Controlling for Fixed-Income Exposure in Portfolio Evaluation: Evidence from Hybrid Mutual Funds

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We examine whether explicitly controlling for the fixed-income exposure of mutual funds affects conclusions drawn in performance assessment. We focus on daily return data from two hybrid mutual fund samples. Comparing abnormal performance estimates from the Carhart (1997) model to extensions designed to correct for bond holdings, we find that the estimates within one of our samples change from positive to significantly negative. Additional evidence indicates that cash flows to the funds are more closely correlated with the traditional Carhart measure, clearly indicating that the absence of bond indices misleads investors who use a fund's risk-adjusted performance as the basis for investment decisions. (*JEL* G11, G20)

The four-factor model of Carhart (1997) is widely accepted by academic researchers for measuring the abnormal performance of equity fund managers. The model is designed to explain equity returns and to measure the abnormal return generated from picking stocks that outperform the benchmark on a risk-adjusted basis. Because its focus is on equity fund performance, no bond indices or factors are explicitly included as part of the model. However, an examination of reported asset allocation data indicates that fixed-income securities compose a nontrivial percentage of the holdings of equity mutual funds and a substantial portion of the assets held by hybrid funds.

We appreciate the comments of Jeffrey Busse, Martin Gruber, Phyllis Keys, Wayne Lee, Matthew Spiegel (the editor), and an anonymous referee. In addition, we appreciate the feedback of workshop participants at the 2006 Center for Research in Security Prices (CRSP) Forum, Georgetown University, and Hofstra University. We also thank Eric Gauthier, Herminio Romero, and Dustin Salvenson for excellent research assistance. Comer acknowledges the financial support provided by the Georgetown University Graduate School of Arts and Sciences and the Dean's Leadership Fund of the McDonough School of Business. Rodriguez acknowledges the financial support provided by the University of Puerto Rico Graduate School of Business Administration and Office of the Dean of Graduate Studies and Research. Address correspondence to G. Comer, 417 Old North, Georgetown University, Washington, DC 20057; telephone: (202) 687-0676; e-mail: gc45@georgetown.edu.

doi:10.1093/rfs/hhm087 Advance Access publication December 20, 2007