Do fund buyers still chase past performance?

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We read up and run down the latest academic research on investment so you don't have to.

From active share to information ratio, investors today have more tools at their disposal than ever before when it comes to analyzing fund managers. But even if they don't have strong opinions on whether the Sharpe or Sortino ratio is more useful, they should at least know a manager's beta. Put simply, if a manager is merely replicating the index's performance, they aren't adding much value. After all, it would be supremely irrational to pay active management fees for a beta of one.

It was encouraging, then, that a pair of studies published in 2016 suggested that fund flows did reveal some awareness of beta among investors. Work by professors Brad Barber, Xing Huang and Terrance Odean determined that investors tend not to reward fund managers for returns attributable to the portfolio's beta. Meanwhile, academics Jonathan Berk and Jules van Binsbergen found that flows into and out of funds reliably reflected the capital asset pricing model, indicating that investors do price market risk into their allocation decisions.

But now, a new paper by Itzhak Ben-David at Ohio State University, Jiacui Li at Stanford University, Andrea Rossi at the University of Arizona and Yang Song at the University of Washington has challenged that rosy picture. Contrary to any notion of sophisticated investors separating alpha from beta, they examined whether Morningstar's ratings had a greater influence on fund flows than risk-adjusted metrics.

Importantly, Morningstar's ratings do not take into account a fund's exposure to any systematic risk factors. They do consider the size and volatility of a fund's returns, as well as value style benchmarks, but they do not isolate alpha from factor models such as Fama and French's.

'Our results show that ratings are the main determinant of capital allocation across mutual funds, followed by recent past returns,' Ben-David and his colleagues summarized. 'We find no evidence that investors allocate capital to funds based on the exposure to the market factor or to any other risk factor. Furthermore, while investors follow Morningstar religiously, they do not appear to understand Morningstar's rating methodology. In sum, our results show that mutual fund retail investors do not have a well-defined benchmarking standard for evaluating fund managers.'

In the study, Morningstar's five-star funds were found to attract more than twice as much money as those funds that performed best according to factor models. Morningstar ratings also predicted the direction of fund flows materially better than the capital asset pricing model, ac curately accounting for flows 67.9% of the time compared with 60.6% for risk-adjusted metrics.

Style it out

For added nuance, the academics looked back to June 2002, when Morningstar first started ranking funds by size and value style categories. Although the star system does not draw on factor or style exposures, it is possible that investors could be adjusting for that themselves and then using Morningstar to identify the best managers in a given asset class. However, that did not seem to be the case.

'In fact, investors relied heavily on the ratings both before and after the methodology change,' the academics reported. 'Furthermore, an event study around the transition date

reveals that before Morningstar implemented the style benchmarking, investors not only failed to adjust for style exposure but actively chased funds whose ratings were high due to style-related returns rather than because of managerial ability.'

The researchers therefore concluded that fund buyers in aggregate did not employ the capital asset pricing model or any other factor or risk model in picking managers. 'Rather, they naively rely on external rankings and chase past winners,' Ben-David, Li, Rossi and Song argued. 'It is hard to imagine that investors who fail to distinguish between skill and risk factor exposure would be able to learn about managerial skill and allocate capital optimally, leading to an equilibrium in which the expected adjusted return of all funds equals zero.

'Where do our results leave the study of investor behavior and asset pricing?' they wondered. 'It is clear that mutual fund investors do not use any of the commonly used asset pricing models for their investment decisions. Mutual fund flows indicate that investors pursue easy-to-follow signals – Morningstar ratings and recent returns – which are ultimately not informative about systematic risk.'

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