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The performance of diversified emerging market equity funds



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ABSTRACT

We investigate the performance of globally diversified emerging market equity funds during the first decade of the twenty-first century. A vast majority of these funds do not outperform the market benchmark even before transaction costs. The systematic risk of most of the funds is similar to that of the market benchmark portfolio, which may suggest that they aim to offer diversification benefits rather than seeking superior risk-adjusted returns through active management. We do not find any evidence of market timing ability amongst these funds. Finally, whilst we detect persistence in performance, this result is driven mainly by the poorly performing funds.

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1. Introduction

Investing in emerging markets has been a major trend amongst investors well over last two decades. Emerging markets reportedly offer investors in developed nations the potential of higher returns as well as risk reduction benefits through portfolio diversification (see for example, [Ratner and Leal, 2005](#)).¹ For investors in developed markets, mutual funds have been one of the most important vehicles for investing in emerging markets. Most of these funds are open-end equity funds ([Kaminsky et al., 2001](#)). In this paper, we investigate the performance of globally diversified emerging market equity funds between 2000 and 2010. Specifically, we aim to address two important questions related to diversified emerging market equity funds. First, do these funds produce superior risk-adjusted returns? Second, is there any persistence in the performance of these funds?

Traditionally mutual funds have provided a low cost route to portfolio diversification. However, with the spectacular growth of exchange-traded-funds (ETFs) in recent years, investors now have an alternative vehicle to construct a low cost, well-diversified portfolio. One important rationale for choosing to invest in traditional mutual funds over ETFs can be the expectation of 'abnormal' returns resulting from the perceived informational advantages or superior skills of fund managers. Hence it is important to evaluate whether these funds deliver any (ex-post) positive abnormal performance. Second, from the investor's perspective, it is important to examine whether there is any evidence of persistence in the performance of these funds. If there is predictability in performance of funds, investors may (ex-ante) reallocate their savings towards 'winner' funds and enhance abnormal returns ([Cuthbertson et al., 2008](#)).

There has been a plethora of empirical research on performance of mutual funds in United States (US), United Kingdom (UK) and other developed markets. Overall, the evidence does not appear supportive of the claim of any superior performance.

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¹ The diversification benefits, arguably, have been less visible in recent years due to financial liberalization and integration of international markets. For example, [Charitou et al. \(2006\)](#) find no significant international diversification benefits in the post 1993 period.

There is limited evidence on persistence with most studies finding the phenomenon to be more concentrated amongst the underperforming funds. These findings are generally consistent with the ‘efficient market’ paradigm according to which asset prices quickly assimilate all available information thereby making it impossible for any investor or group of investors to systematically outperform the market on a risk-adjusted basis.

Yet whether the evidence gathered on fund performance from developed markets applies to emerging market funds remains an open question. It is a commonly held notion that many of the emerging markets have weaker regulatory environment relative to developed markets and lack ‘informational efficiency’ due to poor information disclosure requirements in emerging markets. If true, this may imply more opportunities for emerging market funds to exploit these inefficiencies and deliver abnormal returns. On the other hand, even if inefficiencies exist in these markets, the cost of collecting firm-specific information could be sufficiently high to negate any attempt by funds to deliver superior returns (Chan and Hameed, 2006).²

Despite the growth in diversified emerging markets funds, empirical studies on their performance have been rather scarce. Past research conducted on performance of emerging market funds has focused on country specific (like Russia, Poland, India, Malaysia, etc.) or region specific (like Africa or Latin America) funds. Ours is amongst only a handful of studies to analyze the performance of emerging market funds that are diversified across multiple markets. The sample period of most of the past studies do not extend beyond 2006 and hence they are almost a decade old. The exception is Eling and Faust (2010) whose sample period extends to August 2008 but their study has an important shortcoming due to its choice of inappropriate benchmark (S&P 500) in evaluating performance of emerging market funds. Our study analyzes more recent data (2000–2010) to investigate the performance of these funds at an aggregate as well as individual level. To our knowledge, ours is the first study to analyze the performance of emerging market equity funds since the onset of global financial crisis (GFC). We find evidence that is different from some of the earlier findings on performance of emerging market funds on several counts. Our study reveals greater underperformance amongst emerging market funds compared to Eling and Faust (2010). In contrast to Huij and Post (2011), we show that the persistence in performance is mainly attributable to the underperforming funds as in developed markets. Also, we find the abnormal returns spread between the best and the worst performing funds to be much smaller than what they estimate.

The remainder of the paper is organized as follows. Section 2 briefly reviews the literature on mutual fund performance in developed and emerging markets. Section 3 describes our data and methodology used in this study. Section 4 presents the empirical results and Section 5 concludes.

2. Literature review

2.1. Mutual fund performance in developed markets

There is a long history of research in mutual fund performance in the US starting with Jensen (1968) who samples 115 open-end mutual funds over a 20-year period (1945–1964). Using the single factor capital asset pricing model (CAPM), he reports an average excess performance (alpha) of 0.4% and –1.1% gross and net of expenses respectively, which implies that on average, the funds earned approximately 1.1% less per year than the benchmark index (S&P 500) on a risk adjusted basis. The results also find very little evidence of an individual fund’s ability to outperform the market, except by mere chance. Of the 115 funds, only 3 funds show significantly positive alphas.

Ippolito (1989) conducts a similar study of 143 mutual funds over a different 20-year sample period (1965–1984). Unlike Jensen (1968), he finds an average alpha of 0.81% for the sample. However, only 12 out of the 143 funds show significantly positive alphas. The author concludes that net of fees and expenses (excluding load fees), funds are able to outperform the benchmark by a margin that is large enough to cover their load charges. However, Elton et al. (1993) take issue with Ippolito’s benchmark and contest the author’s results. After considering the mutual funds’ holding of non-S&P stocks, they find the average alpha to be –1.49% with not a single fund producing significantly positive alpha.

Grinblatt and Titman (1989) compare gross and net returns of US mutual funds using a single factor model over the 1975–1985 period across four sets of benchmarks. For gross returns, the funds outperform two indexes by 1.8% and 2.28% per annum and underperform the other two indexes by 2.31% and 2.64%. However, outperformance diminishes when net returns are used with no statistically significant alphas against any of the indexes.

Malkiel (1995) employs the CAPM model to evaluate performance of 239 mutual funds in US between 1971 and 1991 and finds that these funds significantly underperform the index both before and after expenses. The reported average alphas for gross and net returns are –2.03% and –3.20% per annum respectively. As a result, he concludes that investors are better off by investing in the market index rather than by investing with active managers. Unlike Grinblatt and Titman (1989) who claim that the impact of survivorship bias is modest, Malkiel finds that the potential upward bias in the estimated alpha due to non-inclusion of non-surviving funds in the sample is quite severe.

Gruber (1996) employs both CAPM and a multifactor model with the inclusion of ‘small minus big’ (SMB) and ‘high minus low’ (HML) factors and also a bond index. The funds in his study underperform by 1.56% and 0.65% p.a. against the single and

² Empirical evidence on the issue of efficiency in emerging markets is divided. Many studies suggest inefficiency or a lower level of efficiency in emerging markets compared to developed markets (see for example, Fillis, 2006; Mobarek et al., 2008; Rizzo, 2009) whilst others contradict this claim (see, for example, Karamera et al., 1999; Griffin et al., 2010). However, there is agreement on the heterogeneous levels in efficiency across these markets.

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