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.

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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.

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