T. TEVFİK*, Gürman TEVFİK**

Abstract

The purpose of this study is to discuss legal and regulatory environment, trends in fund industry in Turkey, a newly organized pension fund industry, new products to be introduced, and finally policy issues that authorities should consider.

For the last three years Turkish mutual fund industry grew at a annual compound rate of 78.63. The major change in the investment fund sector is the the launch of new private pension funds in October 2003. Exchange Traded Funds (ETF's) are expected to be introduced in Turkey.

The large number of small funds in Turkey is a rather troubling feature. Because it is acknowledged that there are some significant economies of scale in running a mutual fund. Therefore, the *Government* and *Capital Market Board* should consider measures that would encourage the smaller funds to merge.

Key words: Investment funds, mutual funds, Type A, Type B, net asset value, pension funds, market capitalization, returns, performance, EFT's.

1. INTRODUCTION

Global investment trends continue to effect Turkish Investment Industry. In general, investment fund industry in Turkey has been growing steadily for the last couple of years and much of this growth is in fixed income instruments.

Fluctuations in oil prices, war in Iraq, global terrorism, foreign exchange fluctuations, oil prices, international trade and global consumption trends and the upward trend in global interest rates were among the top developments that economists were most concerned about in Turkey. All of these developments have the ability to effect Turkish capital markets largely. On the other hand, the increase in global interest rates, can negatively affect all emerging market countries as well. Although inflation figures are still good in Turkey, the current level of domestic debt and primary surplus targets still make the general economic outlook fragile.

Currently, there is very suitable economic environment for the interest rates to decline compared with previous years. Turkish Treasury has now far better financing opportunities from foreign markets, which may eventually increase confidence level in

* Dr. Kyrgyz-Turkish Manas University

** Dr. CEO, İş Asset Management, Istanbul, Turkey

Turkish markets. Besides, there is progress in key political areas such as Cyprus issue and accession to EU, which eventually may help financial markets to get confidence.

However, current accounts deficit and some other macroeconomic concerns are forcing all investors to act prudently. Government is already considering certain measures for the growing current accounts deficit.

The purpose of this study is to discuss legal and regulatory environment, trends in fund industry in Turkey, a newly organized pension fund industry, new products to be introduced, and finally policy issues that authorities should consider.

2. LEGAL AND REGULATORY ENVIRONMENT

Mutual funds are established in the form of open-end investment companies in Turkey. They do not have any legal entity. They are operated in terms of the rules stated in the prospectus of the fund, which includes general terms about management of the fund, custody of the assets, valuation principles and conditions of investing in the fund. Mutual fund founders are restricted to banks, insurance companies, non-bank intermediaries, unemployment funds and pension funds in Turkey.

As an incentive, all mutual funds are exempt from corporate tax permanently and only B Type mutual funds are subject to 10 % income tax according to the current Tax Code. In addition, individual investors are exempt from income tax on their mutual fund revenues until the end of 2004. However, with the launch of new pension funds in Turkey, major changes in taxation of all investment funds in Turkey is possible in the near future.

3. TRENDS IN INVESTMENT FUNDS SECTOR IN TURKEY

A mutual fund allows individual small investors to combine resources with other investors and hire professional managers and research analysts. The investor buys a part of a fund (open end or closed end) that suits his/her objectives (growth, growth-income, income, index, technology stocks etc)¹. Diversification is achieved by buying a number of different types of funds. An easy approach is to buy an index fund.

Following are the main advantages of investing in mutual funds versus direct investment²:

- Diversification
- Professional management
- Reduced trading costs
- Systematic accumulation and withdrawal plans
- Security custody and bookkeeping
- Increasing an economy's capital supply by opening markets to the small investor

The main disadvantages of mutual funds can be summarized as follows³:

- Management fees
- Transaction costs
- Accounting, distribution, and other miscellaneous costs
- Sub-optimal investment for a particular investor.

There are two different types of mutual funds in Turkey, Type A and Type B funds⁴. Type A mutual funds are required to invest at least 25% of their assets in equities that are

¹ See: Gürman Tefik, *Dünya'da ve Türkiye'de Yatırım Fonları*, Türkiye İş Bankası Kültür Yayınları, 1995, and Jeffrey Laderman, *Guide to Mutual Funds*, McGraw-Hill, 1993.

² Keith Redhead, *Introducing Investments: A Personal Finance Approach*, Prentice-Hall, 2003, p.20.

³ Keith Redhead, p. 20.

issued by Turkish companies. Mutual funds that have no such obligations are classified as Type B mutual funds.

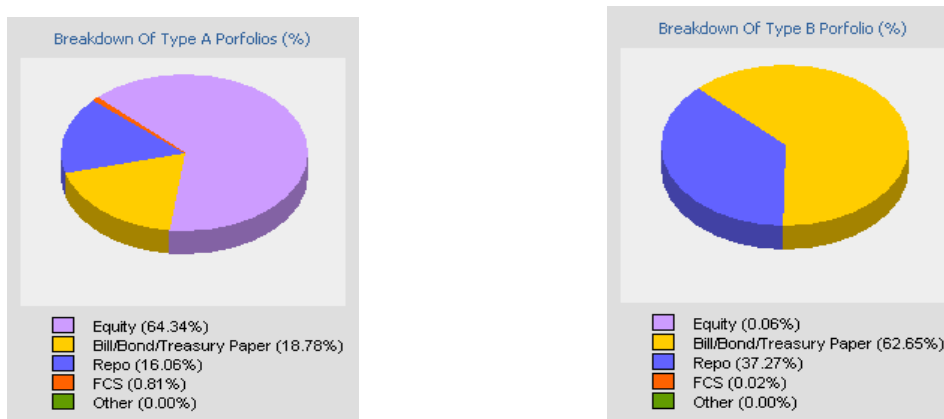
The founder is responsible for the protection and safekeeping of the fund's assets. Moreover, the fund's assets are separate from those of the founder. Mutual funds are required to protect securities in their portfolio by depositing them in a depository institution (The ISE Settlement and Custodian Bank, Inc.).

The assets of the mutual funds are subject to valuation on a daily basis. They are valued at weighted average prices or rates of the market in case such a price or rate exists. In case not, the valuation is based on the last existing market price for stocks and the internal rate of return for fixed income securities. After valuation is done for each of the assets, they are summed up to find the portfolio value. Finally, by including the credits and excluding the debts and other costs of the fund, the net asset value of the fund is reached.

As of July 20, 2004, the total net asset value of all A Type mutual funds in Turkey is approximately US\$522 million. There are certain categories of A Type Mutual Funds. They can be summarized as; *Foreign Securities, Variable, Equities, Sector, Index, Mixed* and *Private Funds*. The total asset allocation of all A Type mutual funds as of May 2004 is as follows; *Government Bonds & Treasury Bills* : 18.78 %, *Reverse Repo* : 16.06 %, *Equities* : 64.34 %, *Foreign Equities* : 0.81 %. There are 125 A Type mutual funds in Turkey as of May 2004.

B Type Mutual Funds, on the other hand, are comprised of different types of investment funds which all have different investment criteria. They heavily invest in fixed income securities with a small amount of exposure in equities. These B Type Mutual Funds can be summarized as, *Liquid Funds, T.Bills & Government Bonds Funds, Variable Funds, Mixed Funds, Foreign Securities Funds*. As of July 20, 2004, the total net asset value of all B Type Mutual Funds is US\$15,507 million. As of May 2004 there are 121 B Type mutual funds in Turkey and the total asset allocation of all B Type Mutual Funds is as follows; *Government Bonds & Treasury Bills* : 62.65 %, *Reverse Repo* : 37.27 %, *Equities* : 0.06 %, *Foreign Securities* : 0.02 %.

Figure 1: Asset Allocation of A and B Type Investment Funds, Excluding Pension Funds (As of May 2004)



⁴ This paper does not address closed-end mutual funds such as investment companies, real

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)], KYD Newsletter, May 2004, www.kyd.org.tr.

Historical developments in net asset values of mutual funds can be summarized as in Table 1:

**Table 1: Net Asset Values (NAV's) of Mutual Funds
(in millions US\$)**

Dates	NAV of A Type Funds	NAV of B Type Funds
30/09/02	237	4846
31/10/02	257	5275
30/11/02	381	6195
31/12/02	271	5788
31/01/03	274	6428
28/02/03	288	6668
31/03/03	239	6275
30/04/03	283	7298
31/05/03	312	8641
30/06/03	300	8802
31/07/03	286	9292
29/08/03	309	10723
30/09/03	367	10921
31/10/03	446	11470
30/11/03	438	12309
31/12/03	530	13603
31/05/04	522	15507
30/09/04	551	15688

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)], *KYD Newsletters*, September 2002- September 2004, www.kyd.org.tr.

For the last three years Turkish mutual fund industry grew at a annual compound rate of 78.63. It is very hard to sustain that rate in the future. As of the end of 2001, the European savings and investment market grew at a compounded annual rate of around 12 %⁵.

Total assets managed under B Type Funds in Turkey has grown steadily since the beginning of the year 2002 while the the total assets of A Type Funds has been

estate investment trusts, and venture capital investment trusts.

⁵ Howard Davies, "The Regulation of Fund Management in Europe," *11th Annual Fund Forum International Conference, Grimaldi Forum, Monte Carlo*, Jul 4, 2001.

fluctuating during the same period. Recent analysis of the asset size of all investment funds in Turkey shows a slow investment trend towards longer terms. Previously the prevailing investment perspective in the mutual funds sector in Turkey has always been for shorter terms. Pension funds introduced in October 2003 also helps general investment sentiment to shift to longer terms, however, A & B Type investment funds still invests for shorter perspectives.

Currently B Type investment funds are still by far the most popular mutual fund type in Turkey and the largest category among all B type investment funds in Turkey is B Type Liquid Funds. During 2004 both A & B Type Funds have shown very strong growth rates until April in USD terms. Part of this growth was due to strong Turkish lira against USD. And markets in general performed very well. However, as a result of confidence issues and global developments such as global interest rate hikes and global political issues, there have been small declines in capital markets. But as of June 2004, total assets of investment funds has grown very steadily based on June 2003. However the general investment trends still remain pretty much the same.

According to data at the end of September 2004, the total net asset value of all A and B Type funds in Turkey has reached TL 24,297,822,438 million and US\$16,239.43 million: A Type funds have reached \$ 551.32 million and B Type funds have reached US\$15,688.11 million of net asset value. There are 121 A Type, 122 B Type and a total of 243 investment funds available at the end of September 2004.

Table 2: Fund Market Summary (as of 17/11/2004)

	Unit	Market Capitalization (in million TL)	Market Capitalization (in millions US\$)
Type A	120	806,761,595	556.88
Type B	124	23,806,275,825	16,432.54
Total	244	24,613,037,420	16,989.41
USD 1 = TL 1,448,728			

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)], *KYD Newsletter*, September 2004, www.kyd.org.tr.

As of the end 2002, only 2.55 % of the assets of of all open-ended mutual funds were invested in shares, down from pre-crisis high of 21.83%⁶. As of the end of May 2004, it is around 2.15%.

As of September 2004, according to *year to date* performances, 19 A Type funds managed to beat the year-to-date rate of return of ISE-100 index which was 18.22 %⁷. The best return among these A Type funds was 97.33 %. On the other hand, as of the same period, based on year-to-date rate of returns, none of the B Type funds, managed to beat the *year-to-date* rate of return of 91 day DİBS index which was 20.23 %. The

⁶ World Bank, *Non-Bank Financial Institutions and Capital Markets in Turkey*, 2003, p. 42.

⁷ For measures of performance and the results of early study, see: "Arman T. Tefvik, Gürman Tefvik, A Tipi Yatırım Fonlarının 1993 Yılındaki Başarımı," *Banka ve Ekonomik Yorumlar*, Sep. 1994, pp. 31-40; for a recent study, see: Cudi Tuncer Gürsoy, Y. Ömer Erzurumlu, "Evaluation of Portfolio Performance of Turkish Investment Funds," *Doğuş Üniversitesi Dergisi*, 2001/4, pp. 44-58.

highest *year-to-date* rate of return among all B Type investment funds has been posted as 19.52 %.

Table 3: KYD B Type Fund Index Returns (in %)

Date	Monthly returns	3 Months Returns	6 Months Returns	Annual Returns
June 2003	2н43	8н84	17н79	24н64
July 2003	2н54	7н92	17н36	40н32
August 2003	2н92	8н1	17н68	39н98
September 2003	2н33	7н73	17н25	38н87
October 2003	2н01	7н17	15н66	37н01
November 2003	1н68	5н71	14н27	34н92
December 2003	1н87	5н67	13н84	34н09
January 2004	1н45	5н09	12н63	32н18
February 2004	1н67	5н25	11н26	30н93
March 2004	1н7	4н9	10н85	29н97
April 2004	0н92	4н35	9н66	26н83
май.04	0н69	3н34	8н76	24н29
June 2004	1н42	3н06	8н11	23н07

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)],

KYD Newsletter, June 2004, www.kyd.org.tr.

Table 4: KYD A Type Fund Index Returns (in %)

Date	Monthly returns	3 Months Returns	6 Months Returns	Annual Returns
June 2003	-1н43	11н41	9н52	24н64
July 2003	-1н39	-0н84	4н42	10н52
August 2003	7н67	4н66	8н73	23н33
September 2003	10н84	17н04	30н4	39н3
October 2003	11н75	30н77	29н67	41н87
November 2003	3н44	22н04	27н72	23н93
December 2003	13н3	25н51	46н9	60н88
January 2004	-0н73	13н08	47н87	54н4
February 2004	2н72	15н59	41н07	53н38
March 2004	4н21	6н33	33н45	74н01
April 2004	-0н09	-2н62	10н11	42н79
май.04	-1н52	-6н64	7н92	37н83
June 2004	1н48	-9н15	-3н4	41н91

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)],

KYD Newsletter, June 2004, www.kyd.org.tr.

4. PENSION FUNDS IN TURKEY

The Individual Retirement Law in Turkey passed in the parliament and published in the Official Gazette recently. The main properties of the *Individual Retirement System* are as follows⁸:

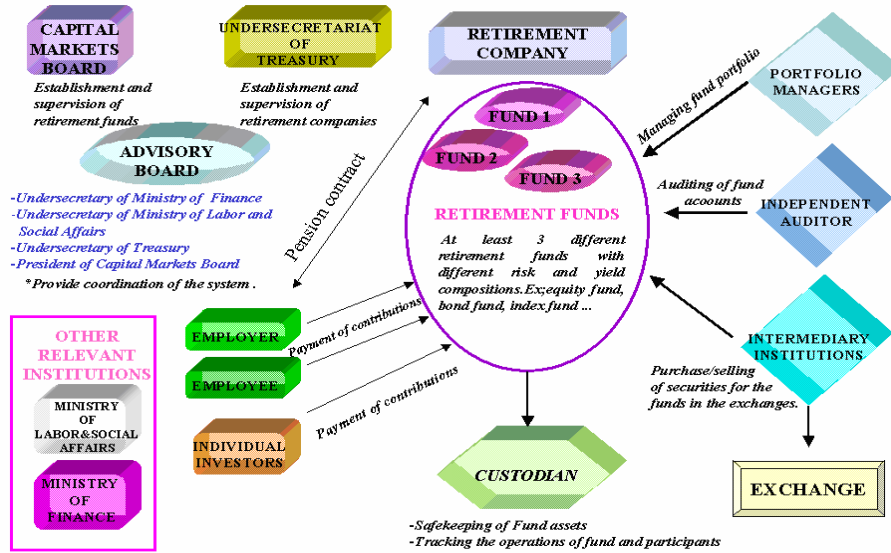
- The system will be supplementary to the existing state pension plans.
- The system will be voluntary and will be based on defined contribution plans.
- The contributions collected from the individuals will be transmitted to pension funds.
- Anybody who is able to use his civil rights can enter the system.
- Only retirement companies (which have been introduced to the financial markets with this new law) will establish the pension funds. Retirement companies will be established with permission of *Undersecretariat of Treasury*. Retirement companies need an initial capital of 14,285,714 USD for establishment. Half of this amount should be paid in cash when the company begins to operate.
- At least 3 different funds with different portfolio structures must be established. (In this way individuals will be able to choose a fund according to their personal risk and yield expectations) .
- Although not stated in the law clearly, both employees and employers, if any, as well as individuals can make contributions to the pension funds.
- The rights of the investors are portable and accumulations can be transferred into another retirement company .
- At retirement, the investors can take their accumulations as lump sum or they can withdraw the accumulations partially. They will have an option in either buying an annuity from an insurance company or leaving the money in the funds to be invested. Retirement age is 56 provided that, people make contributions to the fund for at least 10 years.
- The fund will be managed by portfolio management companies, which will be authorized by *Capital Markets Board (CMB)*.
- The assets of the fund will be deposited in a custodian bank which will be approved by the *CMB*. The custodian that is selected by the pension company and approved by the *CMB*, will be a bank which operates in accordance with the Law on Banking.
- The system will be coordinated by *Advisory Board*. The regulations will be made by relevant institutions, *Undersecretariat of Treasury* and *Capital Markets Board*.

The process of the retirement system can be summarized graphically as follows⁹:

⁸ Capital Market Board of Turkey, *Pension Mutual Funds: Brief Guide*, <http://www.cmb.gov.tr/kyd/yf/yf.htm>.

⁹ Capital Market Board of Turkey, *Pension Mutual Funds: Brief Guide*, <http://www.cmb.gov.tr/kyd/yf/yf.htm>.

Figure 2: Individual Retirement System in Turkey



As of July 12, 2004, there are 156,759 investors who invest in pension funds, and total assets of pension funds in Turkey has reached TL 78.3 trillion (approximately US\$55 million)¹⁰. Historical developments in net asset values of mutual funds can be summarized as in Table 5:

Table 5: Net Asset Values of Pension Funds in Turkey

Date	(in millions TL)
31.10.2003	28 928 219
28.11.2003	38 057 802
31.12.2003	42 791 147
30.01.2004	36 189 845
27.02.2004	39 447 419
31.03.2004	44 774 299
30.04.2004	50 280 474
31.05.2004	62 014 027
30.06.2004	77 995 807
30.07.2004	97 388 823
27.08.2004	119 251 245

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)], *KYD Newsletters*, October 2003- August 2004, www.kyd.org.tr.

¹⁰ Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)], *KYD Newsletter*, July 2004, www.kyd.org.tr.

Considering that all pension funds were introduced in October 2003, this amount also indicates a steady and fast growth in pension funds industry in Turkey. There are currently 11 pension fund companies with 82 new pension funds in Turkey. These firms are entirely separate entities from traditional investment companies and asset management firms.

Types of funds and their market shares are shown in Table 6:

**Table 6: Types of Pension Funds in Turkey
(As of August 2004)**

Types of Funds	Market Shares (%)
Bill/Bond/Treasury Paper (TL)	37H99
Balanced (Flexible & Mixed)	21H87
Liquid	19H01
Eurobonds (Turkish Treasury)	8H9
Equity	4H08
Bill/Bond/Treasury Paper (FX)	3H59
Index	2H58
International (Mixed & Flexible)	1H01
International bonds	0H97

Source: Institutional Investment Managers' Association [Kurumsal Yatırımcı Yöneticileri Derneği (KYD)], *KYD Newsletters*, August 2004, www.kyd.org.tr.

5. NEW PRODUCTS & OUTLOOK

The major change in the investment fund sector is the the launch of new private pension funds in October 2003. In addition, there are new regulations in Turkey regarding investment performance presentation standards and corporate governance. Turkish Institutional Investment Managers' Association (KYD), representing the investment funds industry in Turkey, has been accepted to FEFSI (*Fédération Européenne des Fonds et Sociétés d'Investissement*) on June 11, 2004. As a result of this, Turkish investment funds are also expected to apply all rules and regulations that are enforced by FEFSI. Code of good conduct in investment fund industry is among these rules. Besides, KYD actively involves in working groups on different topics that are established by FEFSI.

New pension funds are expected to boost investment funds sector in Turkey with increased liquidity in equities market as well as in fixed income securities. Short term investment perspective in Turkey is slightly shifting to longer terms. Approximately US\$10 billion is expected to accumulate in pension funds in 5 years time. There are more optimistic assumptions in the sector as well. Pension funds will definitely contribute in maintaining stability in Turkish capital markets in the long term.

Exchange Traded Funds¹¹ (ETF's) are expected to be introduced in Turkey. Capital Markets Board of Turkey and Turkish Institutional Investment Managers' Association

¹¹ For more information see: Keith Redhead, *Introducing Investments: A Personal Finance Approach*, Prentice- Hall, 2003, p. 23.

have been working together on the ETF launch for the last 6 months. EFT's are shares that replicate indices such as IMKB-100. They are traded at prices that continuously reflect the relevant index, whereas mutual funds are bought or sold at prices that are established just once a day. They can be bought or sold in the same way as any other shares.

6. CONCLUSION

As shown in Table below, as of the end of the assets of open-ended funds totaled 2.42 % of GDP. While this figure is higher than Argentine and Poland, it will take considerable time before it reaches developed countries levels.

Table 5: Open Ended Mutual Funds in Turkey and Some Other Countries

Data for end 2001	Number of funds	Total asset of funds (US\$ million)	Average size of funds (US\$ million)	GDP (US\$ million)	Assets As % of GDP
Argentina	219	3,751	17.13	268,773	1.40
Brazil	2,452	148,189	60.44	502,509	29.49
India	292	13,490	46.20	477,555	2.82
Italy	1,059	359,879	339.83	1,090,910	32.99
Korea	7,117	119,439	16.78	422,167	28.29
Mexico	350	31,723	90.64	617,817	5.13
Poland	92	1,317	14.32	174,597	0.75
South Africa	426	14,561	34.18	113,274	12.85
Spain	2,524	159,899	63.35	557,539	26.68
Turkey	277	3,576	12.91	147,627	2.42
United Kingdom	1,982	316,702	159.79	1,406,310	22.52
United States	8,307	6,974,976	839.65	10,171,400	68.57

Source: World Bank, *Non-Bank Financial Institutions and Capital Markets in Turkey*, 2003, p. 43.

There are still a lot of people knowing nothing about mutual funds in Turkey. An education program should be conducted by CMB/KYD to train potential investors to attract them to mutual fund/pension fund industry.

The mutual fund market is characterized by a very few large funds and a large number of very small funds. It is estimated that 10 largest funds have about 70 % of the assets of all funds.

The large number of small funds in Turkey is a rather troubling feature. Because it is acknowledged that there are some significant economies of scale in running a mutual fund¹². Lower costs mean higher return to investors. Large fund sponsors are voluntarily merging their funds to take advantage of scale economies. Furthermore, the Government and Capital Market Board should consider measures that would encourage the smaller funds to merge.

¹² See: John Rea, Brain Reis, and Kirberlee Millar, "Operating Expense Ratios, Asset and Economics of Scale in Equity Mutual Funds," in *Investment Companies Institute Perspectives*, Dec. 1996.

REFERENCES

- CAPITAL MARKET BOARD OF TURKEY, *Pension Mutual Funds: Brief Guide*, <http://www.cmb.gov.tr/kyd/yf/yf.htm>.
- DAVIES, Howard. (2001). "The Regulation of Fund Management in Europe," *11th Annual Fund Forum International Conference, Grimaldi Forum*, Monte Carlo, Jul 4, 2001.
- GÜRSOY, Tuncer Gürsoy, Y. Ömer Erzurumlu. (2001). "Evaluation of Portfolio Performance of Turkish Investment Funds," *Doğuş Üniversitesi Dergisi*.
- INSTITUTIONAL INVESTMENT MANAGERS' ASSOCIATION. *KYD Newsletters*. (September 2002- September 2004).
- LADERMAN, Jeffrey. (1993). *Guide to Mutual Funds*, McGraw-Hill.
- TEVFİK, Arman T. ve Gürman Tevfik. (1994). "A Tipi Yatırım Fonlarının 1993 Yılındaki Başarımı," *Banka ve Ekonomik Yorumlar*.
- TEVFİK, Gürman. (1995). *Dünya'da ve Türkiye'de Yatırım Fonları*, Türkiye İş Bankası Kültür Yayınları.
- WORLD BANK. (2003). *Non-Bank Financial Institutions and Capital Markets in Turkey*.
- REA, John, Brain Reis, and Kirberlee Millar. (1996). "Operating Expense Ratios, Asset and Economics of Scale in Equity Mutual Funds," in *Investment Companies Institute Perspectives*.
- REDHEAD, Keith. (2003). *Introducing Investments: A Personal Finance Approach*, Prentice-Hall.