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Emerging market mutual fund performance: Evidence for Poland

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ABSTRACT

This paper provides evidence on the performance of mutual funds in a prominent emerging market; Poland. Studying an emerging market provides an excellent opportunity to test whether the consensus on the inability of mutual funds in developed and highly efficient markets to beat the market, also holds in less efficient markets. While the weaknesses of legal institutions and underdeveloped capital markets in emerging countries could negatively contribute to performance, a certain level of market inefficiency might also enable fund managers to successfully apply security selection and therefore beat the market. This paper presents an overview of the Polish mutual fund industry and investigates mutual fund performance using a survivorship bias controlled sample of 140 funds. The latter is done using the Carhart (1997) 4-factor asset-pricing model. In addition, we investigate whether Polish fund managers exhibit “hot hands”, persistence in performance. Finally the influence of fund characteristics on risk-adjusted performance is considered. Our overall results suggest that Polish mutual funds *on average* are not able to add value, as indicated by their negative net alphas. Interestingly, domestic funds outperform internationally investing funds, which points at informational advantages of local over foreign investors. Finally, we detect strong persistence in mean returns up to 1 year. It is striking that “winning” funds are able to significantly beat the market, based on their significantly positive alpha's. These results deviate from studies on developed markets that conclude that even past winners are not able to significantly beat the market.

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1. Introduction

Studying mutual funds has served as an excellent laboratory for numerous researchers interested in testing for market efficiency. Based on over 4 decades of mutual fund performance studies there now exists a strong consensus on the inability of mutual funds to beat the market after all relevant fees are deducted. More specifically, the alpha's on the estimated factor models are significantly negative, by about the amount equal to the fees that are charged. The vast majority of these studies however focused on the US mutual fund industry which in terms of assets under management and holding of the domestic equity market is far ahead of the rest of the world.¹ More recently several studies turned to European mutual funds as data coverage on non-US markets improved. However, most European studies focus on individual countries, which makes it difficult to draw comprehensive conclusions across countries.² A notable exception to this is offered by Otten and Bams (2002). By studying a survivorship bias free sample of 506 mutual funds from France, Germany, Italy, United Kingdom and The Netherlands they find that the average European mutual fund produces an alpha that is insignificantly different from zero. Adding back management fees, led to 4 out of 5 countries exhibiting significant outperformance at an aggregate level. The authors argue that the smaller market importance of European mutual funds might put them in a better position to follow or even beat the market. This in sharp contrast to US funds which represent over 30% of stock market capitalisation, while European funds only represent about 10% of their local stock market capitalisation.

Evidence on emerging market mutual funds is scarce. Based on for instance Ferraira et al. (2006) and Khorana, Servaes, and Tufano (2005) there is a positive relation between risk-adjusted performance and variables like the strength of legal institutions and the development of the capital market. Following those arguments it is expected that emerging market mutual funds underperform. On the other hand, several studies of emerging market mutual funds based in *mature markets* document an outperformance. For instance, Borensztein and Gelos (2000) have shown that managers of emerging market mutual funds are characterised by better market timing. On average, they were able to rebalance their portfolios at least one month before a crisis. A more recent study by Huij and Post (2009) finds that US mutual funds investing in emerging markets are able to generate returns that are sufficiently large to cover their expenses. Also, the authors document a strong persistence in performance of past winners over past losers. They conclude by stating that emerging market funds generally display better performance than US funds. The two above mentioned studies are based on emerging market funds, based in mature markets (such as the US). Based on informational advantages one could suspect that local (domestic) investors would outsmart foreign investors, especially in emerging markets. This is well documented by for instance Brennan and Cao (1997), Coval and Moskowitz (1999) and Hau (2001). Otten and Bams (2007) examine local versus foreign mutual fund performance in a developed market, the United States, and find no difference. Therefore, our study will focus on mutual funds, operating and investing in an emerging market, in contrast to previous studies that scrutinize emerging market funds from mature markets investing in emerging markets. We choose to study the Polish fund market for three reasons. First, in the group of Central European countries that became members of the European Union (EU), Poland was characterised as the most developed mutual fund market. Secondly, the Polish fund market provides an opportunity to study a fast growing market. During the 8-year period of our analysis the number of funds grew by 23% per year and the total value of assets under management grew tenfold. Thirdly, in contrast to studies on Polish pensions funds by Voronkova and Bohl (2005) and Stanko (2003) studies on the Polish mutual funds market are scant. To our knowledge the only published study on the topic is the paper by Swinkels and Rzezniczak (2009). Based on a sample of 38 surviving funds from January 2000 to April 2007 they conclude that Polish funds produce 1-factor CAPM alpha's that are insignificantly different from zero. We extend the above mentioned analysis of Polish funds by Swinkels and Rzezniczak (2009) in three ways. First, we employ

¹ See for instance Jensen (1969), Malkiel (1995), Gruber (1996), Carhart (1997), Wermers (2006) and French (2008).

² For instance Dermine and Roller (1992) on French mutual funds, Ward and Saunders (1976), Shukla and van Imwegen (1995) and Blake and Timmermann (1998) on UK funds, Wittrock and Steiner (1995) on German funds, Ter Horst, Nijman and De Roon (1998) on Dutch funds, Fernandez, Bermejo, Bilan (2008) on Spanish funds, Sorros (2001), Rompotis (2007) on Greek funds, and Dahlquist et al. (2000) on Swedish funds.

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