Chapter 2

Literature Review

2.1 Review of Relevant Literature - Other Countries

Performance persistence was of particular interest to researchers and many studies had been done to answer the question whether the good fund managers can consistently outperform the index or other managers. These include Grinblatt and Titman (1992), Jegadeesh (1990), Hendricks, Patel, Zeckhouser (1993), Goetzmann and Ibbotson (1994), Malkiel (1995), Gruber (1996), Elton, Gruber and Blake (1996), Carhart (1997) etc.

Grinblatt and Titman (1992) analyzed how mutual fund performance relates to past performance using the time-series regression method. Monthly cash-distribution-adjusted returns and investment goals for 279 funds that existed from December 31st, 1974 to December 31st, 1984 were examined. Performance measure used in this study was computed relative to the eight-portfolio benchmark, P8, as used in Grinblatt and Titman (1989a). This studies found evidence that differences in performance between funds persist over time and the persistence is consistent with the ability of fund managers to earn abnormal returns.

Jegadeesh (1990) examined the predictability of monthly returns on individual securities over the period 1929 to 1982 using monthly cross-sectional regression method as in Fama and McBeth (1973). There were strong evidence of predictable behaviour of security returns and seasonality pattern in January. Stock returns were found to have negative serial correlation at one-month lag and positive serial correlation at larger lags. The results documented in this study reject the hypothesis that the stock prices follow random walks. Predictability of stock returns can be attributed either to market inefficiency or to systematic changes in expected stock returns.

Hendricks, Patel, Zeckhouser (1993) studied the extent of short-run predictability of mutual funds relative performance, called the "hot hands" phenomenon. This study revealed the existence of short-run persistence of superior performance, called "hot hands", at one year lag. There were also some funds that sustained underperformers, called "icy hands". Investors who establish the strategy of selecting, every quarter, the top performance based on the last four quarters can significantly outperform the average mutual, although doing only marginally better than some benchmark market indices. The authors confirmed that the hot hands phenomenon were not attributable to known anomalies or survivorship bias.

Goetzmann and Ibbotson (1994) examined the performance of large sample of equity mutual fund portfolios over the period 1976-1985. Total fund return over successive two-year intervals was calculated. Funds were categorised as winners or losers based on whether the raw return was above or below the median return for the period. The repeat winner pattern was present in four out of the five two-year periods, with the overall chance of picking a winner based on prior period winner performance being about 60%. The studies were repeated using Jensen's alpha risk-adjusted returns and the results showed the repeat winner pattern present in all five periods. In addition, regression analysis was used to measure the magnitude of the impact of the prior two-years alpha on the subsequent two-years alpha. The results were significant in four of the periods, and extremely significant for the combined regression results. Similar results for the total sample were achieved when the above tests were conducted using one-year returns and monthly returns.

Malkiel (1995) analysed performance persistence of all equity mutual funds in existence from 1971-1991 using contingency tables and annual raw total returns. Statistically significant positive persistence was identified in 7 years in the 1970's. However, over the period 1980-1990, only 4 years recorded positive persistence whilst 3 years recorded negative persistence. Comparing the two overall periods, winners tended to repeat 65% of the time in the 1970's, but only 52% of the time in the 1980's.

Gruber (1996) and Elton, Gruber and Blake (1996) reconfirmed Hendricks, Patel and Zeckhauser results that hot hands was a short-run phenomenon. Elton, Gruber and Blake (1996) used a sample that consisted of all the common stock funds in 1977 that had $15 million or more in total assets. All the 188 funds were followed from 1977 to the end of 1993 through name changes and mergers. This study measured the funds performance using risk–adjusted returns over the period of one year and three years. The results revealed strong evidence that past performance was predictive of future performance in both the short-run and the longer-run. The study also found that expenses accounted for only part of the differences in performance across funds where persistence was found after the impact of expenses was removed.

Carhart (1997) re-examined the issue of consistency in mutual fund performance, called the "hot hands" phenomenon using a four factors extension of the index model. The four benchmark portfolios are the S&P 500 index and portfolios based on book-to-market ratio, size, and prior-year stock market return to capture the impacts of small firm effect, the book-to-market effect and the intermediate-term price momentum suggested by Jegadeesh and Titman (1993). Carhart's analysis indicated that one-year momentum in stock returns accounted for Hendricks, Patel and Zeckhouser's (1993) hot hands effect in mutual fund performance. Individual funds did not earn higher returns from following the momentum strategy in stocks because transaction costs consume the gains from following a momentum strategy in stocks. Though Carhart found persistence in relative performance of managers, his results did not support the existence of skilled or informed mutual fund portfolio managers because much of the persistence seemed due to expenses and transaction costs rather than gross investment returns.

A recent study by Bradfield on the persistence of South African General Equity fund performance found no evidence of fund performance persistence. Instead, the author found some evidence of winning funds become losing funds and vice versa. The author put forward tentative evidence of creating low-risk strategy though combining winning funds and loosing funds.

A number of studies on persistence in unit trust fund performance in Australia have found no evidence of persistence performance. These studies include Robson (1986), Vos, Brown and Christie (1995) and Hallahan (1997). Hallahan, for example, studied the persistence in performance of Rollover Funds in Australia. Three methodologies were adopted for identifying performance predictability, they are, simple regression, contingency tables and top quartile rankings. Fund performance were measured by the raw returns, Jensen alphas, Sharpe ratios and information ratios. The overall results of the analysis suggested that the past performance of a fund is an unreliable guide to future performance.

Another studies on persistence in the performance of unit trust in Singapore was carried out by Tan (1993). His analysis included 11 unit trust funds in Singapore from 1977 to 1992. Market index benchmarks used as surrogates for market portfolios are Singapore Strait Times Industrial Index, SES All-Share Index and weighted value of KLSE Industrial Index. The results revealed that some unit trust demonstrated short run performance persistence. And, for all unit trusts that demonstrated short run performance persistence, the study found that short run performance persistence are robust and non seasonal.

Grunbichler and Pleschiutschnig (1999) studied the persistence of European Mutual Funds performance. The study used a sample of 333 European equity mutual funds. The findings revealed that persistent performance was present amongst European mutual funds. The researchers demonstrated that persistence was neither caused by Fama and French (1996) related anomalies nor disappears if we correct for the European momentum effect. Using Sharpe (1992) Asset Class Factor model to control for style issues, the researchers confirmed that persistence was not induced by mutual fund style related issues. Persistent performance were found to be a robust phenomenon and not very sensitive to different methodologies for testing persistence or adjusting for risk.

2.2 Review of Relevant Literature – Malaysia

Although there were many studies carried out to study performance of unit trust funds in Malaysia, there were limited studies done to examine the persistence of performance.

Lee (2000) studied performance of unit trust funds in Malaysia. Lee found that past performances of unit trusts in Malaysia are not consistent over time and therefore investors cannot rely on past performance as a guide for future performance. His findings also suggested that investors should choose funds, which are larger in size and exist longer in the market, as older and larger unit trusts are more secure and provide better risk-adjusted returns.

In 1985, Chua studied performance of 12 unit trusts, 9 government-sponsored funds and 3 private funds, over a 10-year period from March 1974 – April 1984. The results revealed that unit trust funds provided better returns when compared to investments in risk-free assets and market portfolios. The government-sponsored funds were found to perform better than the private funds.

Tan (1995) analysed performance of 21 funds consisting of 13 government-sponsored funds and the rest are private funds. The study covered a period of 10 years from January 1984 to December 1993. This study concluded that unit trust funds performed worse than the market portfolio, contradicted earlier studies done by Chua (1985). This study also concluded that government-sponsored funds performed better than the private funds, consistent with Chua's findings.

Ch'ng (1997) examined the performance of unit trusts and property trust for a 6 year period from January 1991 to December 1996, Ch'ng sub-divided the period of studies into two sub-periods. The first sub-period was from 1991 to 1993 and the second was from 1994 to 1996. Unit trusts under studied were found to perform better in sub-period 1991-1993 than in sub period 1994-1996. Generally, unit trusts were found to outperformed the market portfolio in almost all the periods.

In 2000, Ong compared performance of unit trusts before and during the financial crisis in Malaysia. Using monthly net asset value returns, the findings revealed that the Malaysian unit trusts were able to outperform the stock market before and during financial crisis. The performances of Malaysian unit trusts during the financial crisis were found to be "better" than before. The government-sponsored funds performed better than private funds before the financial crisis. However, situation became reverse during the financial crisis. Finally, this study concluded that fund size did not significantly influence performance.

Tan (2001) studied the impact of service charge on the performance of unit trust funds. The study concluded that unit trust funds on average would be able to outperform the KLCI during the bear market, however due to the front load that funds charged, the excess return was completely wiped out and some funds even ended with under-performance. In order to achieve better market performance, the author suggested that investor to choose funds with lower front-end fees with proven past few years of performance instead of just one year of performance.