On luck versus skill when performance benchmarks are style-consistent

Andrew Mason[a], Sam Agyei-Ampomah[b], Andrew Clare[c], Stephen Thomas[c]

[a]*Surrey Business School, University of Surrey, Guildford GU2 7XH*
[b]*Cranfield School of Management, Cranfield University, Cranfield MK43 0AL*
[c]*The Sir John Cass Business School, City University, London EC1Y 8TZ*

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Abstract
We firmly believe that style-appropriate, investible benchmarks not only provide a more parsimonious way of describing manager performance, but also that their use better aligns performance evaluation with the real world performance targets of fund managers'. It is against such benchmarks that managers should be judged. With this principle foremost in our approach, we use style-consistent benchmarks to determine whether any observed alpha produced by a sample of U.S. equity funds is due to skill or to luck. We find that different segments of the market, ranging from large-cap growth to small-cap value, exhibit different levels of skill and luck. Our results also show that the use of standard multi-factor models underestimates managerial ability and overstates the proportion of funds whose abnormal performance can be attributed to chance rather than to skill, when compared against the use of style-consistent practitioner benchmarks. We also find that a single factor performance evaluation model that uses Russell style indices consistent with the style orientation of a fund and market practice provides a parsimonious way of accounting for fund performance. Finally, our findings should be of particular relevance in mutual fund markets where the risk factors commonly used in the academic literature to evaluate manager performance – SMB, B/M, MOM and others – are not readily available

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