Swedroe: Investor Biases & Mutual Funds

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The relationship between investment flows and mutual fund performance is of great interest. For example, do investors naively look only at raw returns when making asset allocation decisions, or do they adjust returns for risk, using an asset pricing model?

Mutual Fund Investor Concerns

Itzhak Ben-David, Jiacui Li, Andrea Rossi and Yang Song, authors of the October 2018 study "What Do Mutual Fund Investors Really Care About?", sought to determine whether investors use prominent asset pricing models—such as the CAPM (capital asset pricing model) and the three- and four-factor versions of Fama-French models—to allocate capital, or whether Morningstar's star ratings (which do not account for systematic exposure to explanatory factors) explain mutual fund flows better than risk-adjusted returns.

Following is a summary of their findings:

- Ratings are the main determinant of capital allocation across mutual funds, followed by past returns.
- Morningstar ratings predict the direction of flows up to 68% of the time versus 60.4% for the CAPM, and even lower (between 57.8% and 59.6%) for other common asset pricing models.

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- The spread between flows to top and bottom funds is best explained by Morningstar ratings. For example, when using Morningstar, 67% of top-ranked funds receive positive flows, while only 16% of bottom-ranked funds receive positive flows, generating a difference of 51 percentage points—significantly higher than all other measures, which generate differences in the 16-23 percentage point range.
- At the aggregate level, in every single year, funds rated highest by Morningstar received more money than the funds ranked highest according to any asset pricing model.
- There is no evidence that investors discount fund returns related to market risk exposure or to the other risk factors.
- Recent past returns, but not volatility (once Morningstar ratings are accounted for), explain capital allocation beyond Morningstar.
- Fund flows are weaker for high-volatility funds only because Morningstar ratings penalize funds for high volatility.

Ben-David, Li, Rossi and Song concluded: “In summary, we find no evidence that investors use the CAPM, or any other of the commonly-used factor models, to allocate capital to mutual funds. Rather, they naively rely on external rankings as a way to chase past winners.” They added that their results “support the proposition that mutual fund investors do not care about risk or do not understand risk.”

Ratings & Performance

These findings beg the question of why investors rely on Morningstar rankings when there is no evidence supporting the view that they have predictive value (though low star ratings are a predictor of poor future performance, that’s a function of their high expense ratios).

For example, the paper “Mutual Fund Ratings and Future Performance” from Vanguard provides evidence on the ability of star ratings to predict the future. Authors Christopher Philips and Francis Kinniry Jr. examined excess returns over the three-year period following a given rating. They chose the three-year period because Morningstar requires

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at least three years of performance data to generate a rating, and investment committees typically use a three-year window to evaluate the performance of their portfolio managers.

The 2010 study covered the period June 30, 1992 through August 31, 2009. The following is a brief summary of the authors' findings:

- 39% of funds with five-star ratings outperformed their style benchmarks for the 36 months following the rating, while 46% of one-star funds did so.
- All the star-rating groups produced negative excess returns in the succeeding three years. Even worse, the four- and five-star figures were more negative than those of lower-rated groups.

Philips and Kinniry concluded: "Higher ratings in no way ensured that an investor would increase his or her odds of outperforming a style benchmark in subsequent years."

In fact, they found that "5-star funds showed the lowest probability of maintaining their rating, confirming that sustainable outperformance is difficult. This means that investors who focus on investing only in highly rated funds may find themselves continuously buying and selling funds as ratings change. Such turnover could lead to higher costs and lower returns as investors are continuously chasing yesterday's winner."

Other studies have come to similar conclusions. For example, Morningstar's own 2010 study found that expense ratios were a better predictor than its star ratings.

Summary

Investors reveal their preferences and dislikes by how they allocate capital across active mutual funds. The evidence presented shows that investor allocations are influenced by Morningstar's ratings (which overweight recent performance, weighting 10-year performance more than five-year performance, and five-year performance more than three-year performance) and their own recency bias, increasing cash flows to funds that have performed the best in the most recent period.

Sadly, it appears that investors are generally naive as to adjusting performance for risk, are subject to recency bias, and ignore the evidence that star ratings have little value. Education doesn't have to be expensive, but ignorance can cost you dearly.

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