UNIVERSITI PUTRA MALAYSIA

AGENCY COST OF SHARIAH GOVERNANCE AND IMPACT ON FUND VALUE IN MALAYSIA

MOHD FIKRI BIN SOFI

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AGENCY COST OF SHARIAH GOVERNANCE AND IMPACT ON FUND VALUE IN MALAYSIA

By

MOHD FIKRI BIN SOFI

Thesis Submitted to Putra Business School, in Fulfilment of the Requirements for the Degree of Doctor of Philosophy

October 2018

DEDICATIONS

To my beloved parents, Mr. Sofi Bin Saad and Mrs. Hasnah Binti Bidi for their consistent moral support, encouragement, and motivation through this sacred journey

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirement for the Degree of Doctor of Philosophy

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MOHD FIKRI BIN SOFI
October 2018

Chairman : Mohamed Hisham Dato Haji Yahya, PhD
Faculty : Putra Business School

The mutual fund has become an increasingly important investment vehicle for retail investors, especially among households. Besides developing an institutional investment as efficient momentum trader and information extractor, separation of ownership and control prevails within a mutual fund contract during asset movement to fund management given an expected level of return by investors. The unobserved activities and widely magnitude decision skills of managers with the tendency of self-interest distress the shareholders, predominantly in Shariah Mutual Fund (SMF), pertaining to conflicting dual investing interests. High concern on fund value by performance is equally important that all generating return incomes are engendered from activities and course of actions that are in accordance to Shariah principle. This study aims to examine the effectiveness of multiple internal governance control mechanisms comprising ownership concentration, the board structure, and fund fees, especially when additional governance of Shariah Advisory Panel (SAP) emerges in a complex governance structure of fund management between Shariah and conventional within principal-agent relationship. Moreover, the objective also devotes on measuring SAP material to agency cost and the linking relationship. An assortment of data attributes to mutual fund is obtainable from published annual reports, while other data, such as monthly dividend adjusted Net Asset Value (NAV) and monthly market index return are possibly retrieved from Datastream to measure fund value market return. Dynamic panel data regression is employed to generate model that best explains unbiased estimation controlling for many recent econometric issues, such as endogeneity to avoid spurious evidence. The main finding indicates a significant association of Shariah governance with agency cost despite the absence in difference for a greater level of agency cost in such a more complex governance structure fund. However, there is only little or weak evidence between the relation of Shariah governance and fund value.

Nevertheless, the coefficients direction are consistently negative following an increase in fund operational expenses.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk Ijazah Doktor Falsafah

KOS AGENSI URUS TADBIR SHARIAH DAN KESANNYA KEPADA NILAI DANA UNIT AMANAH DI MALAYSIA

Oleh

MOHD FIKRI BIN SOFI
Oktober 2018

Pengerusi : Mohamed Hisham Dato Haji Yahya, PhD
Fakulti : Putra Business School

Dana unit amanah telah menjadi satu instrumen pelaburan yang semakin penting bagi pelabur runcit, terutama dalam kalangan isi rumah. Selain daripada membangunkan pelaburan secara institusi sebagai pengurusniaga momentum dan pemantau maklumat yang cekap, pemisahan pemilikan dan kawalan secara rasminya berlaku dalam kontrak jual beli dana unit amanah semasa pemindahan aset kepada pihak pengurusan dana dengan harapan pulangan yang tinggi sebagai jangkaan pelabur. Aktiviti-aktiviti yang tidak diperhatikan dan kemahiran meluas pengurus membuat keputusan yang mengutamakan kepuasan individu menyukarkan pemegang saham terutamanya dalam dana unit amanah Shariah (SMF) berhubung dua matlamat utama pelaburan yang konflik. Kebimbangan utama prestasi dana unit amanah adalah sama pentingnya dalam memastikan semua pulangan dijana daripada aktiviti dan tindakan yang selaras dengan pematuhan prinsip Shariah. Kajian ini bertujuan mengukur keberkesanan pelbagai mekanisme kawalan urus tadbir dalaman yang terdiri daripada penumpuan pemilikan, struktur tadbir urus, dan pelbagai yuran kesan kewujudan tadbir urus tambahan (SAP) dalam struktur kompleks pengurusan dana unit amanah antara dana konvensional dan Shariah dalam hubungan pemilik-ejen. Objektif kajian juga memberi tumpuan mengukur kesan material SAP kepada kos agensi dan hubungan antara kedua-duanya. Pelbagai jenis data ciri-ciri dana unit amanah boleh didapati dari laporan tahunan yang diterbitkan manakala data lain seperti nilai dividen terlaras aset bersih (NAV) bulanan dan pulangan indeks pasaran bulanan juga diperolehi dari “Datastream” untuk mengukur prestasi nilai kewangan pasaran dana. Regresi data panel secara dinamik digunakan untuk menghasilkan model yang menjelaskan anggaran bebas prejudis dengan kawalan pelbagai isu ekonometrik yang terkini seperti “endogeneity” bagi mengelakkan bukti dapatan palsu. Penemuan utama menunjukkan hubungan yang signifikan tadbir urus Shariah dengan kos agensi walaupun tiada perbezaan kos agensi yang lebih tinggi dalam dana yang menggunapakai struktur tadbir urus yang lebih

kompleks. Walaubagaimanapun, terdapat hanya sedikit atau bukti lemah antara hubungan tadbir urus Shariah dan prestasi dana. Namun begitu, arah koefisien adalah konsisten negatif ekoran peningkatan dalam perbelanjaan operasi dana.

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I certify that a Thesis Examination Committee has met on **09 October 2018** to conduct the final examination of Mohd Fikri Bin Sofi on his thesis entitled "Agency Cost of Shariah Governance and Impact on fund Value in Malaysia" in accordance with the Universities and University Colleges Act 1971 and the Constitution of the Universiti Putra Malaysia [P.U.(A) 106] 15 March 1998. The Committee recommends that the student be awarded the Doctor of Philosophy.

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This is to confirm that:

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AAOIFI	Accounting and Auditing Organization for Islamic Finance
ADF	Augmented Dickey Fuller
BOD	Board of Directors
BNM	Central Bank of Malaysia
BPG	Breusch-Pagan-Godfrey
CAPM	Capital Asset Pricing Model
CMF	Conventional Mutual Fund
CMSA	Capital Market and Services Act
CEO	Chief Executive Officer
DEA	Data Envelopment Analysis
FiMM	Federal of Investment Managers Malaysia
FBMKLCI	FTSE Bursa Malaysia Kuala Lumpur Composite Index
FBMHIJRAH	FTSE Bursa Malaysia Hijrah Shariah
GCC	Gulf Cooperation Council
GLS	Generalized Least Squares
GMM	Generalized Method of Moments
HAC	Heteroscedasticity and Autocorrelation Consistent
HT	Harris-Tzavalis Test
ICI	Investment Company Institute
IMC	Investment Management Company
INS	Institutional Investors
IPO	Initial Public Offering
JA	Jensen Alpha
JB	Jarque-Bera Test
LLC	Levin-Lin-Chu Test
LM	Lagrange Multiplier
MCCG	Malaysia Code on Corporate Governance
MER	Management Expense Ratio
NAV	Net Asset Value
OECD	Economic Co-operation and Development
OLS	Ordinary Least Regression
PCA	Principal Factor Analysis
PLS	Profit and Loss Sharing
PTR	Portfolio Turnover Ratio
RESET	Regression Specification Error Test
ROA	Return on Asset
ROE	Return on Equity
SAC	Shariah Advisory Council
SAP	Shariah Advisory Panel
SC	Securities Commission
SGF	Shariah Governance Framework
SMF	Shariah Mutual Fund
UK	United Kingdom
UTC	Unit Trust Consultant
VIF	Variance Inflating Factor
3SLS	Three Stage Least Squares Regression

LIST OF APPENDICES

CHAPTER ONE

BACKGROUND OF STUDY

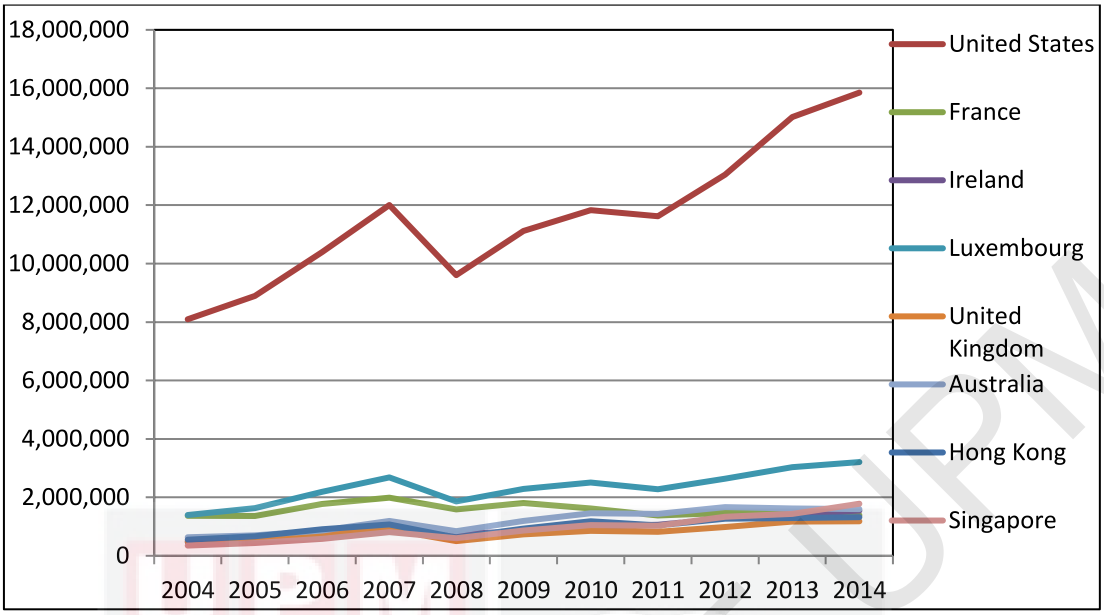
1.1 Introduction

The chapter commences with the entire growth of the mutual fund industry worldwide highlighted in Section 1.2, followed by the background of the study in Section 1.3. The problem statement explaining emerging issues is presented in Section 1.4 accompanied by research objectives and questions, in both Sections 1.5 and 1.6. A further exposition of motivation, the scope of study and the significance of study is presented accordingly in Sections 1.7 and 1.8. The research framework is depicted in Section 1.9. Finally, Section 1.10 provides the course of the entire study.

1.2 The Growth of Mutual Fund Industry

The mutual fund industry has experienced a strong growth worldwide following an increase in asset under management amounting to $33.4 trillion. According to 2014 annual report of Investment Company Institute (ICI), a significant growth has been witnessed, especially after the 2008 major financial crisis. Additionally, the growth highlights high valuable market of Americas, European, and Asia Pacific regions with a specific attention of newly emerging to Canada, Brazil, and Chile (Investment Company Institute, 2015). United States, for instance has doubled the value of asset management since 2004, indicating the highest value in the world followed by most of developed countries, advanced economies, and financial centre points that on average manage more than one billion assets.

Greater protection to shareholders and stringent capital market regulation stimulate local and foreign investors coupled with attractive returns of clear investment objective to draw more flows. Figure 1.1 illustrates the growth of asset under management measures in net asset value (NAV) by major industry player amongst developed countries.



Adapted from: Investment Company Institute

Figure 1.1: Total net asset value (NAV) in most developed countries

The presence of Australia, Hong Kong, and Singapore in Asia Pacific boosts many other countries in the same region to put efforts in expanding assets. In fact, the growth of asset development has some positive impact to Asian countries including Malaysia in creating an innovative fund and emphasizing asset investing internationally.

The dramatic growth has been driven particularly by Americas region while Asia Pacific almost constantly remains over the years. Overall, the world's asset under management as stressed earlier has achieved another best economic data for a significant growth. Consequently, the latest position as depicted by Figure 1.2 implies slow growth among Asia Pacific countries in managing those assets.

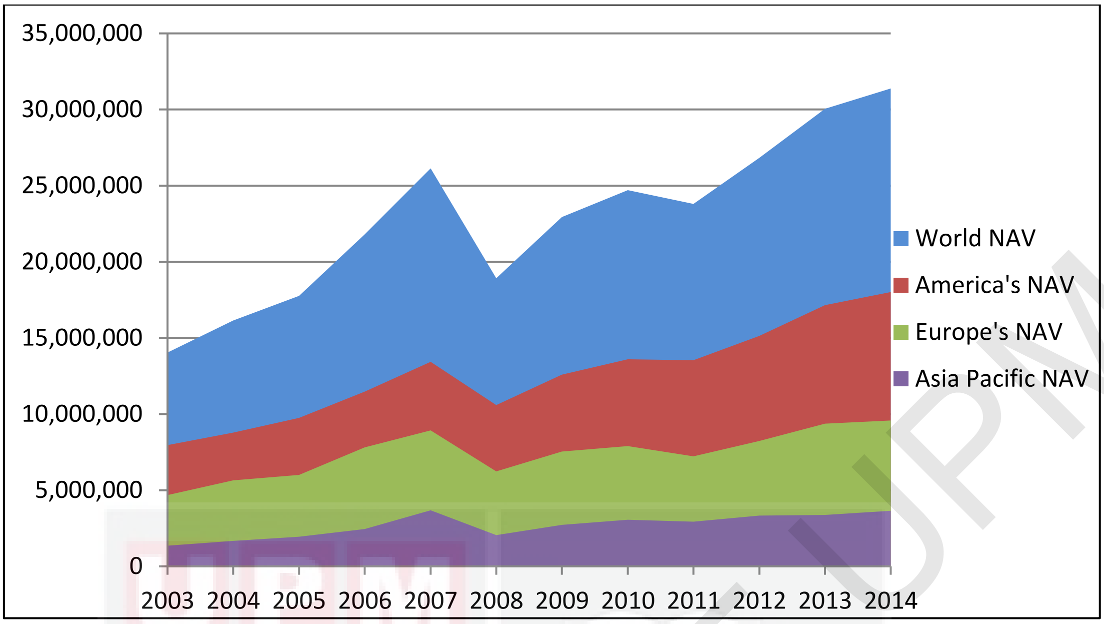


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Figure 1.2: Total NAV by region

A clearer picture of the latest NAV shares is observed by region in Figure 1.3 with strong evidence of Americas region holding 53 per cent while Asia Pacific and Africas controlling only 11 per cent. Both Americas and Europe get more attention from new fund flows, predominantly from developing countries to build an efficient investment portfolio. However, the total value is not absolute due to the proportion belonging to Africas as well.

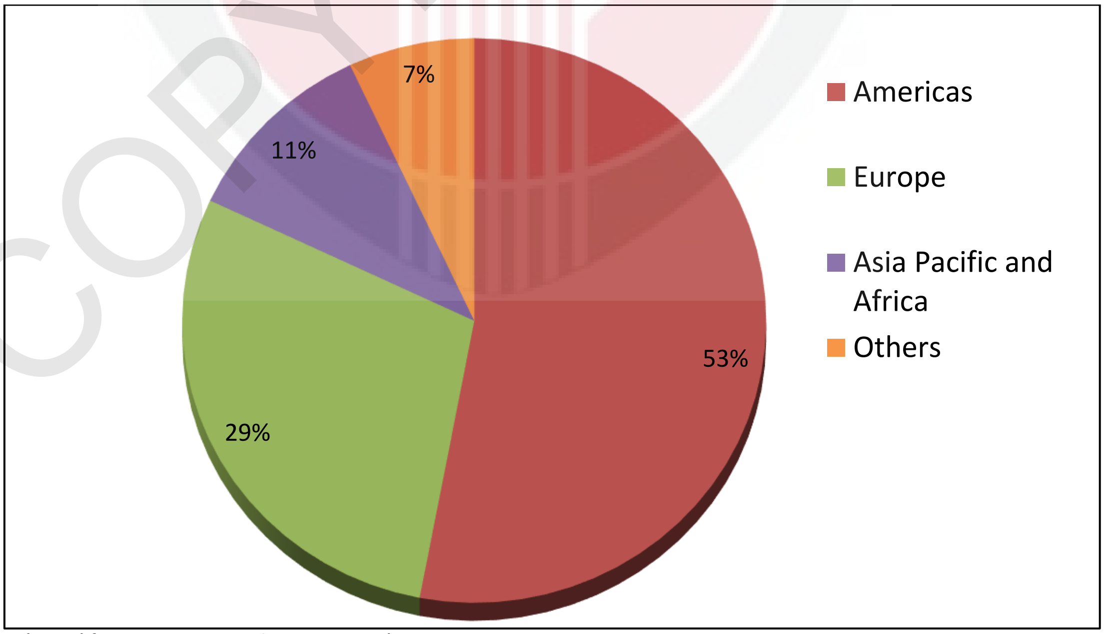

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Figure 1.3: The proportionate market share NAV by region in 2014

The claim of such constant growth in Asia Pacific region is especially true as Figure 1.4 focuses on the pattern of NAV value since 2003. Apart from the historical financial crisis, the value remains almost unchanged between the range of 10 and 12 per cent despite the highest record during 2007. Surprisingly, the growth value of Asia Pacific goes against both America and Europe in 2007. With an avarge value of 11.57 per cent asset for Asia Pacific, America holds 55.29 per cent, while Europe hits the lowest NAV with an average of 32.72 per cent. Thus, Asia Pacific's originated funds are on the right track to steadily accelerate more growth in the future.

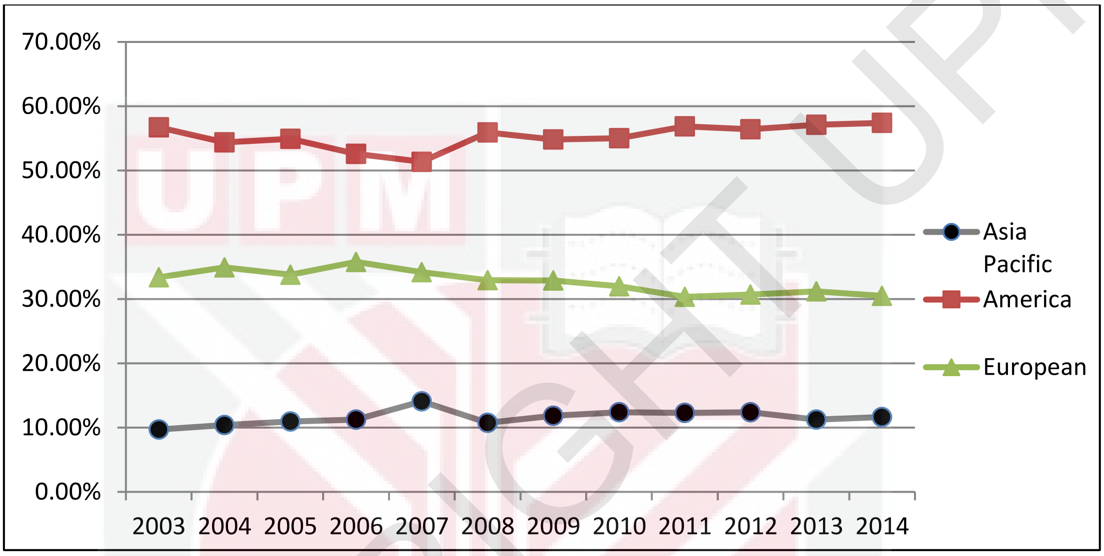

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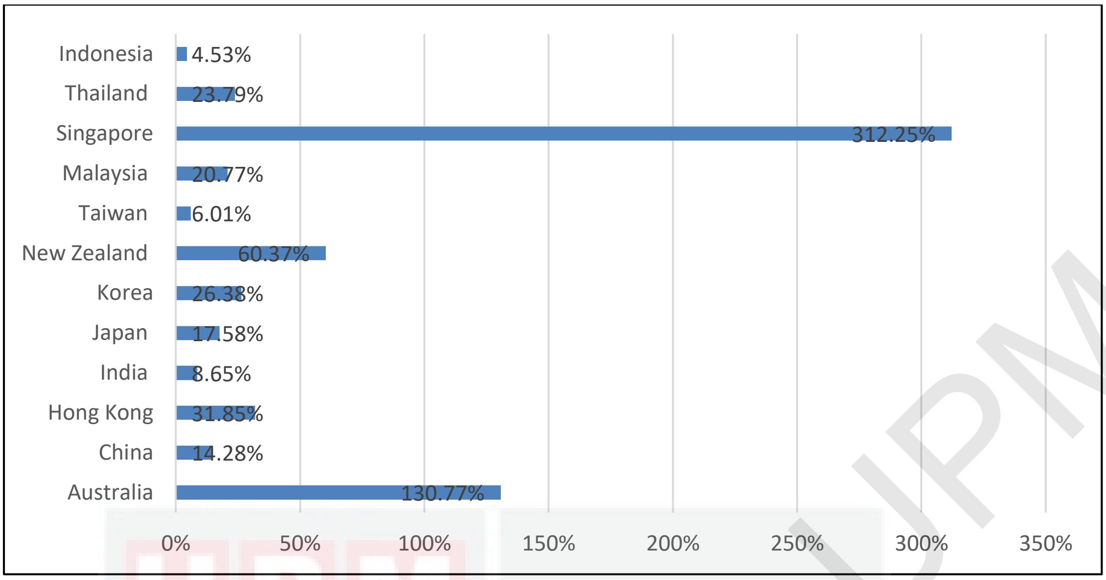
Figure 1.4: Asia Pacific region mutual fund NAV

Recognizing the data of assets under management is essential not only to document the record of the industry, but also to acknowledge the contribution toward equities market. Penetration in stock exchange market capitalization by mutual fund is significant due to the preferred asset of equities. Thus, an increasing ratio typically used to measure the NAV over the stock exchange market capitalization implies an actively high turnover investment and portfolio proportion by fund management.

Australia and Singapore exhibit an outstanding position in Asia Pacific with extensive growth relative to main indicators such as stock exchange market capitalization. Both values of asset exceed 100 per cent most probably due to the existence of foreign funds. Malaysia has also significantly contributed to the asset management industry among other Asian countries, even though few steps behind neighboring countries such as Thailand. Figure 1.5 shows the ratio of NAV over each country's market capitalization encompassing Asia Pacific countries for 2014.

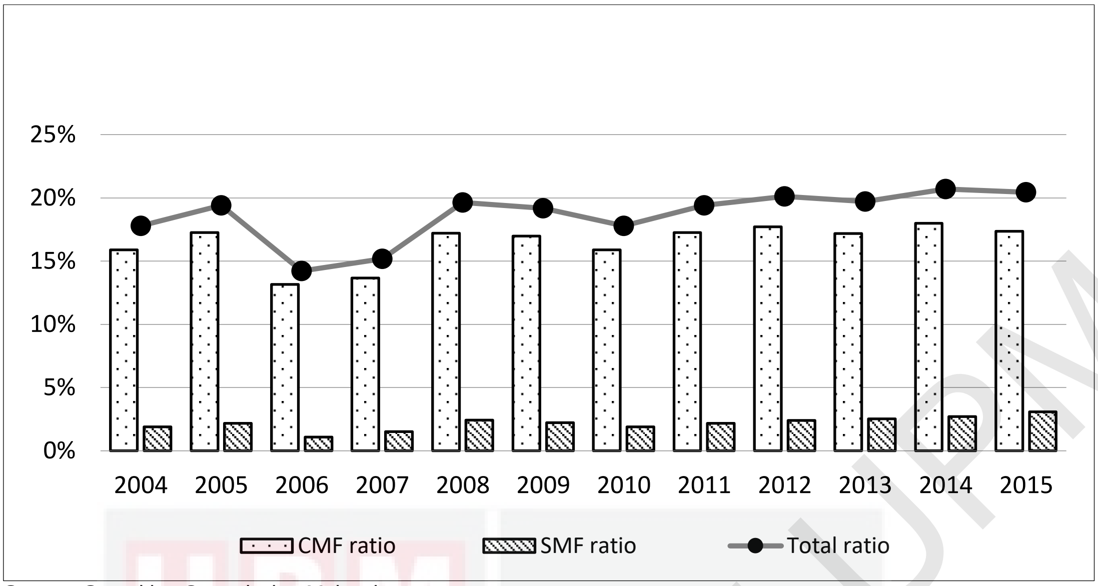


Source: Investment Company Institute, Bursa Malaysia, Securities Commission Malaysia, Indonesia Financial Services Authority, Monetary Authority of Singapore, Securities and Exchange Commission Thailand, Securities and Futures Commission of Hong Kong, Bloomberg, World Bank, and International Monetary Fund

Figure 1.5: The ratio of NAV over stock market capitalization in 2014

Narrowing to Malaysia's environment, a similar ratio has also been employed to analyze the overall value of the mutual fund industry. Due to the reliance on an increasing equities value over time, the result from this ratio depends considerably on an equally greater value of NAV to reflect the true position of the industry. The higher ratio explains the higher penetration of mutual fund fraction over equities as the financial intermediary function to stock exchange house. That would likely be the reason of an average constant value between the range of 15 and 20 per cent. Figure 1.6 presents the ratio of NAV over local Bursa Malaysia's market capitalization.

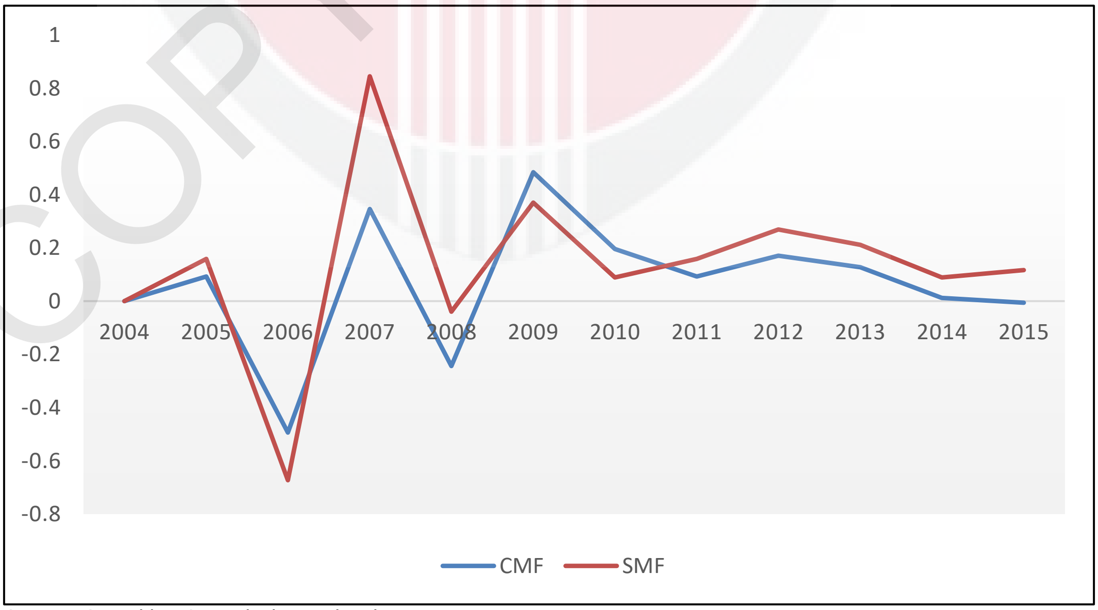
Further analysis of the growth trend between both funds suggests that Shariah mutual fund (SMF) gains a greater fraction during bearish market compared to conventional mutual fund (CMF) whose fund is reliable during post financial crisis. A recent trend since 2010 implies a positive and greater growth of SMF rather than CMF, though the industry faces market uncertainty with investor demand moving up and down. Figure 1.7 briefly demonstrates the growth pattern of both funds.



Source: Securities Commission Malaysia

Figure 1.6: The ratio of NAV over Bursa Malaysia market capitalization

Certainly, the economic development landscape furnishes the demand and drives a high liquid type of investment. This beneficial constituent accommodates investors with cash convertible requirement at lowest cost possible relative to many other assets. Both developed and developing countries encounter positive effects from this factor.[1] Undeniably, the total populations especially in developing countries as predicted in Figure 1.8 also favour this growth mainly due to high birth rates and young populations. Crenshaw, Ameen, and Christenson (1997) support the claim toward fostering the economy by both middle and low income households that rely heavily on mutual fund as two-in-one investment and savings vehicle.

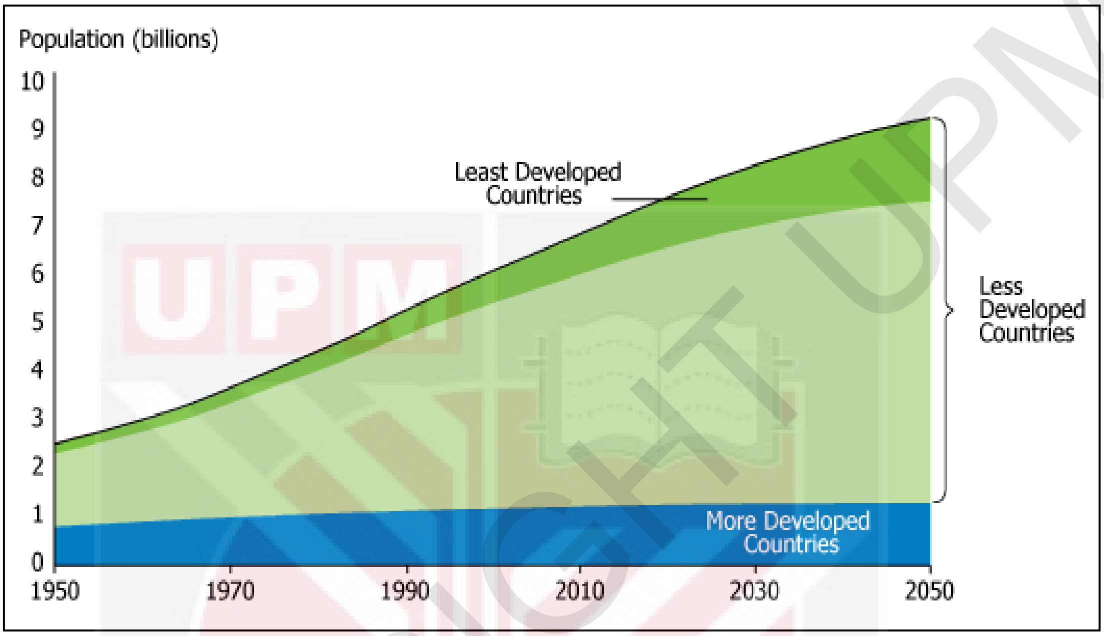


Source: Securities Commission Malaysia

Figure 1.7: The growth change of CMF and SMF

[1] Investment Company Institute (2015)

Furthermore, according to the estimation growth of Muslim population, it would hit 25 per cent of total population in the world by 2030. This increasing number stipulates the demand for all Shariah products and services, which probably leads to an increasing demand in Shariah investment market, for instance. The exposure of international facilities rendered by Shariah investment to different markets and countries builds more attraction for investors to pool new funds.



Adapted from: United Nations

Figure 1.8: World population prospects

1.3 Background of Study

As defined by Parrino, Sias, and Starks (2003), institutional investors (INS) are heterogeneous group of an organization holding at least 5 per cent of ownership and having potentially divergent predilections toward exercising influence. The mutual fund is an instance of crucial institutional investors apart from banks, pension funds, and insurance companies. A large fraction of ownership held by INS demonstrates a greater influence on corporate decisions (Drobetz, Schillhofer, and Zimmermann, 2004), resulting in one of the good external control mechanisms for investors to put pressure on corporate governance standards (Drobetz et al., 2004).

Due to unaffordable capacity of retail investors, INS are present to stimulate financial markets, acting as important providers of capital. Grinblatt, Titman, and Wermers (1995), Jones, Lee, and Tompkins (1997), Badrinath and Wahal (2002), and Basak and Pavlova (2013) contend that this group of investors plays an important role as profitable momentum trader. Their transaction may have sizeable effects on asset prices following the excess and higher demand of risky assets. Consequently, it boosts index stocks, pushes up price further, generates price pressure on stock market, and influences volatility.

Del Guercio (1996) mentions the prudence stocks preferred by mutual funds and banks, while Falkenstein (1996) explains the characteristics of those such as high in liquidity, good flow of information, and volatility. More specifically, Gompers and Metrick (2001) states clearly that INS invest in larger stocks, have more liquidity, and earn relatively low returns during previous year, reflecting the rational and beneficial decision.

Evidences from literatures have shown the advantages of INS to remain beneficial to its shareholders in the market. Each investment decision is carefully taken into account to reflect a prudence transaction as indicated by Wermers (1999), Nofsinger and Sias (1999), and Gompers and Metrick (2001) in which INS are better informed than other investors and certainly good in predicting future returns. Huge sources coupled with greater incentives and research expertise make them leader in informational efficiency (Gompers and Metrick, 2001; Boehmer and Kelley, 2009) toward controlling speculation and asymmetric information. Generally, INS such as mutual funds collectively raise funds from retail investors to strategically provide capital on certain assets. Thus, the consistent existence of this group of investors is fundamental to ensure a sound and competitive financial market.

The mutual fund industry or popularly known as unit trust in Malaysia has shown tremendous development since decades ago with the recorded investment value of RM426 billion measured by NAV as at the end of 2017 by Securities Commission (SC) Malaysia.[2] From the total value, besides an increase in CMF to more than RM349 billion, it also boosts Islamic based or SMF to more than RM77 billion.[3] Furthermore, that total value represents 22.39 per cent of Bursa Malaysia's market capitalization, which indicates the importance by value of this investment vehicle.[4]

Despite the parallel operation of Malaysian Islamic financial model to an established conventional system, both funds are interconnected on their functional basic of operation. Both equities type of mutual funds provide capital for Bursa Malaysia and many other types of securities, imposed fees, and are superintended by the Board of Director (BOD). However, the difference in principle embraced by conventional and Shariah law has restricted SMF activities from engaging in investments universally (Abbasi, Hollman, and Murrey, 1989). For instance, entertainment, alcohol, tobacco, and widely interest-based activities are strictly forbidden industries for investing according to Shariah law (Abdul Ghafar and Achmad, 2010).

[2] Securities Commission Malaysia (2014)
[3,4] Securities Commission Malaysia (2014)

This principle is based on the belief and value system exclusively in Shariah law (Derigs and Marzban, 2008), which enforces a screening process (Hassan, Abu Nahian, and Ngow, 2010) mainly on business activities, financial and non-financial criteria in order to meet the requirement. Investment selection would be done to screen out those business organizations that violate the law. Unlike CMF, the investment portfolio held by SMF is relatively undersized. Sometimes, investment decision might change drastically subject to the Shariah Advisory Council's (SAC) circulation by the Central Bank of Malaysia (BNM).

There are many other financial instruments disallowed by Shariah law including government bills, government and corporate bonds, and derivatives contracts such as futures, forwards, options, and swaps (Hassan et al., 2010). The huge difference in investment practice from CMF leads to a critical function of Shariah Advisory Panel (SAP), which has been equally important to the BOD. A regular and frequent review of the investment universe is necessary before any investment decision could be performed by fund managers.

Good corporate governance is indispensable for a corporation such as fund management to meet and achieve the ultimate objective. By setting control, policies, and guidelines, the best practice of good corporate governance realizes the desirable interest of stakeholders, predominantly shareholders. The most acceptable definition of corporate governance is highlighted by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) as a set of mechanisms for outside investors to protect themselves against misappropriation, misrepresentation, and fraudulence by management. Coles, McWilliams, and Sen (2001) and Gibson (2003) further elaborate the concern of how shareholders lay out governance mechanisms and structure the organization for effective decision making by managers and performance maximization.

Although various mechanisms exist internally and externally, internal governance mechanisms are prevalent and widely exercised to monitor management activities. Among others, internal governance mechanisms are concerned primarily with the governance structure (Jensen and Meckling, 1976; Baysinger and Butler, 1985; Guercio, Dann, and Partch, 2003) ownership holdings by managers (Jensen and Meckling, 1976; Morck, Shleifer, and Vishny, 1988; McConnell, Servaes, and Lins, 2008), and managers compensation or fund fees (Murphy, 1985; Mehran, 1995; Drobetz et al., 2004).

Internal governance mechanisms are also effective primary devices to restraint agency cost (Jensen and Meckling, 1976), an internal cost stemming from conflict of agency between principal and agent encompassing monitoring cost, bonding cost, and residual loss against fund value creation.

The presence of SAP at the decision level of investment is likely to enhance the quality of investment activities in accordance to Shariah law most of the time, particularly the principle and value opted by investors. Such additional monitoring function is claimed by Lewis (2010), Wan Amalina, Percy, and Stewart (2013), and Mollah and Zaman (2015) as additional or multi-layer governance to assist the BOD and strengthen the governance structure in advising, reviewing, and supervising all related Shariah activities and promoting good governance as well.

Their special designation is proper to serve the dual interests of investors who emphasize that Shariah principle compliance is equally important to good financial return or fund value as the main investing objective. Consequently, additional numbers of decision makers may carry benefits to investors as more independent parties are located in the fund management to oversee vigilantly the decision making process. Moreover, the Shariah compliance practice validated by SAP regularly has applied Shariah governance framework complements to the existing corporate governance (Lewis, 2010).

The mounting concern of an additional layer of governance roles also raises conflicts in investment decision and excessive control over monitoring mechanism, since dual interests are shown by shareholders in SMF with particular attention to high compliance of Shariah principle. In a typical mutual fund contract, various fees are highlighted as important expenses borne by investors upon subscription. A huge portion of the fees is dedicated to management and administration fees, particularly to compensate managers in running the investment fund's daily activities. Any excessive fee caused by the need of another layer of governance could exacerbate the agency problem instead of functioning as salient nature of contract.

A large number of researches have paid attention on mutual fund performance but greatly ignored the most important function of the BOD in negotiating the lowest best fund fees to generate a superior performance. Dependency on control mechanism with regard to SAP as an additional layer of governance would result in higher cost of monitoring (Ghoul and Karam, 2007; Shank, Hill, and Stang, 2013), similar to the improvement in corporate governance conforming to the new regulation requirements (Morck et al., 1988). Thus, unstructured immaterial fees for the purpose of describing additional necessary activities performed by SAP insist high prices of mutual funds for a greater cost of agency and could potentially diminish fund value.

Although the managerial ownership mechanism offers an incentive for investor protection in closely monitoring managers and maximizing fund value, the possible negative impact and unproductive application would likely distract the effectiveness especially when there is a greater dependence on other monitoring governance mechanisms. An incentive reward of shares ownership or holdings would probably turn managers into an entrenched controlled shareholder (Morck et al., 1988) even in small stakes. It makes them completely powerful and arbitrary in making decision with all sources and information in hand.

Apparently, there is high possibility for insiders to be an opportunist by utilizing perquisites and giving priority to their personal interest without shareholder knowledge. At least, shares ownership by managers are insignificant rather than institutional and director ownership in the context of high monitoring function. Hence, it would unlikely eradicate agency problem, but only drop the fund value.

With different governance structures in both CMF and SMF, the use of such internal governance mechanisms is puzzling through its function and effectiveness toward aligning interest, reducing agency cost, and enhancing fund value. Further empirical evidence is beneficial to enrich good corporate governance literatures and provide new insights, especially in the different governance structure such as SMF so that investor's dual interests of maximizing fund value and investing in Shariah compliant assets are aligned.

1.4 Problem Statement

Despite the phenomenal figures and numbers disclosed statistically, industry analysis implies a massive gap of growth with potential market surroundings Asian countries. The NAV ratio has always been the benchmark to visualize the slow growth of the mutual fund industry. While it is very surprising to find that Malaysia is ahead of some developed countries including Japan, the aggressiveness in promotion of good governance of funds is not as good as the well-diversified funds in Australia and Singapore. There is a substantial value of SMF under management in Malaysia, but outrageously decreased to almost 20 per cent in 2012 as opposed to the leading player, Saudi Arabia.

The decreasing trend shown by Malaysia indicates a significant deprivation portion of assets from existing and potential investors. This could be due to the growth that is deteriorating at the international level by many quick exit actions, or perhaps, less new fund flows is created. Identifying the most likely central issue of this is how the management creates and adds value over the expenses incurred to investors through a variety of fees. Johnson, Boone, Breach, and Friedman (2000) have emphasized the weakness of corporate governance that affected the loss of confidence by domestic and foreign investors, leading to an increase in capital outflows and contributing to large vulnerability of nominal currency depreciation and stock market crash during the Asian financial crisis in 1997. Meanwhile, Giannetti and Simonov (2006) viewed the quality of corporate governance as a primary concern to continue holding shares because investors enjoy security benefits of competitive investing cost, returns, and company growth.

Dasgupta and Prat (2008), Guerrieri and Kondor (2012), Kaniel and Kondor (2012), and He and Krishnamurthy (2013) describe the poor performance that triggers outflows as mainly due to the contracting frictions among parties, managerial ability, and exogenous reason such as performance itself. More specific, Pinkowitz, Stulz, and Williamson (2006) add the tunnelling activity in poor investor protection countries to cause shareholders to discount the asset value when they believe the benefit has depleted.

Low profitability also suggests that an unprofitable project is wasted on and weak governance monitoring mechanism seemingly gullible and dysfunctional to allow poor managers to stay and inefficiently allocate the resources (Joh, 2003). These issues remained controversial and are gaining interest following stringent governance reforms worldwide, to the extent of raising a puzzling question for the reason the public is willing to contribute inflows when they know neither corporate governance, nor legal rights effectively insulate from expropriation (Gomes, 2000). However, raising the potential number of growth is possible by strengthening the management and internal governance. Moreover, the growth of fund could be made significantly appealing by consistently adding value and minimizing agency cost associated by the presenting some internal governance mechanisms in house.

While shareholders desire high risk-adjusted returns at low cost, the fund management company wishes to maximize the level of assets under management in association with management fees and expense ratio (Jensen and Meckling, 1976). This fundamental divergence that leads to conflict of interest among various parties (Jensen and Meckling, 1976) has caused excessive unrealized costs being imposed to investors for the purpose of monitoring even in longer term, resulting in multiple losses. The inclination of fund operating expenses to increase in the recent years seems uncontrollable, predominantly in double layer of governance structure, most probably because investors are sensitive to initial fees than deferred expenses (Barber, Odean, and Zheng, 2005).

Divergence in interests among fund management, managers, and shareholders makes value creation almost impossible without the optimal function of corporate governance (Liu, 2014). It is the BOD’s obligation to ensure all activities within fund management are executed according to the contract in the best interest of owner and for the benefit of the company (Molz, 1985).

Thus, a consistent positive fund growth in contrary to negative fund value is typically prevalent to support such conviction. At this point, the role of the BOD especially outside and independence directors is necessary to monitor every decision making and report inappropriate managerial behavior (Berle and Means, 1932). Moreover, the unrealized excessive costs are likely caused by

Shariah governance adopted by SMF due to heavy reliance on monitoring function for dual interests at the trade-off between the benefit and cost.

The fact that investors allocate their capital and hold the trust associated in a contract of principal and agent relationship could turn out to be a net loss valued investment following the separation of ownership and control (Shivdasani and Yermack, 1999) if not being managed according to the priority owners' interest. Though the expansion of the industry in Malaysia has been pretty good, ineffectiveness of fund management caused by voting controlled managers and violation of such Shariah principle and value (Wilson, 1997) would create uneasiness of costly agency among those who entrusted them.

1.5 Research Objectives

Research objectives are very important in determining goals and direction along the way toward good and excellent research achievement. Thus, the objectives specified must be able to answer all research questions that emerged. The general objective of the study is to provide empirical evidence on the impact of ownership, the governance structure especially Shariah governance, and fund fees on agency cost and fund value. It is executed by preparing an implication analysis between CMF and SMF. The more specific objectives are underlined as follows:

1.5.1 To compare between the level of agency cost in CMF and SMF due to the additional incorporation of Shariah governance in SMF.
1.5.2 To examine the impact of internal governance mechanisms on agency cost of Malaysian mutual funds, particularly the effect of Shariah governance in SMF.
1.5.3 To inspect the impact of internal governance mechanisms on fund value of Malaysian mutual funds, particularly the effect of Shariah governance in SMF.
1.5.4 To investigate the relationship between agency cost and fund value of Malaysian mutual funds.

1.6 Research Questions

Several research questions are determined subsequent to the research objectives to provide the stipulated empirical evidence. The general question is the comparable impact of ownership concentration, the governance structure especially Shariah governance, and fund fees toward enhancing fund value differentially between CMF and SMF. More particular questions are as follows:

1.6.1 Is the level of agency cost higher in SMF compared to CMF due to the incorporation of Shariah governance in SMF?
1.6.2 How do internal governance mechanisms affect agency cost in Malaysian mutual funds, particularly Shariah governance in SMF?

1.6.3 To what extent do internal governance mechanisms influence the fund value of Malaysian mutual funds, particularly Shariah governance in SMF?
1.6.4 Would there be any relationship between agency cost and fund value in Malaysian mutual funds?

1.7 Motivation and Scope of Study

This study is primarily motivated by the Malaysian Accounting Standards Board (2001) on financial reporting disclosure requirements for unit trusts, and the Malaysian Code on Corporate Governance (MCCG) introduced in 2000, later revised in 2007, and subsequently issued a blueprint in 2012.[5] Both standard and code aim to facilitate a more efficient, sound, and progressive capital market through a higher standard of disclosure, due diligence and excellent corporate governance culture by strengthening market discipline and promoting good, sustainable, and ethical compliance. Although the latter is highly enforced to companies listed on Bursa Malaysia, the guideline, however, is encouraged and not a mandatory among mutual funds.

It becomes more relevant as especially these heterogeneous investors understand that their money is being put at risk without optimum protection. Hence, MCCG is on the right track to encourage best corporate governance practice and better quality, full, accurate, and timely information disclosure to public investors. Although the newly released code intends to enhance business prosperity and corporate accountability, the practice is still unsatisfactory in most corporations.

It seems that corporate governance practice is viewed as a trivial matter for the implementation in the fund management context, as agency tension keeps increasing particularly if the information in the management possession does not fully reflect the recent market movement (Zitzewitz, 2003). Connelly, Limpaphayom, and Nagarajan (2012) add by demonstrating that mutual fund is inactive institutional investors for promoting corporate governance. In fact, it turns worse resulting in long-term average suboptimal financial performance at the expense of investors.

A newly introduced and comprehensive Shariah governance framework (SGF) was launched in 2009 and enforced in 2011 to set a centralized and strong composition of SAP in Islamic financial institutions (Bank Negara Malaysia, 2009). Subsequently in 2013, the Financial Services Act and Islamic Financial Services Act[6] came into the financial landscape reinforcing the preceding regulation, particularly on the issue of shares holding, corporate governance, and Shariah governance with regards to the policies, procedures, and operations compliance. In consequence, the replacing regulations increase

[5] Securities Commission Malaysia (2007) and Securities Commission Malaysia (2012)
[6] Bank Negara Malaysia (2013) replaced the Islamic Banking Act 1983 and the Takaful Act 1984.

consumer protection and promote financial stability through competitive services.

This study examines the impact of ownership concentration, governance structure, and fund fees in controlling agency problem, thus enhancing fund value. It will emphasize on conventional and Shariah compliant markets of mutual fund in Malaysia, the second biggest and significant home market of SMF industry. A consistent improvement on MCCG since 2000 implies a weaker investor protection and minority shareholder rights in emerging and developing market (Connelly et al., 2012). As a result, controlling shareholders obtain the capacity to practice expropriation coupled with low corporate transparency, rent-seeking, crony capitalism, and relationship-based transactions that could possibly weaken corporate governance, leading to poor performance and conducive to macroeconomic crises as recorded across Asian countries in 1997 (Claessens and Fan, 2002; Gibson, 2003).

Ownership by foreign investors are less preferred in this market due to the discount price they must be willing to pay after reassessment as per Leuz, Lins, and Warnock (2010) who argue that corporation engages most often in earning management. Besides, Lim, How, and Verhoeven (2014) suggest that a greater ownership concentration is likely found as a result of more severe agency conflict caused by a more complex fund operation and poor governance structure (Larcker, Richardson, and Tuna, 2007; Jensen and Meckling, 1976).

With regard to CMF and SMF, data of ownership concentration encompassing managers, directors, and the related INS, the governance structure, and the variety of fund fees are collected within the period from 2008 until 2015 from each open-end mutual fund with complete data domiciled in Malaysia.

1.8 Significance of Study

The corporate finance literature has experienced meticulous and thorough research and theories extension from various areas so far. Researchers have so long shown interest in organizational and agency theory contributing to important insights of organizational phenomenon. However, insufficient research on some other issues such as conflict between managers and shareholders in the monitoring landscape of double layer directors of governance surroundings potential market perspective, like mutual fund industry, deserves an extra special attention.

Currently, there are many researches being done in the related area to bring up evidence, following the interest taking activity and ineffective governance by managers in most developed countries. The disparity between developed and developing countries in mutual funds nature of operation in terms of characteristics, size, regulations, disclosure requirements, ownership, and many more signifies a more relevant research to be conducted in a local environment.

Although similar studies have been done, most of them are focused on active investors in the stock market. Being the potential market to achieve the Islamic financial hub, the first contribution of this study provides new empirical evidence of the central roles of the BOD and SAP within corporate and Shariah governance framework comparatively.

A relatively small number of evidence is captured in developing countries and emerging markets like Malaysia with such progressing regulation under minimum investor protection. The suggestion of Berle and Means (1932) to bring an empirically testable perspective on problems of cooperative effort would enrich the context under positivist stream to align managerial behavior under stringent governance structure. Thus, the second contribution from this study implicates the emerging evidence from weak investor protection and shareholder right.

The third contribution of this study attempts to extend agency theory literature by examining the effectiveness of each best governance mechanism and simultaneously minimizing agency conflict, agency cost, and accelerating fund value. Moreover, this study intends to fill the gap in literature by discovering investor's dual interests served by double layer governance with regard to SAP, dealing with agency cost, and the enhancement of fund value to shareholders.

Another dimension of the fourth contribution is further implication on the mutual fund industry by providing evidence of corporate and Shariah governance efficacy following several governance and regulations reforms. It would shed light on some possible areas to the attention of policy makers and regulators in the future. By fulfilling the research objectives, it fills the gap and extends the insights on Islamic-based mutual fund literatures; thereby contributing to the body of knowledge and Islamic finance development.

1.9 Research Framework

Based on several research objectives prescribed, a research framework is established as illustrated in Figure 1.9. It explains the rationale and defines predictions for causal relationships between internal governance variables and its outcome of agency cost and fund value. From the general observation by theories, this framework visualizes strong possible predictions of hypotheses besides clearly indicates the position of all variables.

On the left is independent variables comprise the board governance structure, ownership concentration consisting of managers, directors, and the related institutions, fund fees and expenses, and Shariah governance. The explanatory variable of interest is Shariah governance proxied by SAP. Shariah governance represents a governance mechanism to control agency cost or the sources of additional agency cost in a double layer governance structure model compared to conventional. There are two dependent variables namely, agency cost and fund value. The two-way connection is clearly indicated between governance mechanisms and fund value.

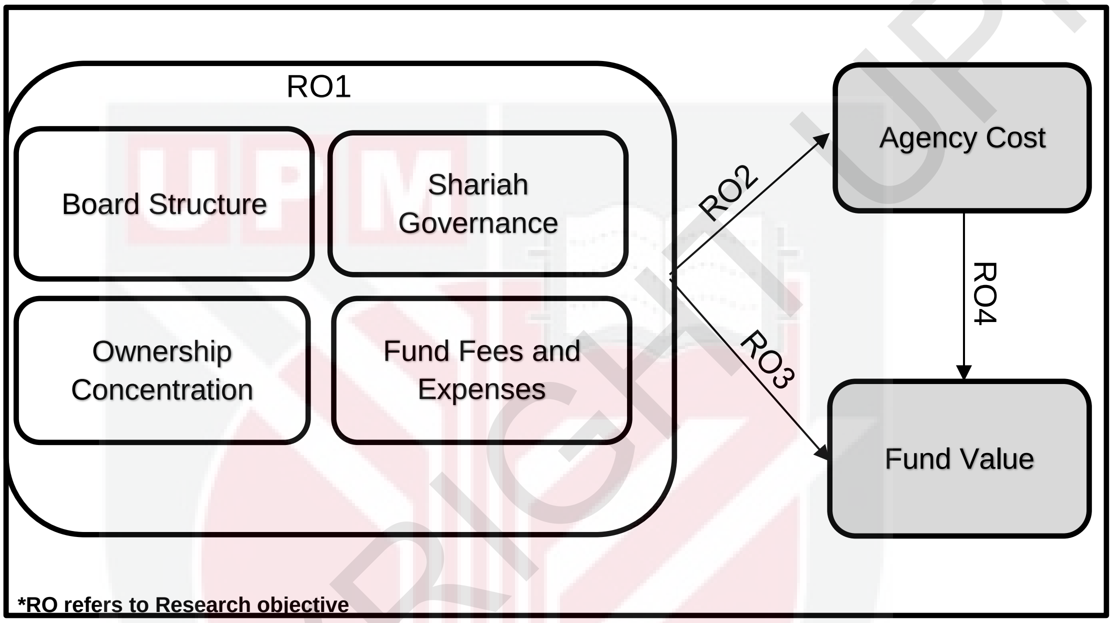


Figure 1.9: The research framework

1.10 Organization of the Study

The next chapter provides an introduction to the mutual fund and an overview of the mutual fund industry in Malaysia. The parties involved in a mutual fund's contract are highlighted with more explanation about the comparison between conventional and Shariah funds. Additionally, the existing conventional and Shariah governance is justified for their presence respectively following a rigorous review of literatures.

Chapter Three entails the method employed by the study. From approach to research design, an equally important note is all types of techniques, governance variables clarification, and estimation analysis are expected to be utilized in realizing each objective. As the estimator tests each hypothesis as well, other issues concerning the estimation model need an extremely high attention to generate non-biased results.

Chapter Four finalizes the sample into a complete dataset. Subsequently, all variables are analysed to provide basic descriptive statistics with some issues implicating estimation. Each variable can also be viewed in details through trend analysis. The main analysis results are presented correspondingly to each hypothesis with some additional estimation and followed by relevant discussions to properly answer research questions. Not to mention, robustness test is reported to reaffirm whether the results are consistent. Econometric issues are checked and controlled before a closing summary of the chapter.

Chapter Five summarizes, highlights, and concludes the whole study. Further, it suggests the contributions, limitations, and future avenues for research.

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