With an Eye to Capital Markets: Trading Strategies and the Net of Actual Costs
By Ashiq Ali

Ashiq Ali is Charles and Nancy Davidson Distinguished Professor of Accounting and Information Management. He researches the role of financial accounting information within the capital markets. He earned the Executive MBA Distinguished Faculty Award in 2002 at the University of Arizona. He received his Ph.D. in 1987 from Columbia University.

Academic literature has identified various trading strategies to take advantage of systematic mispricing in the stock market. An interesting question that follows is whether sophisticated investors can profitably implement such trading strategies. Several recent studies attempt to address this issue by comparing hypothetical returns from the trading strategies with estimates of trading costs that may be incurred when implementing the strategies. However, these studies provide mixed evidence primarily because they consider either different sets of trading costs or estimate the magnitude of the costs using different approaches. My research addresses the above concern by considering returns to these trading strategies net of *actual* rather than estimated transaction costs.

I show that actively managed equity mutual funds in the United States are able to make significant excess returns net of *actual* transaction costs by following two well-known trading strategies, the accruals anomaly and the post-earnings announcement drift. I find that the top 10 percent of mutual funds that most actively follow these strategies exhibit excess returns of 3 percent to 4 percent per year. I also find that mutual funds more active in using these strategies exhibit higher return volatility and higher fund flow volatility. These factors represent the adverse consequences of arbitrage risk that funds face when they follow these strategies. Overall, my research findings provide portfolio managers considering such strategies a better idea of the related costs and benefits.

Related research that I am pursuing examines a new method to identify mutual funds that are likely to produce persistent superior performance in the future. This method considers mutual funds that have in the past actively and persistently followed trading strategies that have been shown in the literature to generate predictable returns. A potential practical value of this study is to offer investors a new tool to assist their fund selection decisions. This research is supported by The Institute for Quantitative Research (Inquire UK).

***