EQUITIES

Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns

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Individual retail investors actively reallocate their money across different mutual funds. By looking at which funds have inflows and which have outflows, one can measure individual sentiment. Can this information be used to predict future returns? If sentiment pushes prices above fundamental value, investors should expect low future returns.

To systematically test this hypothesis, we examine flows and returns over the period 1980–2003. Our main result is that on average, retail investors direct their money to funds which invest in stocks that have low future returns. The Authors believe, to achieve high expected returns, it is best to do the opposite of these investors. We calculate that mutual fund investors experience total returns that are significantly lower due to their reallocations.

Therefore, mutual fund investors are “dumb” in the sense that their reallocations reduce their wealth on average. We call this predictability the “dumb money” effect.

Our results contradict the “smart money” hypothesis, which contends that some individual investors can identify skilled fund managers and benefit by placing their money with them. Martin Gruber and Lu Zheng have shown that the short-term performance of funds that experience inflows is significantly better than those that experience outflows, suggesting that mutual fund investors have selection ability. We find that this smart money effect is confined to short horizons of about one quarter, but at longer horizons the dumb money effect dominates.

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