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Full Length Article

The role of active management and asset allocation policy on government and corporate bond fund returns

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Abstract

The role of asset allocation policy and active management on equity mutual fund returns has been a popular research topic, while there is almost no literature on the subject covering bond funds. We check sources of performance for Israeli corporate and government bond funds, which together account for above 70% of the Israeli mutual fund market, using a unique monthly database of approximately 10-years. Our results reveal that active management is far more important than policy for corporate bond fund returns, which is mainly attributable to managers' security selection skills. The reverse is true for government bond funds and strategic long term policies account for a larger part of excess market return variability. Furthermore, if we take into account management fees, government bond funds lose from active management. The greater heterogeneity of investments open to corporate bond funds is a possible explanation for the difference in results.

JEL classification: G11; G12

Keywords: Active management; Bond funds; Corporate bonds; Policy; Security selection; Timing

1. Introduction

Performance attribution has been one of the most important topics for mutual funds. The total returns of mutual funds are generally attributed to three main components, the market in which they are operating, their passive investment policy and active management, which is defined by fund managers' tactical allocations (market timing) and security selection. In this research, we aim to address which factor and/or factors play the most important role in explaining the variability and level of returns for Israeli bond funds after excluding the impact of the general market. There is a large amount of literature on pension funds, balanced and equity mutual funds, while research on bond mutual funds in general has been relatively limited (Goldstein, Jiang, & Ng., 2017). Moreover, to our knowledge, so far no research looked simultaneously into all of the determinants of performance in bond mutual funds and their ability to create value above the market benchmarks.

This question is particularly relevant for the Israeli market, because most of the growth of the mutual fund industry in Israel owes to Domestic Bond funds, which grew by almost three folds since the beginning of 2006 and constitute around 73% of the Israeli mutual funds (167 billion shekels as of December 2015). Money market funds and funds abroad follow with a big gap, accounting for 12% and 9% of the market, respectively. On the other hand, domestic equity funds are relatively small, capturing a 5% market share. Therefore, it is worthwhile to analyze the performance of domestic bond funds and where their value creation stems from; whether due to asset allocation policies, management

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skills or simply exposure to Israeli bond markets in general: the result of rising tide lifting all boats. Chart 1 shows the mutual fund categories according to their asset sizes between 2008 and 2015 and Chart 2 compare the nominal yields of domestic bond funds to that of equity funds from 2008 until 2015 (based on available data).

In Israel, debt funds are generally safer than equity funds because they primarily invest in rated bonds in which defaults are rare. Chart 2 shows that government bond funds in Israel are less volatile than corporate bond funds and equity funds; and their returns tend to be steady and in a constant range. Government bonds are considered almost risk-free and Corporate bonds are rated by different credit rating agencies which allow the investor to gauge the risk of the investment. Despite their higher risks, we observe that, on average, equity mutual funds could not outperform bond funds significantly, except for the year 2009.

While both Debt funds and equity funds seek to deliver potential returns, they can be quite different based on their asset allocation decisions, risk profiles and how they make profits for the investor. There has been quite substantial amount of research on balanced funds and equity funds, while bond funds and determinants of their performance received rare attention.

Since bond fund yields in Israel are relatively stable compared to those of equity funds, we could expect asset allocation policies to exert a higher influence on their expected returns than active management. In this article, we test the validity of this argument for the Israeli government and corporate bond funds. We check whether there are differences in active management and asset allocation decisions of government and corporate bond funds and the impact of these decisions on their performance.

According to recent research, asset allocation policies and active management are equally important for U.S. balanced mutual funds and equity funds (Xiong, Ibbotson, Idzorek, & Chen, 2010) and active management in general plays a minor role for pension funds (Aglietta, Briere, Rigot, & Signori, 2012). Different from the previous literature, we find that active management is the most important component

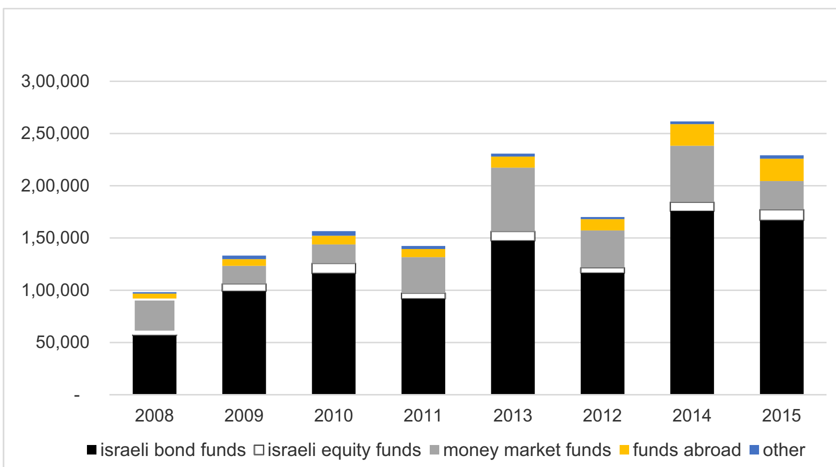

Chart 1. Distribution of israeli mutual funds by asset size.

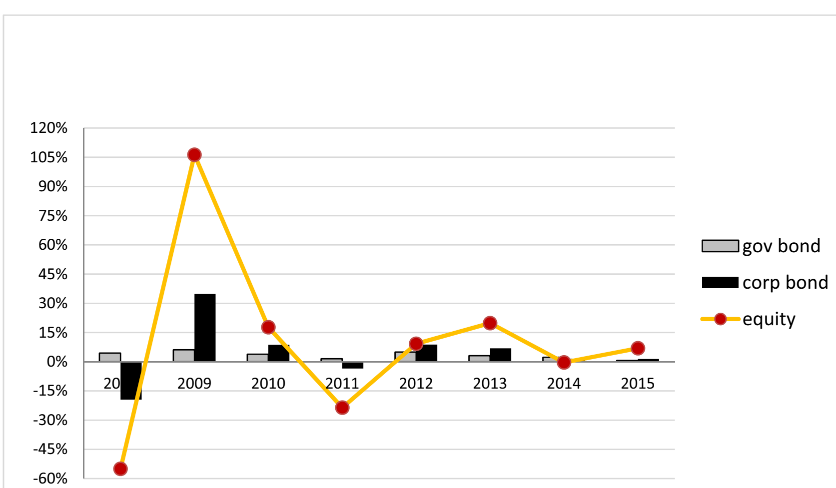

Chart 2. Domestic bond vs. equity nominal yields.

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