Chapter 7
Current Trends in Investment Analysis

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ABSTRACT

The purpose of this chapter is to review the current trends in investment management and performance research. The adaption of both the classic CAPM and the factor models seems to continue, with the realistic factors playing a crucial role and best represent the drivers of investment performance. Another rising area is the search for skill, which is based on the enhanced benchmarks. The availability of quantitative and qualitative data in the academic community has allowed for these areas to evolve in recent years and to emerge as expected in the next decade, as well as to be explored.

INTRODUCTION

Both investment consultants and academic researchers have a deep interest in investment management and investment performance issues. This book chapter aims to review the existing methods of evaluating the investment management and the investment performance and highlight the developments in these areas in the past decade. Moreover, this book chapter is trying to expand the investigation areas, which are strongly believed to evolve shortly.

The classic theories and empirical studies of investment performance include the Capital Asset Pricing Model (CAPM) of Sharpe (1964, 1967) and Jensen's (1968) and the multi-factormodels of Fama and French (1992, 1993) and Carhart (1997). These models play an active and important role in the current academic research. However, they have not met the requirements of the investment industry. There is still a need to find measurements to calculate an industry's investment performance or a business.

Furthermore, it can be said that there is a wide range of opinions on the efficacy of such models. On one hand, there are individuals, who broadly accept the findings of Fama and French (1992, 1993) and use them extensively. On the other hand, some believe that these models' assumptions and artificial

results have no importance to evaluating the investment performance, as these measurements are not going to be used, neither from the investors, nor from the investment managers.

A reluctance from the investment industry is observed to accept these traditional factor models and adopt them to measure the investment performance. The refinements of these models and why the investment industry has not adopted them are topics that need to be discussed. As a result, this points out the refinements that should be implemented in the classic benchmarks, where the models have more resemblance to the benchmark for an investment style or a category of funds. These models have a lot of similarities with the CAPM and the single factor models. However, with a specific benchmark, they can represent the appropriate investment universe and align with investment practices. Such alignment is not completely out of context with the multifactor models developed by Fama and French (1993).

Connor (1995) supported shortly after Fama and French (1993) that such models can be characterized as fundamental factor models. These models rely on empirical findings from the worldwide bibliography concerning the stock characteristics, such as size or book-to-market ratio. More recent studies examine, whether such effects can be captured by the models, which use a single benchmark and are more closely aligned with these funds.

In order to evaluate an investment skill or a manager's value-added, a proper benchmark should be utilized. Some important questions should be answered such as: is there a skill, what type of skill is it, how can this skill be captured? However, the global research has moved past this stage and is trying to answer the crucial question, if there is excess performance and if there is, is it due to skill or pure luck?

Mutual funds are investment funds in which the capital is pooled from several different investors and then used to buy securities such as stocks, bonds or money market instruments. Although investing in mutual funds, rather than direct investment in individual securities, still presents a certain degree of risk, it has become more and more common practice around the world (Nandrajog, 2018).There are four main types of mutual funds, categorized by the nature of their principal investments, namely: stock or equity funds (whether domestic or international), bond or fixed income funds, money market funds and hybrid funds.The biggest part of the money invested in equity mutual funds is still invested in active management (Ferreira et. al., 2019).

The U.S. total mutual funds net assets value reached 21.25 trillion $ in January 2020 and the US mutual fund industry remained the largest in the world at the year-end of 2019. The majority of US mutual fund net assets at year-end of 2019 were in long-term mutual funds, with equity funds alone making up 53 percent of US mutual fund net assets. Domestic equity funds were the second largest category, with 39 percent of net assets (Investment Company Institute, 2020).

Despite the rapid growth of index funds and significant redemptions, actively managed funds still account for 80% of U.S. equity funds. Specifically, at the end of 2019, the actively managed funds accounted for $13.9 trillion under management in the U.S., while the passively managed funds accounted for $8.4 trillion (Refinitiv Lipper, 2020). That implies that an abundant amount of investors believe that investment managers have the skills to outpace the market.

Another set of questions that needs to be answered is if most investors are misinformed and do the investors have motives or incentives that people cannot understand? Thus, a research is expected to be implemented to discover more appropriate benchmarks and improved identification and assessment of skill, as well as to continue the expansion in the anticipated future. Suppose the theories and the investment models are not accepted or applied by the investors and the investment industry. In that case, an issue will occur regarding the economic impact new benchmarks and skill assessments can have.

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