The cross section of conditional mutual fund performance in European stock markets ☆

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ABSTRACT

This paper implements strategies that use macroeconomic variables to select European equity mutual funds, including Pan-European, country, and sector funds. We find that several macro-variables are useful in locating funds with future outperformance and that country-specific mutual funds provide the best opportunities for fund rotation strategies using macroeconomic information. Specifically, our baseline long-only strategies that exploit time-varying predictability provide four-factor alphas of 12–13% per year over the 1993–2008 period. Our study provides new evidence on the skills of local versus Pan-European asset managers, as well as how macroeconomic information can be used to locate and time these local fund manager skills.

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1. Introduction

A vast literature focuses on the predictability of U.S. and international stock returns using macroeconomic variables, such as the short government interest rate or the yield spread between defaultable and government bonds. For instance, Ferson and Harvey (1993) find that returns on international stock indexes are predictable using macroeconomic indicators as conditioning variables. More strikingly, Ferson and Harvey (1999) find that broad economic variables explain the cross-sectional variation in U.S. individual stock returns better than the Fama and French (1993) empirical factors. Avramov and Chordia (2006) extend this literature by showing that

substantial alphas are derived from choosing individual stocks based on macroeconomic conditioning variables. These papers, as well as numerous others in the academic literature, indicate that substantial gains in portfolio choice can be obtained from the use of macroeconomic information.

Other literature examines whether asset managers or sell-side analysts are better able to collect private information on equities of corporations in their geographic area. For instance, Coval and Moskowitz (1999) find that fund managers are better able to select stocks of firms headquartered nearby, and Cohen, Frazzini, and Malloy (2008) find that fund managers with past educational ties to corporate managers overweight and outperform in the stocks of those corporations. This literature suggests that geographic proximity or social networks, or both, can aid the transfer of private information. Further, Sonney (2009) finds that European sell-side analysts with a country specialization outperform analysts with an industry specialization, suggesting that an understanding of local product markets is crucial to analyzing stock valuation.

Together, these two seemingly unrelated bodies of research suggest that professional asset managers could be better able to choose local stocks under certain macroeconomic conditions. For instance, during the recent financial crisis, active UK asset managers could be expected to be valuable because of their ties to London financial institutions, in the face of large asymmetric information on the value of banking stocks. During the technology collapse, investors could prefer active Scandinavian managers with a specialized knowledge of local telecommunication companies, who could help to sort out which firms might recover most quickly. In essence, macroeconomic information can help to indicate when local skills are most needed in a particular market. Hence, a rotation among asset managers with local expertise as macroeconomic conditions evolve could outperform strategies involving either local expertise or macro-indicators alone to choose active managers.

This paper brings these issues to a unique data set that contains the monthly returns of European-domiciled equity mutual fund managers over a 20-year period. Specifically, we ask whether an investor can outperform when she has access to country-specific managers across several developed European markets and is allowed to rotate the portfolio allocation among the countries (and managers) as macroeconomic conditions in Europe evolve. If such a strategy does result in outperformance, we wish to know which country's local equity managers exhibit the best skills during a particular phase of the European business cycle. To address these points, we explore whether, under some macroeconomic conditions, a multi-country fund (i.e., a Pan-European fund) should be chosen due to its ability to time various countries and sectors (perhaps itself using macroeconomic information) or to provide lower-cost diversification. Conversely, we ask whether a country or regional fund should sometimes be chosen due to its greater knowledge of industries or stocks in its local geographic area.

Our study has significant real-world economic implications. European funds grew from a little over $3 trillion during 2000 to nearly $9 trillion during 2007. By the end of 2007, the European industry amounted to nearly three-quarters of the size of the U.S. mutual fund industry, which, over the same period, grew from $7 trillion to $12 trillion. Further, there were more than 35 thousand European-domiciled mutual funds by the end of 2010 (Investment Company Institute, 2011), almost five times the number of U.S.-domiciled funds, indicating that the European market is highly fragmented. Clearly, European investors have a confusing array of decisions to make in choosing their stock portfolio managers, including country allocations, sector allocations, and Pan-European versus individual country funds.

Despite the economic significance and fragmentation of the European mutual fund industry, European-domiciled funds remain very much an under-researched area. Some studies have been conducted at the individual country level, e.g., for funds that invest in the UK, Germany, Italy, or France, or some combination of these countries. One such widely known study is Otten and Bams (2002). However, no comprehensive study has simultaneously examined the performance of stock funds that invest across Europe (Pan-European funds), funds that invest in specific countries or regions (e.g., Germany or Scandinavia), and funds that invest in specific sectors (e.g., telecommunications) over a long time period that includes the integration of European financial markets of the past 20 years. This gap is an important omission, because investors in any European country find it increasingly easy and inexpensive to invest in mutual funds incorporated in other countries as a result of this market integration and the adoption (by many developed European countries) of the common euro currency.

We focus on the dynamics of active management skills and how an investor might optimally choose active funds during varying business conditions. Building on studies such as Avramov and Wermers (2006) and Moskowitz (2000), we allow for the possibility of time-varying mutual fund alphas and betas among active managers in Europe. Following Christopherson, Ferson and Glassman (1998) and Ferson and Schadt (1996), we model such time variation using a publicly available set of conditioning state variables. Thus, another of the objectives of our study is to explore which, if any, macroeconomic state variables are helpful in identifying funds with superior future skills in selecting European equities.

We first construct Pan-European size, book-to-market, and momentum risk factors for stocks. Then, we report on the average performance of European mutual funds over our time period using these benchmarks. Our findings are similar to those of many studies of U.S. mutual funds (e.g., Carhart, 1997; Wermers, 2000). Specifically, the median one-factor and four-factor alphas are −0.90% per year and −0.32% per year, respectively. This finding indicates that our benchmarks successfully control for common variation in European equity mutual fund returns.

We next move to our main contribution, which is to determine whether a European investor can actively select Pan-European, regional, country, and sector funds with persistent performance, relative to our European risk factors, and, if so, to identify how macroeconomic information