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Return-based classification of absolute return funds

Original Article Published: 07 May 2015

Volume 16, pages 117–130 (2015) Cite this article



Journal of Asset Management

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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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Acknowledgements

The authors are grateful for research support provided by the German Investment and Asset Management Association (BVI). Opinions and errors are solely those of the authors and not of the institutions with whom the authors are affiliated. © 2015 Gerlach and Maurer.

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Cite this article

Gerlach, P., Maurer, R. Return-based classification of absolute return funds. *J Asset Manag* **16**, 117–130 (2015). https://doi.org/10.1057/jam.2015.9

Received	Revised	Published
28 February 2015	28 February 2015	07 May 2015

Issue date
01 March 2015
DOI
https://doi.org/10.1057/jam.2015.9

Keywords

absolute return funds | return-based classification | style analysis

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