

Predicting Emerging Market Fund Performance

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Author(s): Pamela Black

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Abstract (Document Summary)

According to Aron Gottesman and Mathew R. Morey of the Finance Department at Pace University, who conducted a study examining the ability of fund characteristics such as size, expense ratio, turnover, past performance, Morningstar rating and manager tenure to predict emerging market fund performance, the expense ratio is the only fund characteristic that consistently predicts future fund performance. There is also some limited evidence that passive management outperforms active in emerging market funds.

Full Text (371 words)

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Authors: Associate professors Aron Gottesman and Mathew R. Morey of the Finance Department at Pace University.

What It Is: A study examining the ability of fund characteristics such as size, expense ratio, turnover, past performance, Morningstar rating and manager tenure to predict emerging market fund performance.

Major Findings: The expense ratio is the only fund characteristic that consistently predicts future fund performance. There is also some limited evidence that passive management outperforms active in emerging market funds.

Highlights: Impressive returns (36% annualized from 2003 to 2005 for example) have led to growth in the number of emerging market mutual funds, from nine in 1991 to over 200 in 2006. While research in domestic mutual funds has shown that low expense ratios, recent strong performance, moderate size and high turnover have better future performance than other funds, there has been no such study of emerging market funds.

The authors studied major fund characteristics for three time periods: 1997 to 1999; 2000 to 2002; and 2003 to 2005. The results showed that only the expense ratio significantly predicts future returns. It was negatively related to fund performance in the first and last periods; funds with lower expenses tended to perform better than funds with higher expenses. For the 2000 to 2002 sample, the coefficients for the expense ratio were negative, but insignificant.

Previous 12-month return and net size only predicted future performance in the 2003 to 2005 sample. Variables such as manager tenure and turnover were not able to significantly predict future fund performance in any of the samples.

The authors also looked at the percentage of funds that did not outperform a standard diversified emerging market index to assess the ability of active management to outperform passive fund performance.

At least in terms of Sharpe ratios and mean monthly returns, passively managed funds performed somewhat better.

The Authors Say: "Our results show relatively similar findings to those espoused in the domestic mutual fund arena by such well known

practitioners as Bogle (1994); namely, that lower fees are somewhat related to better performance, and that index funds, with their lower fees, should be considered by investors searching for superior fund performance.

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