



Most mutual funds rely on luck not skill

>By Keith Cuthbertson, Dirk Nitzsche and Niall O'Sullivan

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It is important to know if voluntary saving in mutual (and pension) funds over the next 20 years will be sufficient to fill some of the "savings gap" noted in the recent Turner report. Only then will those reaching retirement age have sufficient savings to provide an adequate standard of living.

A key issue is the attractiveness of savings products in general and also the choice between actively managed and passive (or index-tracker) funds.

This was the subject of the Myners (2001) and Sandler (2002) reports, where it was noted that a high proportion of retail investors choose actively managed mutual funds (93 per cent in 2001), compared with institutional investors (70 per cent in the UK and less than 60 per cent in the US), even though one might think that retail investors have fewer resources to devote to an active strategy.

The FSA has recently proposed that, in a "simplified prospectus", investors should not only get basic information on total expenses and turnover of a fund but also returns data over the previous 10 years. This is due to come into effect in March 2005. These raw performance figures are of little use since they fail to make adjustments for the risk of the fund and the role of "luck".

Recent research* by Cass Business School throws some light on these issues by separating the elements of "skill" and "luck" in the performance of individual "active" mutual funds, even when the risk across funds is highly non-normal, such as having a higher risk of a bad outcome. For the active fund management industry, our findings are something of a mixed bag. Based on a fund's "alpha", our research indicates that after accounting for luck, there are very few top funds that have genuine skill.

We do find that some top-ranked equity income and equity growth funds show genuine stock-picking skills, whereas such ability is not found among small stock funds and general equity funds. We also find genuine outperformance among some top onshore funds, whereas for offshore funds, positive performance is due to luck. Indeed there is less than 1 chance in 100 that an incompetent drunken tipster could have achieved the results shown by these top funds.

Unfortunately, "genuine" top performers are not necessarily those with a historic ranking right at the top. This makes it extremely difficult for the "average investor" to pinpoint active funds

that demonstrate genuine skill based on track record.

At the negative end of the performance scale, our analysis strongly rejects the view that poorly performing funds are merely unlucky. On a risk adjusted return basis, 300 of the 750 funds in the study (restricted to funds with a performance record of at least 60 months) could be said to show "bad skill". Our results are based on the methodology of Kosowski et al (2003)** who find similar qualitative results for US mutual funds.

The continued existence over long periods of a large number of funds with truly inferior performance (which cannot be attributed to bad luck), together with many funds with positive performance due to good luck (rather than good skill), indicates that many investors either cannot correctly evaluate fund performance or find it "costly" to switch between funds. This confirms points made in the Sandler and Myners reports.

Overall, recent research suggests that the majority of funds have either no skill and do well because of luck, or have "bad skill" and waste investors' time and money. If you choose your active funds by throwing darts at the Financial Times or Wall Street Journal mutual fund pages, you are highly likely to choose a fund that has no skill - and pay through the nose for it. You would be better off choosing an index fund.

On the other hand, a careful analysis of risk-adjusted performance taking full account of luck across all funds can identify, with reasonable probability, those few funds with genuine skill. After all, when the going gets tough, the tough need advice.

*Mutual Fund Performance: Skill or Luck?' at www.cass.city.ac.uk/faculty/d.nitzsche

**Kosowski, R., Timmermann, A., White, H. and Wermers, R. (2003) Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis, Discussion Paper, INSEAD.

Keith Cuthbertson is professor of finance and Dirk Nitzsche associate professor at Cass Business School. Niall O'Sullivan is assistant professor at University College, Cork.

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