

Mutual Fund Performance Evaluation with Active Peer Benchmarks[☆]

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Abstract

We propose a simple approach to account for commonalities in mutual fund strategies that relies solely on information on fund returns and investment objectives. Our approach augments commonly used factor models with an additional benchmark that represents an equal investment in all same-category funds, which we call an “Active Peer Benchmark,” or APB. We find that APBs substantially reduce the average time-series correlation of residuals between individual funds within a group when added to a four-factor equity model (or to a seven-factor fixed-income model). Importantly, adding this APB significantly improves the selection of funds with future outperformance.

Keywords: G11, G23, mutual funds, performance measurement

1. Introduction

The open-end mutual fund industry is now the main venue through which retail investors participate in traded securities.¹ It is widely known that a growing number of their fund managers follow passive strategies, linking their investments to a particular index. The majority, however, still claim that they can add value

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¹As of 2010, households hold 37.8% of total assets in financial assets. Of financial assets, 15% are held in pooled investment funds, not including holdings in retirement accounts or money market funds, while 18% are directly held in stocks and bonds. An additional 38.4% is held in retirement accounts, much of which is allocated to mutual funds (Board of Governors of the Federal Reserve System, 2010).