What is the Abnormal Return Performance of Mutual Funds due to Private Earnings Information?

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Abstract

This study, employs a unique database of monthly portfolio holdings of Australian mutual funds to measure the monthly abnormal returns realised by mutual funds due to earnings information across all months in a typical year. We find evidence consistent with mutual funds realising abnormal returns due to earnings news in both the pre-announcement period and over the announcement window. The results suggest that earnings information explains approximately 25% of a mutual funds average monthly abnormal performance. Finally, we find that the contribution of earnings to the performance of mutual funds is greatest in the month in which earnings are announced.

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1. Introduction

This study examines whether the typical mutual fund realises abnormal returns from the possession of private current period earning information. The performance of the mutual fund is examined with respect to both abnormal returns in the pre-announcement period attributable to earnings news and earnings announcement date abnormal returns.

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The hypotheses examined in this paper arise out of the frequent assertion in both the academic literature and financial press that mutual funds focus on near-term earnings performance in their trading (e.g., Rajgopal and Venkatachalam, 1998; Lang and McNichols, 1997; Bushee, 1998, 1999). Mutual funds themselves, claim they are investors who are better informed than the market such that they can "beat the market" in recognising changes in a firm's value and therefore consistently realise abnormal returns from trading. Together these claims imply that mutual funds should profit from abnormal returns due to earnings news.

The primary contribution of this study is to use a unique database of monthly portfolio stock holdings of Australian mutual funds to measure the average monthly abnormal return performance of a typical mutual fund due to earnings information. We use the traditional mutual fund performance methodology as our starting point and measure the average monthly abnormal return performance of a typical mutual fund. We then develop a methodology that enables us to extend the traditional mutual fund performance methodology and to attribute the abnormal return performance of a typical mutual fund into two components. We attribute the performance into that due to "earnings information" and that due to what we term "other information". By measuring the abnormal returns that mutual funds realise due to earnings information we can provide insights into the magnitude of profits that they realise from earnings information and the relative contribution of earnings information to their overall performance.

By measuring the earnings abnormal return performance of mutual funds we contribute to two streams of literature. Firstly, we contribute to the accounting literature that seeks to understand how public disclosure of corporate financial information affects private information acquisition activity in the pre-earnings announcement period (hereafter the "pre-earnings announcement information asymmetry literature"). This literature has been greatly influenced by the theoretical models of Kim and Verrecchia (1991) and others, and has hypothesised cross-investor pre-earnings announcement information asymmetry. This is an issue of importance to accounting policy regulators who often justify required public disclosure of accounting information as a way to "level the playing field" by providing equal access to information across investors (see e.g., Lev, 1988).

While both accounting policy regulators and accounting academics are interested whether investors are differentially informed there is very little direct conclusive empirical evidence in regard to this issue. Aside from a concurrent study by Ali et al. (2004), the bulk of the existing literature has employed an indirect approach to an examination of the existence of pre-earnings announcement information asymmetry. Typically prior research tests for a differential price or volume reaction between firms with different aggregated levels of institutional ownership at *the time of the earnings announcement* (e.g., Potter, 1992; Kim et al., 1997; Walther, 1997; El-Gazzar, 1998). However this measure of information asymmetry between institutional investors and the market is indirect, as it does not examine whether the institutional investors have realised abnormal returns. As a consequence there are large number of alternative explanations for a differential price or volume reaction other than information asymmetry.

We advance the accounting literature in three main ways. Firstly, we examine more directly than the prior literature whether mutual funds possess private current period earnings information. We approach this by determining whether their trades realise abnormal