



# Market Timing and Selection Skills of Fund Managers:

Are Managerial Skills of Shariah-Compliant and Socially Responsible funds any Different?

By:



Dr Wajahat Azmi



Prof Dr Shamsher Mohamad



Assoc Prof Dr Mohamed Eskandar Shah

**W**e assess the managerial skills of globally invested 686 ethical funds taking into consideration the macroeconomic efficiency and fund inflows/outflows. It was observed that managers exhibit negative selection and market timing skills but no consistent pattern for style timing.

A cursory glance at the literature indicates little support for superior managerial abilities, especially in terms of timing skills. Notwithstanding, some have highlighted the importance of including fund flows in the traditional models and argue that excluding it can lead to spurious timing skills (Bollen and Busse, 2001). The findings indicate that the investors increase their exposure to funds during a bullish period and reduce it during a bearish period. The increase in cash holdings of fund companies during a bullish period leads to lower beta whereas a temporary decrease in cash position leads to higher fund beta. Both the scenarios lead to underestimation of timing abilities and suggest that the

test of skills without taking into account the fund flows may undermine the true skills of the managers.

In recent times, the emergence and increasing popularity of socially responsible funds (SRFs) and Shariah-compliant funds (SCFs) has led to a significant niche class of asset in its own right and hence, the importance to examine them as a separate asset class<sup>1</sup>. More importantly, the increasing popularity of ethical funds have even prompted the conventional funds to offer tailored financial products to meet investors demand. Given its increasing growth and acceptance at the global level, it is important to investigate some relevant issues surrounding these funds.

We examine the relationship between managerial skills and the fund flow of these niche funds. Documenting the managerial skills of SCF and the SRF managers is important for at least two reasons. First, both types of funds are subjected to a screening process that reduces

<sup>1</sup> As per Global Sustainable Investment Review (GSIR) 2016, at the start of 2016, total of \$22.89 trillion of assets were professionally managed based on SR principles. On the other hand, as at end Q1 2017, total Islamic funds under management reached \$70.9 billion (Islamic funds: Gearing Up, MIFC – 2017).





the scope of the investment universe to select assets that could affect the portfolio's diversification strategy. The issue becomes more pertinent with the increase in money flow into the funds that could lead to decisions to invest in stocks with lower risk-adjusted return, implying an adverse impact on the stock selection skills of managers. Second, the constituent stocks are screened periodically to ensure continuous compliance with the set guidelines. The continuous readjustment of portfolios due to non-compliance will affect the market timing skills of the managers. It is therefore important to control for the fund flow effects when measuring managerial selection and timing skills.

A survivorship-free bias sample of 686 equity-based open-ended funds with 212 SCFs and 474 SRFs with an investment focus in Asia Pacific, Emerging markets, Europe, Global (with no focus to any specific country or region), Middle East and North Africa (MENA) and North America was selected for analysis. The data was sourced from EurekaHedge, Bloomberg and fund prospectuses for both the funds, for the period January

2002 to December 2013. Before we did so, we also examined the performance of these funds. To achieve the objective, we utilized the single (CAPM) as well as the three-factor Fama-French model and four-factor CARHART model (1997). As the four factors are not available for all the regions, we construct the factors based on the Worldscope database. To examine the skills, we apply two of the most widely used measures proposed by Treynor and Mazuy (TM) (1966) and Merton and Henriksson (HM) (1981). An extended version of TM and HM models was applied to examine style-timing abilities and to demarcate the skills with the money flowing into/out of these funds and pure skills induced by the fund flows.

Our findings show that both types of funds significantly underperformed the market, consistent with Capelle-Blancard and Monjon (2014) and Nainggolan's et al. (2016) findings. The stock selection and market timing skills are negative, consistent with Ferruz et al. (2012) and Mohammad and Ashraf (2015), but inconsistent with that of Hammami and Oueslati (2017). The findings are inconclusive on the style timing capabilities of these funds as no consistent pattern is observed across different models. It is possible that the poor selection and timing skills of these managers are due to a smaller investment universe where the ability to diversify is limited and the results may be biased as fund flows are omitted.

An extended analysis that incorporates fund flows also revealed no significant effect on the skills, as the timing coefficient remained negative and significant. These findings are consistent with Munoz et al. (2014) that also documented no effect of fund flows on managerial skills. To control for macroeconomic efficiency, re-estimations were made by incorporating important macro factors into the models, but no significant changes were observed.

Several policy implications could be inferred from the findings. First, it could be that SCF/SRF managers are still in the learning phase and require a longer learning curve to improve their selection and timing skills. The increasing validation that the return of SCF/SRF indices is comparable to their conventional counterparts exerts added pressure on these fund managers to be competitive for long-term survival.

The findings on the performance of SCF/SRF indices suggest that, at worst, the performance of these indices are at par with the conventional benchmark, which imply that the SCF/SRF investors would be better off by investing in the SCF/SRF indices. It also implies that to motivate the SCF and SRF fund managers, the remuneration of these managers needs to be benchmarked based on performance and must be as competitive, if not better, than their conventional counterparts. This is in the interest of mitigating any moral hazard issues and providing an incentive for them to be more committed. In fund management parlance, managers should have more skin in the game. ■