Short-Term Persistence in Mutual Fund Performance

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We estimate parameters of standard stock selection and market timing models using daily mutual fund returns and quarterly measurement periods. We then rank funds quarterly by abnormal return and measure the performance of each decile the following quarter. The average abnormal return of the top decile in the post-ranking quarter is 39 basis points. The post-ranking abnormal return disappears when funds are evaluated over longer periods. These results suggest that superior performance is a short-lived phenomenon that is observable only when funds are evaluated several times a year.

The net new cash flow invested in U.S. mutual funds in 2000 was $229.2 billion, which exceeded the 2000 gross domestic product of all but 19 countries.[1] Not surprisingly, a large industry exists to provide investors with information to help them choose from among the thousands of available mutual funds. The existence of the mutual fund selection industry is predicated on the assumptions that some mutual fund managers possess significant ability and that this ability persists, allowing the astute investor to predict future performance based on past results.

From an academic perspective, assessing the existence and persistence of mutual fund managerial ability is an important test of the efficient market hypothesis; evidence of persistent ability would support a rejection of its semi-strong form. What should we expect in equilibrium? Grossman and Stiglitz (1980) argue that we should not expect that security prices fully reflect the information of informed individuals; otherwise, there would be no reward for the costly endeavor of seeking new information. In the context of mutual fund performance, we should expect some fund

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[1] Net new cash flow is defined as the dollar value of new sales minus redemptions, combined with net exchanges, and is obtained from the Investment Company Institute's 2001 *Mutual Fund Fact Book*, http://www.ici.org. Gross domestic product data is from the World Bank, http://www.worldbank.org.

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