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On Swiss Timing and Selectivity: In the Quest of Alpha

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Abstract:
This paper presents an overview of the theories underlying the major portfolio performance measurement models, with an empirical application to assess the market timing and stock-picking abilities of an exhaustive sample of 60 Swiss-equity investment funds over the 1977-1999 period. Regardless of the benchmark portfolio or the performance measurement model, we find no evidence that Swiss-equity mutual funds, either individually or as a whole, provide investors with superior stock selection or market timing relative to a passively managed benchmark portfolio. We also found a negative correlation between selectivity and timing results. Finally, the influence of asset size, funds age and management fees are considered as an explanation of the results.

Executive Summary:
Over the past thirty years, mutual funds Œ and particularly stock mutual funds Œ have gained tremendous popularity among investors. By pooling and managing the resources of several individuals, mutual funds made saving and investing simple, accessible, and affordable. While being strictly regulated, they offered access to professional management, diversification, liquidity, affordability and convenience, ease of record keeping and full disclosure.

Encouraged by the market growth, the analysis of mutual fund performance attracted considerable attention from both academics and practitioners, with essentially two distinct lines of research. The quantitative line of research concentrated on whether mutual funds outperform or underperform their benchmark on a risk-adjusted basis and on which performance measures should be used to accurately identify market timing or selectivity skills from fund managers. The qualitative line of research accepted the existence of performance differences among mutual funds and rather focused on their causes and consequences.

Unfortunately, most of the studies confined themselves to US and UK markets and resulted in different conclusions depending on the sample studied, the performance measure used, the reference benchmark and the period of observation.

In this paper, we attempt to link the two above-mentioned lines of research and fill the gap with respect to an almost undiscovered fund market, namely, Switzerland. In a first part of the paper, we review and compare the advantages and limits of a series of performance measures that are typically applicable to mutual funds since they consider portfolios whose composition is unknown, but whose returns are observable on a regular basis. These measures include the venerable Jensen (1968) alpha, the Trenor-Mazuy (1966), Merton-Henriksson (1981), Connor-Korajczyk (1991), and Battacharya-Pfleiderer (1983) selectivity and timing measures, as well as the Grinblatt-Titman (1989, 1994) positive period weighting measure.

In a second part of the paper, we apply this set of performance measures to a sample of 60 Swiss equity mutual funds. Although the number may appear small with respect to some U.S. studies, this sample includes almost the complete universe of Swiss Equity funds that existed between July 1977 and August 1999, including all closed funds. The only condition that we requested (for statistical significance) is that the corresponding funds existed for at least three consecutive years.

Unlike the standard approach to performance measurement, we did not select a common observation period and run a beauty contest. Rather, we considered each fund during its entire existence and attempted to detect its stock picking and market timing abilities. In addition to applying several performance measures, we used several benchmarks to test for under or over-performance. Finally, we also tested if the performance differential with respect to a benchmark can be justified by more qualitative characteristics, e.g. the fund's age, its size (assets under management), its registration country or the structure of its fees.

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