



On the performance of emerging market equity mutual funds

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ABSTRACT

We document persistence in the performance of emerging market equity funds and find several notable differences compared to US equity funds. First, the contribution of winner funds to the return spread between winner and losers is substantially larger for emerging market funds. Second, only a small portion of the return spread between winners and losers can be attributed to momentum effects in emerging markets. Third, winner funds in emerging markets generate returns that are sufficiently large enough to cover their expenses. Overall, our findings suggest that emerging market funds generally display better performance than US funds.

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1. Introduction

A notable development in the asset management industry in the past two decades is the enormous growth of emerging market equity mutual funds (henceforth, EM funds). Despite the growing popularity of these funds, research on their performance has generally been lacking, presumably due to limited data availability, and important questions remain unanswered. For example, is there persistence in the performance of EM funds? Is the persistence for EM funds stronger than for United States equity mutual funds (henceforth, US funds)? To which extent can the persistence be attributed to fund expenses, load fees and exposures to systematic factors such as market risk, size, value and momentum?

A fair amount of academic research has been conducted on persistence in the performance of US funds. Most authors report persistence in the performance of US funds and find that the largest portion of the persistence can be attributed to fund expenses and exposures to size and, most importantly, momentum

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¹ We welcome comments, including references to related papers that we have inadvertently overlooked. The usual disclaimer applies.

factors. A smaller portion of the persistence is attributed to fund manager informational advantages [see, e.g., [Hendricks et al. \(1993\)](#), [Elton et al. \(1996\)](#), [Carhart \(1997\)](#) and [Bollen and Busse \(2005\)](#)]. However, the results found in the academic literature on US funds do not directly carry over to EM funds. Emerging markets are generally perceived to be less efficient than developed markets, and therefore one might expect that there are more opportunities for active fund managers to find abnormal returns in emerging than developed markets.

In addition, a recent strand of literature documents that active fund managers who make relatively large bets by holding concentrated portfolios display better performance than managers who hold more diversified portfolios. [Kacperczyk et al. \(2005\)](#) find that managers of funds who concentrate their holdings in specific industries perform better after controlling for risk using various performance measures. In a related study, [Cremers and Petajisto \(2009\)](#) look at funds' share of portfolio holdings that differ from the benchmark index and report that funds with the highest active share significantly outperform their benchmark indexes, both before and after expenses. And recently, [Huij and Derwall \(2011\)](#) show that the observed relation between portfolio concentration and performance is mostly driven by the breadth of the underlying investment strategies. Since emerging markets offer investors a wide range of weakly correlated investment opportunities, emerging market fund managers may have a competitive advantage over developed market fund managers that invest in assets that exhibit higher levels of correlation with aggregate market movements.

The only study, to our knowledge, that investigates predictability in the performance of EM funds is the recent work by [Gottesman and Morey \(2007\)](#). The authors employ a regression framework and investigate the ability of several fund characteristics, including expense ratio, turnover, fund size, manager tenure and past performance, to predict EM fund performance. The authors find that the expense ratio is the only fund characteristic that appears to consistently predict future fund performance. Specifically, EM funds with lower expenses show better performance on average.

This study takes another look at persistence in the performance of EM funds. The main distinguishing feature of our study is that it investigates persistence using a rank portfolio approach as in [Hendricks et al. \(1993\)](#), [Elton et al. \(1996\)](#), [Carhart \(1997\)](#) and [Bollen and Busse \(2005\)](#). The primary attractive feature of this approach is that the outcomes provide an economic assessment of the statistical persistence finding.

Using this framework, we document compelling evidence in favor of persistence in EM fund performance. When we rank EM funds monthly by their return over the past quarter and evaluate their performance in the following month, the return spread between the top and bottom ninth of funds is 7.26% per annum. Differences in market risk exposures, fund expenses and load fees do not explain a material part of persistence in EM fund performance.

While the return spread between winner and loser funds in emerging markets is in the same order of magnitude as the spread that has been documented for US markets, the contribution of winner funds to the return spread is substantially larger for emerging markets. For example, [Carhart \(1997\)](#) reports that persistence in the performance of US funds returns can largely be attributed to the worst-return funds and documents an outperformance of 2.64% per annum for the top decile of funds and an underperformance for the bottom decile of – 5.40% relative to the market. We find that these figures are 4.29% and – 2.80% for EM funds, respectively.

Subsequently, we investigate to which extent exposures to size, value and momentum factors can explain the observed persistence patterns. We construct Small-Minus-Big (SMB), High-Minus-Low (HML) and Winners-Minus-Losers (WML) factors using all stocks in the S&P/International Finance Corporation (IFC) investable emerging markets index to investigate the profitability of size, value and momentum strategies in emerging markets, respectively. The analysis yields several new findings. Emerging market stocks seem to exhibit a strong size and value effect. The return on the emerging-market SMB factor is as large as five percent per annum and the return on the HML factor even exceeds 12% per annum. We also find that momentum strategies are highly profitable in emerging markets. The WML factor yields a highly significant return of roughly 13% per annum in our sample.

Despite these strong stock-level effects, EM fund performance is not materially affected by differences in SMB, HML and WML exposures. We find that roughly one-sixth of the return spread percent between EM winner and loser funds can be attributed to differences in exposures to momentum factors. For comparison, [Carhart \(1997\)](#) attributes more than half of US fund persistence to momentum exposure. In addition, we find that the top ninth of EM funds earn a positive four-factor alpha of 2.28% per annum. While

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