

On Persistence in Mutual Fund Performance

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ABSTRACT

Using a sample free of survivor bias, I demonstrate that common factors in stock returns and investment expenses almost completely explain persistence in equity mutual funds' mean and risk-adjusted returns. Hendricks, Patel and Zeckhauser's (1993) "hot hands" result is mostly driven by the one-year momentum effect of Jegadeesh and Titman (1993), but individual funds do not earn higher returns from following the momentum strategy in stocks. The only significant persistence not explained is concentrated in strong underperformance by the worst-return mutual funds. The results do not support the existence of skilled or informed mutual fund portfolio managers.

PERSISTENCE IN MUTUAL FUND performance does not reflect superior stock-picking skill. Rather, common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns. Only the strong, persistent underperformance by the worst-return mutual funds remains anomalous.

Mutual fund persistence is well documented in the finance literature, but not well explained. Hendricks, Patel, and Zeckhauser (1993), Goetzmann and Ibbotson (1994), Brown and Goetzmann (1995), and Wermers (1996) find evidence of persistence in mutual fund performance over short-term horizons of one to three years, and attribute the persistence to "hot hands" or common investment strategies. Grinblatt and Titman (1992), Elton, Gruber, Das, and Hlavka (1993), and Elton, Gruber, Das, and Blake (1996) document mutual fund return predictability over longer horizons of five to ten years, and attribute this to manager differential information or stock-picking talent. Contrary evidence comes from Jensen (1969), who does not find that good subsequent performance follows good past performance. Carhart (1992) shows that persistence in expense ratios drives much of the long-term persistence in mutual fund performance.

My analysis indicates that Jegadeesh and Titman's (1993) one-year momentum in stock returns accounts for Hendricks, Patel, and Zeckhauser's (1993) hot hands effect in mutual fund performance. However, funds that earn higher

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