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Portfolio Turnover and Fund Investors' Performance

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The considerable growth of the mutual fund industry has led to a significant number of studies on mutual fund performance. In this context, some recent studies (Kacperczyk et al., 2005; Cremers and Petajisto, 2009; Amihud and Goyenko, 2013) develop different active management measures, and explore their relation with funds' results, suggesting that the more active the fund manager is, the better performance their funds achieve.

However, fund investors face some difficulties in order to construct these measures, and can fail to correctly determine the level of active management experienced in the fund portfolio. Despite this, they can easily observe the turnover ratio, as reported in the fund's prospectus, and interpret it as a simply measure of the fund's trading activity, assuming that the higher this ratio is, the higher the level of transactions reached by fund managers. Thus, a high turnover ratio can be interpreted by fund investors as the manager's effort to increase their added value to the fund portfolio, detecting undervalued or overvalued assets, and taking buy and sell decisions to time the market.

Regarding the previous literature, there is some controversy in the relation between turnover ratio and mutual fund performance. Some studies do not support a high turnover ratio in the mutual fund management, since a higher level has no significant effect on fund performance (Golec, 1996; Gottesman and Morey, 2007), or may even be negative (Chow et al. 2011; Elton et al., 1993). In contrast, other authors (Pástor et al., 2016; Wermers, 2000) conclude that high-turnover funds are able to obtain better results and they are equally or more attractive to risk-averse investors (Taylor and Yoder, 1994).

The main objective of this study is to delve into this relationship, and to observe if fund investors can obtain different risk-adjusted returns by investing in funds with high or low turnover ratios. For a sample of 4,058 US domestic equity mutual funds during the period 1999-2014, results show that high-turnover funds do not provide investors with greater risk-adjusted returns than low-turnover funds during last years. In fact, they perform significantly worse after the recent financial crisis.

Then, we wonder if the turnover ratio reported in the fund's prospectus can be interpreted as a proxy of the level of turnover reached in the portfolio during the following year, which, to the best of our knowledge, has not previously been analysed. Using contingency tables on a year-to-year basis, results show that the relative level of portfolio turnover experienced by a mutual fund is persistent over time. Therefore, we analyse the performance of different investment strategies based on the previous fund turnover ratio and past performance, and show that investing in previous low-turnover funds can lead to higher risk-adjusted returns than investing in previous high-turnover funds.

Keywords: mutual fund, turnover, fund investor, performance

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