

Stale performance chasing in mutual funds

■ Investors have access to a wealth of information when selecting a mutual fund. For example, they can draw on analyst reports, manager commentary or the recommendation of a broker. Fund characteristics, including fund size, age, manager reputation and most importantly, past performance, also play a significant role in the selection process. One of the most persistent and robust patterns documented in the mutual fund literature is return-chasing by investors. The disproportional allocation of wealth to funds with superior performance in prior periods transcends mutual fund asset classes, country boundaries, and investment objectives. Given the limited evidence of persistence in mutual fund performance, this trend is largely described in the popular press as irrational. For example, on the heels of the 1999 bull market, concerns regarding the potentially detrimental impacts of return-chasing led the Securities and Exchange Commission (SEC) Chairman, Arthur Levitt, to caution investors against this practice, stating “Chasing fund performance is often the quickest way to hurt your mutual fund returns”.

The past performance of mutual funds is reported in the form of a holding period return (HPR) over the 1, 3, 5 and 10 year horizons. An improvement in a HPR can come about in one of two ways. The first is strong performance in the most recent period; the second is when weak performance drops from the horizon. For example, a return of -5% dropping from the one year horizon will improve reported performance as long as the most recent return was not worse. If investors have access to the entire time series of fund returns, the change in the HPR can easily be decomposed into new and end-return effects. However, if investors fail

to understand the nuances of how reported performance is calculated, they may be misled by horizon effects on fund returns.

Analyzing investor allocations, we find that investors appear unable to differentiate between the new and stale information components of performance reported by mutual funds. It is well understood that investors “chase” past performance, allocating disproportional wealth to funds with strong recent

performance. Our results suggest that investors react with equal vigor to the stale information component of HPRs. In other words, investors direct disproportionate flows to funds which realize improved HPRs due to end-returns dropping from the horizon of HPR calculations. Mutual funds appear to exploit investor naivety and their sensitivity to horizon effects on reported performance via two channels. First, mutual fund managers preferentially advertise end-return related improvements in reported performance. This behaviour is perhaps not surprising. Improvements in reported performance due to poor performance dropping from the horizon of assessment are likely easier to predict than

improvements due to immediate performance. Hence, funds are better able to systematically plan advertising campaigns around stale performance related improvements in HPRs than recent performance improvements. Second, mutual fund managers also align fee increases with periods of artificially heightened fund demand resulting from end-return related increases in performance, harming existing investors who pay higher fees for the same fund and potentially leaving new investors worse off.

“...OUR ANALYSIS SUGGESTS THAT THE MANNER IN WHICH PAST PERFORMANCE IS CALCULATED AND REPORTED PLAYS A CRITICAL ROLE IN THE FUND SELECTION PROCESS.”

BLAKE PHILLIPS



Overall, our analysis suggests that the manner in which past performance is calculated and reported plays a critical role in the fund selection process. Our research provides new evidence on how and when mutual funds use uninformative information (i.e. stale performance signals) to persuade investors that they are high-performance or quality funds. It has been argued that performance advertising by mutual funds is inherently and materially misleading, violates federal securities antifraud standards, and takes advantage of naive investors. Our results are broadly consistent with mutual fund performance advertising misleading investors who do not appear to appreciate the influence of horizons on reported fund performance.

Finally, our results may offer an economic mechanism to explain the horizon effects found in the asset pricing literature. It is well known in that literature that high stock returns in a month tend to forecast high stock returns 12-, 24-, and 36-months ahead. These effects may be related to investor reactions to reported performance at those horizons. ■



The discussed results were published in the paper "Past performance may be an illusion: Performance, flows, and fees in mutual funds" in the *Critical Finance Review*, 2016 Vol 5-2. Co-authored with Kuntara Pukthuanthong, University of Missouri and Raghuram, University of Cambridge.

BIOGRAPHY

DR. BLAKE PHILLIPS is an Associate Professor at the School of Accounting and Finance at the University of Waterloo. He completed Doctor of Philosophy (Finance), Master of Business Administration and Master of Forestry degrees at the University of Alberta. His research focuses on investor and manager behaviour and the asset pricing implications of this joint behaviour. Dr. Phillips has published research in the *Review of Asset Pricing Studies*, the *Critical Finance Review* and the *Journal of Banking and Finance*.

I received funding from the CSI Research Foundation while completing my Ph.D. at the University of Alberta. The funding allowed me to focus my time on research as opposed to working to cover financial obligations. The gift of time to a Ph.D. student is truly invaluable. The grant kick started my research in the area of mutual funds and played a critical role in allowing me to develop my current research agenda. I am very grateful for the financial support of the CSIRF.

TESTIMONIAL