How to Pick Next Year’s Winning Funds

Stockholm (HedgeNordic) – Most investors likely came across the warning or disclaimer saying past performance is no guarantee future returns. The disclaimer remains accurate and relevant, of course, but a recent study has found a set of quantitative indicators that can help investors determine the likely future short-term performance of active fund managers. Investors and allocators looking to avoid next year’s losing funds should search for vehicles with high information ratios, low net capital inflows and low turnover.

The study conducted by Professor Andrew Clare from Cass Business School and co-authored by Mariana Clare of Imperial College focuses on a sample of around 2,200 surviving and defunct US equity mutual funds over the period of 2000 to December 2017. The researchers found that a fund manager with a high information ratio in a given year is very likely to produce solid benchmark-adjusted returns in the following year. As a benchmark-relative return-versus-risk metric, the information ratio is the ratio of average benchmark-adjusted returns to the fund’s tracking error, where the latter represents a measure of off-benchmark bets a manager takes over a year. A high tracking error is seen as a sign of poor risk control if returns are low but is viewed as a sign of manager skill if returns are high.

The study titled “An examination of ex-ante fund performance: Identifying Indicators of Future Performance” also finds evidence to suggest that actively managed mutual funds that receive high net inflows in a given year are likely to produce poor benchmark-adjusted returns in the next year. The researchers argue that inflows and outflows may distract managers from their investment strategies. The study further finds that high levels of fund turnover can be a sign of future poor benchmark-adjusted performance.

“Choosing the right active fund manager is a challenge for all investors given the wide range of choices out there. It is equally important to know when the time is right to switch investment funds from an existing manager to a new manager. Our research suggests avoiding investing with managers that produce a low information ratio, have high turnover or where the fund experiences high net inflows,” says Andrew Clare. “We hope that our research will help investors make these difficult decisions which in turn will hopefully help them achieve better investment outcomes,” he adds.

The complete study can be downloaded here: http://ssrn.com/abstract=3259088