I. INTRODUCTION

Within the last few years considerable progress has been made in three closely related areas—the theory of portfolio selection,1 the theory of the pricing of capital assets under conditions of risk,2 and the general behavior of stock-market prices.3 Results obtained in all three areas are relevant for evaluating mutual fund performance. Unfortunately, few of the studies of mutual funds have taken advantage of the substantial backlog of theoretical and empirical material made available by recent studies in these related areas. However, one paper pointing the direction for future studies of mutual fund performance has appeared. Drawing on results obtained in the field of portfolio analysis, Jack L. Treynor has suggested a new predictor of mutual fund performance4—one that differs from virtually all those used previously by incorporating the volatility of a fund’s return in a simple yet meaningful manner.

This paper attempts to extend Treynor’s work by subjecting his proposed measure to empirical test in order to evaluate its predictive ability. But we will also attempt to do something more—to make explicit the relationships between recent developments in capital theory and alternative models of mutual fund performance and to subject these alternative models to empirical test.

II. IMPLICATIONS OF RECENT DEVELOPMENTS IN CAPITAL THEORY

A. PORTFOLIO ANALYSIS THEORY5

The theory of portfolio analysis is essentially normative; it describes efficient techniques for selecting portfolios on the basis of predictions about the performance of individual securities. The key element in the portfolio analyst’s view of the world is his emphasis on both expected return and risk. The selection of a preferred combination of risk and expected return must, in the final analysis, depend on the preferences of the investor and cannot be made solely by the tech-

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2 Associate professor of economics and operations research, University of Washington, and consultant, the RAND Corporation. Any views expressed in this paper are those of the author. They should not be interpreted as reflecting the views of the RAND Corporation or the official opinion or policy of any of its governmental or private research sponsors.

