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"Predictive Ability and Market Pricing of Fair Value Earnings Components"

Abstract

This study uses closed-end investment funds from the U.K. and U.S. to investigate the predictive ability and market pricing of realized and unrealized components of fair value earnings. We test whether fair value components of earnings are transitory or display predictable patterns that signal future fund performance. We find that realized gains are negatively related with future fund performance due primarily to the fact that realized gains/losses in period t are strongly negatively related to unrealized gains/losses in period $t+1$. This finding is consistent with closed-end fund managers' tendency to sell winners and hold on to losers. This tendency is consistent with two competing hypotheses in the literature: The disposition effect behavioral bias hypothesis and the market timing hypothesis. Consistent with the market timing hypothesis, we find that realized gains are a strong predictor of future market-wide stock market declines. To further support the market timing hypothesis, we predict and find a number of changes to fund investment strategies that coincide with realized fair value gains and subsequent stock market trends. Our market pricing tests reveal that investors in closed-end funds do not fully impound the signaling information conveyed by realized fair value gains/losses, and as a result, closed-end fund shares exhibit systematic mispricing of the realized and unrealized components of fair value earnings. We find modest evidence that the degree of mispricing is greater for U.K. funds for which the breakdown of realized and unrealized fair value earnings components is less transparent than in the U.S.

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