Significance of Market Timing and Stock Selection Ability of Mutual Fund Managers

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Abstract

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is invested by the fund manager in different types of securities depending upon the objectives of the scheme. Mutual funds cannot guarantee a fixed rate of return. It depends on the market condition. If a particular scheme is performing well then more return can be expected. It also depends on the fund managers’ expertise and knowledge. The present study is aimed to examine the performance of mutual fund managers on the basis of selectivity and market timing abilities in security market. However, the majority of the selected mutual fund managers do not possess market timing ability rather they are relying a little bit on stock selection.

Keywords: Mutual fund, Investment, Security market, Stock selection.

Introduction

In India, the mutual funds industry has been in existence for more than four decades. Unit Trust of India (UTI) was the first mutual fund to be set up in India under the UTI Act 1963. In 1987, the Government allowed mutual funds to be promoted by public sector banks and other financial institutions and in 1993 the doors were opened for private sector mutual funds.

Market timing refers to the dynamic allocation of capital between

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broad asset classes. Treynor and Mazuy (1966) use the following regression to test for market timing:

\[ R_{pt} - R_{ft} = a + bR_{mt} - R_{ft} + g(R_{mt} - R_{ft})^2 + e_t \]

Where \( R_{pt} - R_{ft} \) is the excess return on a portfolio at time \( t \), \( R_{mt} - R_{ft} \) is the excess return on the market, and \( a \) is a measure of timing ability. If a mutual fund manager increases (decreases) the portfolio’s market exposure prior to a market increase (decrease) then the portfolio’s return will be a convex function of the markets return, and will be positive.

The performance results related to both selectivity and market timing skills get modified when we use multi-factor benchmark instead of standard one-factor benchmark. It also shows the impact of observation frequency on the size and significance of performance measures. We deal with two issues regarding market timing measures. They attempt to measure market timing abilities of fund managers not only with regard to the market factor, as in previous work, but also for the three additional Carhart factors. Investors also try to rectify Jagannathan and Korajczyk (1986) bias by constructing synthetic funds using an estimation procedure different from Bollen and Busse (2001).

**Review of Literature**

Maria Doceu Cortez and Florinda Silva (2002), have analyzed the performance of sample of Portuguese both unconditional and conditional measures. They found that the incorporation of public information variables were an important contribution to the process of evaluating fund performance. The authors concluded that time varying bet as might allow for a better assessment of performance. However, they emphasized that further research was needed on conditional models.

Nicolas P.B. Bollen and Jeffrey A. Busse (2004), have analyzed the issue of determination in mutual fund performance emphasizing short measurement period. The authors have suggested that misspecification of the performance model was not driving the results. The results found no evidence of ability using the concatenated returns and isolated a
negative long-term relation between factor loadings and factor returns as the source of the difference between the results of different horizons.

**Indicators**

The Mutual fund investments have been based on the certain indicators which are mentioned as under:

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Importance</th>
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<tbody>
<tr>
<td>Fund's investment objective</td>
<td>There are three general investing goals: growth through capital appreciation, periodic payments of income, and protection of your initial investment. A fund may focus on one or more of these goals.</td>
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<tr>
<td>Role of this fund in portfolio</td>
<td>A diversified portfolio has a variety of funds that invest in different asset classes. One should understand what a fund invests in, how it fits into your overall portfolio, and how it attempts to achieve its investment objective.</td>
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<tr>
<td>Fund actively managed or does it track an index</td>
<td>The return of an actively managed fund depends in part on the manager's selection and timing of individual securities. A passively managed fund is generally designed to try to match that of a given index of securities--for example, the S&amp;P 500.</td>
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<td>Fund's short-term performance record</td>
<td>Investing styles and asset classes tend to move in cycles. A fund that has done well recently may be benefiting from such a cycle, which may or may not continue.</td>
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<tr>
<td>Fund's long-term performance record</td>
<td>A fund's prospectus must list its total return for each of the past 10 years. Comparing long-term performance can indicate how a fund has performed through various market cycles. Bear in mind that past performance is no guarantee of future results.</td>
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<td>Fund's performance varied from year to year</td>
<td>A fund's standard deviation explains how great the range between a fund's highs and lows might be. The higher the standard deviation, the more a fund's performance may vary from its average year-to-year performance, and the more volatile it may be from year to year.</td>
</tr>
<tr>
<td>Duration of current manager run the fund</td>
<td>If a manager is relatively new to the fund, its past performance record and strategy may not accurately reflect its current style and performance.</td>
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<td>Consistent is the fund's approach to achieving its goals</td>
<td>Funds sometimes undergo what is known as &quot;style drift&quot;—subtle changes in the way it invests or what it invests in. Style drift is not necessarily a negative, but one should be aware of how flexible a fund's strategy might be, and how it might fit with other investments in their portfolio.</td>
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<tr>
<td>Fund's turnover ratio</td>
<td>A fund that trades frequently may generate high taxable capital gains, even if the fund has had a negative return, and also will have higher trading expenses than a lower-turnover fund.</td>
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<td>Effects of taxes on the fund</td>
<td>Some funds are best held in taxable accounts like, municipal bond funds. Mutual funds must distribute all capital gains and dividends to shareholders each year. Those distributions are generally taxable. Some funds are managed to maximise tax efficiency.</td>
</tr>
<tr>
<td>Fund's expense ratio</td>
<td>Knowing a fund's expense ratio—what you pay for the fund's annual operating costs can help to judge whether it operates efficiently and whether higher expenses are justified by the fund's returns.</td>
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</table>
Fees and sales charges

Depending on how long you intend to hold the fund and how the sales charges are structured, a fund with a sales load may or may not be more cost-effective than a no-load fund. Sales charges may be reduced for larger investments; find out about a fund's breakpoint levels.

Conclusion

It is proved that success of a mutual fund manager depends on their Market Timing & Stock Selection ability. Those who have perfect ability may perform better than the other fund managers.

References

7. Jagadeesh, N. and S. Titman, 1993, Returns to Buying Winners and Selling Losers: