Abstract: This paper introduces a predictive panel regression framework for holdings-based fund performance measures. The approach facilitates the correction of lagged stochastic regressor bias and allows the application of other statistical tools for panel regressions. We find an “Average Alpha Effect” in three of the four classical measures we study. This Effect is a cross-sectional relation between a fund’s average portfolio weights and the stocks’ average alphas in the benchmark model. The Average Alpha Effect is large in simulated strategies and in data on active US equity funds. It dominates the cross-sectional variation in the classical measures and is stronger in more recent data. The Effect has little relation to active management and does not help predict stock returns, but it is related to the tendency of a fund to follow a buy-and-hold strategy. Removing the Average Alpha Effect changes the before-cost performance of the typical active fund from positive to negative.

Wayne Ferson conducts research on models for security returns and on methods for evaluating the performance of managed portfolios. He is currently the Ivadelle and Theodore Johnson Chair at the University of Southern California. Ferson holds the PhD in finance from Stanford and was formerly on the faculties of Boston College, the University of Washington, the University of Chicago and the Wharton School. He is a former President of the Society of Financial Studies and the Western Finance Association and a former Editor of the Review of Financial Studies and the Journal of Empirical Finance. He is the founding Executive Editor of the Review of Asset Pricing Studies. He has served as an Associate Editor for several journals and as the Faculty Coordinator for the Ph.D program in Finance at the Marshall School at USC. He has written lots of papers. His forthcoming book, “Empirical Asset Pricing: Models and Methods (MIT Press) is targeted at doctoral and advance Masters students in asset pricing.