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Measuring Fund Strategy and Performance in Changing Economic Conditions

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ABSTRACT

The use of predetermined variables to represent public information and time-variation has produced new insights about asset pricing models, but the literature on mutual fund performance has not exploited these insights. This paper advocates conditional performance evaluation in which the relevant expectations are conditioned on public information variables. We modify several classical performance measures to this end and find that the predetermined variables are both statistically and economically significant. Conditioning on public information controls for biases in traditional market timing models and makes the average performance of the mutual funds in our sample look better.

THE PROBLEM OF ACCURATELY measuring the performance of managed portfolios remains largely unsolved after more than 30 years of work by academics and practitioners. Standard measures of performance, designed to detect security selection or market timing ability, are known to suffer from a number of biases. Traditional measures use unconditional expected returns as the baseline. For example, an "alpha" may be calculated as the past average return of a fund in excess of a risk-free rate, minus a fixed beta times the average excess return of a benchmark portfolio. However, if expected returns and risks vary over time, such an unconditional approach is likely to be unreliable. Common time variation in risks and risk premiums will be confused with average performance.

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