# Swedroe: Mutual Fund Flows & Factor Premiums

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Because mutual fund flows can impact securities prices, the relationship between investment flows and the performance of factors and mutual funds 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, and exposure to various factors, using an asset pricing model?

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Recent research has found that mutual fund investors are largely ignorant about systematic risks when allocating capital among mutual funds.

For example, Itzhak Ben-David, Jiacui Li, Andrea Rossi and Yang Song, authors of the November 2018 study "What Do Mutual Fund Investors Really Care About?", sought to determine whether investors use prominent asset pricing models—such as the capital asset pricing model (CAPM) 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% for the CAPM, and even lower (between 58% and 60%) for other common asset pricing models.
- 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 to 23 percentage points 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.

The authors 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."

This naive behavior is why individual investors are referred to as "noise traders." Despite trading on noise—rather than fundamentals—the fund flows that result from the behavior of retail fund investors can impact securities prices and returns to factors that explain performance.

### Flows & Factors

Shiyang Huang, Yang Song and Hong Xiang, authors of the January 2019 study "Fragile Factor Premia," sought to determine what, if any, impact mutual fund flows had on returns of the well-known Fama-French (FF) size and value factors.