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Return-based classification of absolute return funds

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Philipp Gerlach[1] & Raimond Maurer

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Abstract

We apply a return-based classification approach on a sample of absolute return funds registered for sale in Europe. The classification process results in eight groups with specific risk and return profiles. Each group can be characterized by two dimensions of an underlying investment style: asset allocation and trading strategy. While the returns of one group are largely determined by the asset allocation, the returns of the seven other groups are driven by different trading strategies. Our estimated classification explains 20 per cent of the in-sample and 13 per cent of the out-of-sample cross-sectional return variation, which is superior to existing approaches.

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Notes

1. Data source: Lipper, a Thomson Reuters Company.

2. The classification algorithm requires a complete returns time-series for each fund. A sample size of 3 years is a favorable tradeoff between the number of funds that enter the classification and the return history. Despite the relatively

small time span of 36 months, the monthly returns of the various asset classes show substantial fluctuations.

3. The χ^2 test could be sensitive to departures from normality (Brown and Goetzmann, 1997). In our study, the skewness (kurtosis) of the heteroskedasticity-adjusted residuals depending on K are in the range of -0.05 to -0.12 (3.7 and 4.7), indicating that the χ^2 test is well specified.

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Author information

Authors and Affiliations

Finance Department, Goethe University, Grueneburgplatz 1 (Uni-PF. H 23), Frankfurt am Main, Germany
Philipp Gerlach

Additional information

[1]research assistant at the Chair of Investment, Portfolio Management and Pension Finance at the Finance Department of the Goethe University Frankfurt. His main

research interests focus on style analysis and style classification of mutual funds.

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