
HENRIKSSON-MERTON MEASURE

Description of the Measure

The Merton-Henriksson Measure is an absolute measure of performance. It is given by the annualized return of the fund, deducted the yield of an investment without risk, minus the sum of returns on the market portfolio and on a portfolio containing index derivatives.

Interpretation:

The Merton-Henriksson Measure gives the excess return obtained by the manager that cannot be replicated by a mix of options and market portfolio. That represents the excess return that have been economized by the manager because of its market timing ability.

Use:

The magnitude of the Ferson-Schadt Measure depends on three variables: the return of the fund, the market return and the manager's market timing ability.

Potential Misuse:

Accuracy and reliability of this measure is based on the quality of the market proxy.

Formula:

$$HM_{p,t} = [E_t(R_{p,t}) - R_f] - \{ \hat{\beta}_{1,p} [E_t(R_{m,t}) - R_f] \} - \hat{\beta}_{2,p} \text{Max}[0, R_f - E_t(R_{m,t})]$$

where:

$E_t(R_{p,t})$ is the annualized mean return on the fund considered over period;

$E_t(R_{m,t})$ is the annualized mean return on the market portfolio considered over period;

R_f is a proxy for the riskless rate;

$\hat{\beta}_{1,p}$ is a function of the slope of the portfolio return function;

$\hat{\beta}_{2,p}$ is the cost of option saved by the manager.

Two year data of weekly series is considered.

References:

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