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Market Timing and Mutual Fund Performance: An Empirical Investigation

The evaluation of the performance of investment managers is a topic of considerable interest to practitioners and academics alike. Using both the parametric and non-parametric tests for the evaluation of forecasting ability presented by Henriksson and Merton, the market-timing ability of 116 open-end mutual funds is evaluated for the period 1968–80. The empirical results do not support the hypothesis that mutual fund managers are able to follow an investment strategy that successfully times the return on the market portfolio.

I. Introduction

The evaluation of investment performance is of importance for allocating investment funds efficiently and setting appropriate management fees. Because actively managed mutual funds are an important form of investment in the United States, a valid question is whether the active management has achieved a sufficient increase in returns to offset the associated costs of information and transactions, as well as the management fees charged. As a corollary, the ability to earn superior returns based on superior forecasting ability would be a violation of the efficient markets hypothesis[1] and would have far-reaching implications for the theory of finance.[2]

Henriksson and Merton (1981) present statistical techniques for testing forecasting ability with a particular emphasis on the market-timing ability of investment managers. The tests are derived from the basic model of market timing developed by Merton (1981), where the forecaster predicts when stocks will outperform riskless securities and when riskless securities will outperform stocks but does not predict the magnitude of the relative returns.

1. For an excellent discussion of the theory of market efficiency, see Fama (1970).
2. For a description of some of the previous work on the evaluation of investment performance, see Henriksson and Merton (1981).

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