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The persistence of European mutual fund performance☆

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ABSTRACT

This paper examines the performance and persistence in performance of style-consistent European equity mutual funds between 1988 and 2010. Using a large survivorship bias-free sample for six European countries, we document strong evidence of persistence in benchmark-adjusted returns over 1-year time periods as well as over longer periods. We find statistically and economically significant performance persistence for time horizons of up to 36 months, although persistence is much more pronounced for the top and bottom performers. Thus, past performance of European mutual funds have explanatory power for future performance and investors can obtain useful evidence from past performance data.

1. Introduction

Despite the economic importance of the European mutual fund industry, due to the integration of European financial markets in the last decade, European-registered funds are an under-research topic. There is no study which has examined the performance of equity funds investing in the main European financial markets over a long time period. This is an important area of research, investors

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can easily compare the performance of mutual funds investing in different European countries since the introduction of the common Euro currency.

Our paper investigates the performance of monthly returns for mutual funds having a European equity focus over the January 1988 to December 2010 period. Our research aims to provide evidence on whether countries and investment styles are segmented in European financial markets. Heston and Rouwenhorst (1994) study the impact of industry and country factors on stock returns and show that the country factor has a strong influence. Recently, Sonney (2009) finds that stock analysts who are focused in certain countries have an informational advantage over sector specialists due to their better knowledge about country-specific factors and the geographical proximity with the companies they research.

Research into fund performance persistence has a long history, the literature agrees that performance persistence is a relevant issue but disagrees on whether and to what degree persistence is present. Jensen's (1968) early research on mutual funds states that funds do not have abnormal performance. Some later papers contradict this conclusion and show that relative performance persists over short and long periods. Bollen and Busse (2005), Avramov and Russ (2006), and Kosowski et al. (2006) show predictability in fund performance even after accounting for momentum. In costrast, Carhart (1997) using a survivorship-free sample of U.S. equity funds shows that persistence disappears after accounting for momentum in stock returns. Henriksson (1984), Barras et al. (2010), Fama and French (2010), and Busse et al. (2010) show little to no evidence of persistence over long time horizons.

Our main contribution is to determine whether an investor can actively select European mutual funds with a persistent performance objective, relative to European risk factors. Most studies that have considered this question have focused on U.S. equity mutual funds. It is important to find out if this conclusion applies to other markets, in order to corroborate the U.S. results and to see how the macroeconomic characteristics affect the performance of equity mutual funds in Europe.

Our results have economic and practical implications for investment management. From an economic perspective, if previous return performance can be used to forecast future returns, this is an important challenge to market efficiency. From a practical perspective, if there is no persistence in performance, then investors can engage in completely passive asset management. Although taking into account agency problems, entirely passive asset management is an unlikely result. Thus, some degree of active management should exist.

A successful trading strategy would be of interest to many investors in European equity funds. Considering funds whose investment objectives focus on a specific country and investment style, we could allow for a potential investment strategy to generate abnormal returns by timing countries and investment styles, or by identifying funds with superior stock selection in each of our categories. Our results can determine whether country-specific or specialist style funds outperform generalist funds that invest more broadly across countries and investment styles in Europe. Further, our models determine whether macroeconomic factors are most useful in identifying superior European mutual funds.

The paper is organised as follows. Section 2 describes the data, and the variables used in the study. Section 3 reviews the basic models and the methodology. Section 4 presents the main empirical results. Section 5 provides additional empirical results. Finally, Section 6 offers concluding remarks. Tables, figures and details on data sources are provided in Appendix A.

2. Data and summary statistics

2.1. Data

Our main dataset consist of monthly returns of 1050 actively managed equity mutual funds. We focus on the six largest European mutual fund markets, as they account for almost 90% of total mutual fund assets in Europe. The funds are registered in United Kingdom, France, Italy, Spain, Germany and Netherlands.[1] All returns are in local currency, include any dividend paid, and only the primary share

[1] See European Fund and Asset Management Association (EFAMA) 2011 annual statistics. We exclude Luxemburg as it is considered an offshore centre, as a result of fiscal advantages.