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Predictable patterns in ETFs' return and tracking error

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[Studies in Economics and Finance](#)

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ISSN: 1086-7376
(International
Article publication date: 8 March 2011
Standard
Serial
Number.)



3950

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Abstract

Purpose

The purpose of this paper is to assess whether exchange-traded funds (ETFs) can beat the market, as it is expressed by the Standard and Poor (S&P) 500 Index, examine the outperformance persistence, calculate tracking error, assess the tracking error persistence, investigate the factors that induce tracking error and assess whether there are predictable patterns in ETFs' performance.

Design/methodology/approach

The author uses a sample of 50 iShares during the period 2002-2007 and calculates the simple raw return, the Sharpe ratio and the Sortino ratio, regresses the performance differences between ETFs and market index, calculates tracking error as the standard deviation in return differences between ETFs and benchmarks, assesses tracking error's persistence in the same fashion used to assess the ETFs' outperformance persistence, examines the impact of expenses, risk and age on tracking error and applies dummy regression analysis to study whether the performance of ETFs is predictable.

Findings

The results reveal that the majority of the selected iShares beat the S&P 500 Index, both at the annual and the aggregate levels while the return superiority of ETFs strongly persists at the short-term level. The tracking error of ETFs also persists at the short-term level. The regression



Originality/value

The findings of this paper may be of help to investors seeking investment choices that will help them to gain above market returns. In addition, tracking error-concerned investors will be helped by the findings of the paper. Finally, the findings on return predictability can also be helpful to investors.

Keywords

- Investment funds
- Stock exchanges
- Return on investment

Citation

Rompotis, G.G. (2011), "Predictable patterns in ETFs' return and tracking error", [Studies in Economics and Finance](#), Vol. 28 No. 1, pp. 14-35.
<https://doi.org/10.1108/10867371111110534>

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