



Multi-asset class mutual funds: Can they time the market? Evidence from the US, UK and Canada



Andrew Clare^{a,*}, Meadhbh Brid Sherman^b, Steve Thomas^a

^a Cass Business School, 106, Bunhill Row, London EC1Y 8TZ, United Kingdom

^b Economics Department, University College Cork, Cork, Ireland

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ABSTRACT

The importance of asset allocation decisions in wealth management is well established. However, given its importance it is perhaps surprising that so little attention has been paid to the question of whether professional fund managers are skilful at timing market movement across asset classes over time. The timing literature has tended to concentrate on the timing skill of single asset class funds. Using data on US, UK and Canadian multi-asset class funds, we apply two alternative methodologies to identify the asset class timing abilities of managers. Overall, whether we apply a returns-based method or a holdings-based testing approach, we find evidence of only a tiny minority of funds with asset class timing ability.

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1. Introduction

In this paper we examine the asset class timing ability of a large sample of multi-asset class funds in the US, UK and Canada over the period 2000–2012. The interest in such funds continues to grow as investors embrace diversification following two particularly bad experiences with equity-concentrated portfolios since 2000 including the technology stock crash around 2001 and latterly the financial crisis from 2008. Furthermore, as more investors must now take responsibility for their own pension savings in the form of defined contribution savings vehicles, multi-asset class funds are seen as an important ingredient in any practical solution. Individual investors could themselves combine a range of single asset class mutual funds that together comprise a multi-asset class holding. However, it is reasonable to assume that in choosing a multi-asset class mutual fund investors want not just the low cost efficient diversification benefits but also the asset allocation skills of the fund manager. That is, the multi-asset class fund investor is also paying for the manager's ability to time asset class return movements. An important question therefore, largely unanswered, is whether the managers of such funds possess skill in timing the relative movements of asset classes.

Of course the skills of the multi-asset class fund manager will comprise both the selection of strategic long term asset class weights as well as tactical asset class timing and security selection abilities. In the case of most funds it is impossible to know these strategic weights without detailed interrogation of the trustees and their advisers (though see [Andonov et al., 2011](#)). The tactical asset allocation contribution is defined as the difference between the strategic weights and realized allocation

* Corresponding author.

E-mail address: a.clare@city.ac.uk (A. Clare).

weights with the asset class timing component being the over or under-weighting of asset classes relative to the long run strategic target weights. Ibbotson and Kaplan (2000) and Andonov et al. (2012) is unusual in having access to strategic policy weights for a sample of pension funds. They find a roughly equal contribution to returns of 25 bp pa from each of policy weights, asset class timing and security selection. Also Blake et al. (1999) and find that while UK pension funds did not show superior timing ability across asset classes, specialist managers do possess superior security selection skills. However, multi-asset class mutual funds provide a new context to explore market timing skills since their managers are focused on tactical adjustments to maximize their performance, top their league tables, and attract new capital conditional on asset allocations complying with their generic grouping, such as “Conservative”, “Aggressive”, etc. We present results for a large sample of funds with a variety of asset allocation categories and provide fresh insight into tactical asset class timing skills.

A much-investigated question in finance literature is the return performance attribution of strategic and tactical allocation and security selection. A number of researchers have emphasized the contribution of strategic asset allocation decision: Brinson et al. (1986) and Brinson et al. (1991) both suggest that asset allocation policy explains more than 90 percent of overall performance while more recent research suggests that strategic asset allocation accounts for only up to 50% of fund performance, the rest being attributable to tactical adjustments and security selection, Ibbotson (2010), Xiong et al. (2010).

In a further detailed examination of performance attribution, Daniel et al. (1997) examine ‘Characteristic Timing’ (timing ability of different investment styles which determines whether funds can time portfolio weightings on characteristics such as size, book-to-market ratio and momentum) and ‘Characteristic Selectivity’ (whether funds can select stocks which outperform the average stock having the same characteristics). The authors find that while performance is significant, it is no greater than the difference between passive and active fund expenses. This is a vast literature. Our paper focuses on the tactical asset allocation skills of multi-asset class funds, specifically on monthly asset class timing and contributes to the mutual fund timing literature in particular.

To determine the extent of asset class timing skills amongst managers of multi-asset class funds we employ two methodologies. The first is based upon an extension of the conditional beta approach of Ferson and Schadt (1996) which simply requires fund returns as an input. We can think of this as the multivariate extension of the early single-asset market timing measures of Henriksson and Merton (1981) and Treynor and Mazuy (1966), which are based on non-linear regressions of realized fund returns against contemporaneous market returns, and which are generally referred to as ‘returns-based’ measures. A key difference in our paper is that since our focus is on multi-asset class funds, we are seeking evidence of timing ability in more than one asset class: hence we specify the fund beta as being conditional upon anticipated next period returns in multiple asset classes – equity, bond and cash. We test whether the managers of multi-asset funds can successfully ‘time’ their exposures to these markets over time.

A number of econometric issues arise around the returns-based timing literature. Jiang et al. (2007) find that returns-based measures suffer from an artificial timing bias and a lack of statistical power. Artificial timing biases may occur because of a passive timing effect, examples include the non-linear relation between the fund and market returns arising from options holdings in a fund. Returns-based measures also suffer from low statistical power due to the low frequency of data generally available on fund returns. The authors argue instead in favor of a more robust ‘holdings-based’ method to evaluate timing ability. Since holdings-based measures are based on individual assets, data is available at a much higher frequency. Jiang et al. argue that beta can be more accurately estimated from higher frequency data and find evidence of greater market timing ability compared to traditional returns-based techniques. Goetzmann et al. (2000) highlight further methodological issues showing that returns-based measures are biased downwards due to a dynamic trading effect when funds trade between the observation dates of fund returns. This would occur if a fund engages in daily or weekly market timing but returns are measured using monthly data.

The holdings-based method of Jiang et al. (2007) uses observed mutual fund asset holdings data. This involves calculating a fund’s beta as a weighted average of the betas of individual stocks held in a fund and testing whether the covariance between the fund betas at the beginning of a holding period and the holding period market returns is significant. This method relies on *ex ante* information on portfolio holdings rather than *ex post* realized returns and hence there can be no bias due to subsequent trading activity during a holding period or the dynamic trading effect. In market timing tests, Jiang et al. (2007) find that holdings-based timing measures are generally small and insignificant while the returns-based timing measures are significantly negative. Using simulations they find that these holdings-based measures have superior statistical power even when fund holdings are observed less frequently than fund returns. Mutual fund holdings are also used in a range of studies evaluating fund performance including, for example, Grinblatt and Titman (1989, 1993), Wermers (1999, 2000, 2004), and Ferson and Khang, 2002: these show that measures based on holdings data are more powerful in detecting mutual fund stock selection ability. Finally, we note that several studies look at the portfolio allocation between cash and equity components to measure market timing and find little evidence of such timing skill (see for example Becker et al., 1999).

The above discussion highlights research findings that focus solely on equity funds and individual stock information. In this paper we focus on market timing skill in a multi-asset context and hence we develop a simple alternative approach based on relating changes in asset class weights within funds to future (next period) returns, in effect asking whether multi-asset class fund managers can successfully rebalance their portfolios ahead of anticipated returns.

To anticipate our findings, our results indicate overall that timing skill is rare and is found among a small minority of funds. This conclusion is supported by both the returns-based approach and the holdings-based tests. The rest of this paper is organized as follows: in Section 2 we describe our asset class timing methodology, Section 3 describes our large data set while in Section 4 we discuss our results.

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