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## Performance persistence in fixed interest funds: With an eye on the post-debt crisis period



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### ABSTRACT

We examine performance persistence in a sample of Portugal, Italy, Greece, and Spain (PIGS) government debt mutual funds. Performance persistence is measured for short-, medium-, and long-term periods using the conditional CAPM, the Sharpe ratio, and a modified version of the Sharpe ratio. “Cold hands” are found for both short- and medium-term periods, with non-parametric testing reinforcing our findings. While “hot hands” are proven a close second place, in the long-run performance persistence is gradually weakened. Ex-post tests, based on performance persistence results, suggest the possibility to achieve superior performance relative to the market average by sticking to winner and avoiding loser funds.

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### 1. Introduction

Fund of funds managers and large institutional investors like pension funds continually attempt to select the crème de la crème of mutual funds in order to enhance their portfolio returns. Since past

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performance measurements do not provide insights into the future upside potential of individual fund managers, academic research has shed light on the ability of professionally managed portfolios to consistently achieve above average performance. Fixed income assets are at the forefront of investment alternatives. Research on mutual fund performance, however, has been concentrated to the United States and the United Kingdom, leaving under-researched most of the other developed financial markets. Therefore, the questions of whether investors' money is properly invested or of the potential of achieving superior performance by identifying the best performers in bond markets in the context of active portfolio management call for further investigation (Redman and Gullett, 2007).

Bond funds engage in active portfolio management as evidenced by their high turnover rate relative to equity mutual funds (Moneta, 2013). This finding also holds for the fixed income asset management industry of the debt crisis inflicted countries of Southern Europe (i.e., Portugal, Italy, Greece, and Spain or PIGS). Since early 2010, when the European debt crisis erupted, and until mid 2013, PIGS, along with Ireland, encountering though country-specific difficulties<sup>1</sup>, had successively undergone downgrading of their sovereign debt ratings by credit rating agencies. Prior to the debt crisis, bond mutual funds had acted as a minimum risk investment. However, the outbreak of the recent European debt crisis severely impacted fixed income mutual funds performance, resulting in significant losses.

Nonetheless, the debt crisis in the eurozone was short-lived, as evidenced by Greece having resumed long-term borrowing following the sale of a five-year bond issue (The Financial Times, 2014b). The large and developed asset management sector in South Europe continues to seek investments in locally domiciled debt obligations. Moreover, European and global portfolios continue to allot to these markets their deserved share in a well-diversified portfolio. Their investment policies are motivated by volatility spillover effects and cross-sectional returns dispersion co-movement amongst South European markets (Skintzi and Refenes, 2006; Economou et al., 2011). Even during financially constrained periods, fund managers are inclined to engage in active portfolio management. Loss-averse investors are usually reluctant to “flee” from their fund allocations, being aware of the colossal losses they have already sustained. In this respect they may also expect fund managers to minimize any further future losses.

In the wake of the European debt crisis and the possible future opportunities that could arise for globally diversified or country-specific bond portfolios, in this study we examine the performance of fixed income investments in one of the last “yield havens”, the Southern Europe. We believe that detecting past performance patterns may assist portfolio managers with unraveling idiosyncratic markets.

The specificity of the debt crisis in Southern Europe and the paucity in the literature examining performance persistence in any of these debt markets are not the sole reasons that render this research important<sup>2</sup>. We offer further evidence to the issue of performance persistence, especially over longer horizons. We test for performance persistence by using contingency tables constructed on the basis of two seminal performance measurement approaches: the Sharpe ratio and the conditional performance model. In this way, we attempt to elucidate whether the degree of performance persistence varies across different performance measures. To the best of our knowledge, no previous study has explored performance persistence employing these performance measures collectively<sup>3</sup>.

Moreover, we are the first to examine the performance persistence for PIGS, with specific focus on locally domiciled domestic debt fixed income funds. After analyzing potential refinements to the Sharpe ratio, we check for alterations in performance persistence as derived by our selected measures of performance. Our empirical results confirm that the choice of performance measure may in some cases significantly change the ranking of bond mutual funds.

The focus of our analysis is on short-, medium-, and long-term horizons and tests are performed over 6-, 12-, 24-, and 36-month periods. We measure performance and persistence relative to the

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<sup>1</sup> Ireland primarily encountered difficulties in the structure of its banking system, thus is treated as a relatively separate case during the debt crisis in the eurozone.

<sup>2</sup> Agudo and Magallon (2005) and Babalos et al. (2007) stress the need for further research into performance persistence in small developed markets.

<sup>3</sup> Cortez et al. (1999) used the Sharpe ratio and Jensen's alpha.

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