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Active fund management: Global asset allocation funds

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Abstract

We examine the value of active fund management of global asset allocation funds. We use unique daily data and a modified Sharpe's [Sharpe, W., 1992. Asset allocation: management style and performance measurement. Journal of Portfolio Management 18, 7–19] Return-Based Style Analysis method to create a three-index model. We introduce an alternative method derived from Sharpe to calculate attribution returns that measure active fund management performance. Our results suggest that a sample of global asset allocation funds add value for investors. To determine the estimation ability of our model and the implications for estimated asset allocation decisions, we report historical and cross-sectional root mean square errors, which give positive indications of reliability.
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1. Introduction

Global asset allocation funds, which are part of the family of hybrid mutual funds, differ from traditional global or international mutual funds in that they face fewer investment restrictions. Previously, investment restrictions, along with the information costs associated with investment

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outside the United States, discouraged investments abroad, but fewer investment restrictions allow a fund manager to trade more frequently and move funds more freely among asset classes. Recently, the popular press has touted hybrid mutual funds as a less risky alternative to hedge funds.

Global asset allocation funds are specifically chartered to invest overseas and adopt an asset allocation strategy that takes advantage of changing global market conditions and asset classes. For example, the Fidelity Global Balanced Fund states in its prospectus that the fund invests in equity and debt securities, including lower-quality debt securities, issued anywhere in the world. The MFS Global Total Return Fund states that it primarily invests in a balanced combination of global and fixed-income securities. These investment strategies involve a high degree of diversification across global geographical markets.

Investors find it advantageous to invest abroad when the global asset allocation fund is referenced in U.S. dollars (throughout the paper, all references to dollars mean U.S. dollars), the non-U.S. investment is denominated in a foreign currency, and that foreign currency advances against the dollar. Active asset allocation managers can also benefit from favorable fundamentals in foreign stock and bond markets, such as low inflation, falling interest rates, and economic growth. However, there are risks in holding global asset allocation funds. If the foreign currency declines against the dollar, then the foreign portfolio's value will be lowered after translation to dollars. Adverse fundamentals in foreign stock and bond markets may appear. Inflation and/or interest rates may rise. Or the economy may contract.

Additionally, these funds invest in both stocks and bonds worldwide, including U.S. securities. When short-term interest rates creep upward, when stock prices are relatively high, or when dividend yields are low compared to bond yields, fund managers can reposition toward bonds, which can include both corporate and sovereign debt in U.S. and non-U.S. markets. Money that the fund does not deploy in stocks and bonds remains in the form of cash or cash equivalents.

Global asset allocation funds have not attracted the attention of academic researchers, primarily because fund managers rarely report their allocation with a frequency higher than quarterly, but rebalancing actually occurs more frequently. Traditional performance measures may fail to correctly calculate the value that fund managers provide to their investors, because conventional measures assume that allocation is fixed. Our study, which to our knowledge is the first to examine global asset allocation funds, is motivated by the information gap on these funds. Amid international and global fund studies, this one is the first to use daily data and to recognize the impact of fixed-income exposure.

The paper is organized as follows. Section 2 discusses other related work. In Section 3, we describe the data and method we use to examine our research question. In Section 4, we present our empirical test results and report both the historical and cross-sectional root mean squares to give some insight into the performance of the Return-Based style model. Section 5 summarizes and concludes.

2. Literature review

Most previous research focuses on international funds and many studies report that the performance of international mutual funds is no better than that of world indices. Using the security market line measure of Jensen (1968, 1969) and the positive period weighting measure of Grinblatt and Titman (1989), Cumby and Glen (1990) find no superior performance against a selected international equity index benchmark. In their test, covering the period January 1982 through June

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