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# Informative Fund Size, Managerial Skill, and Investor Rationality

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## Abstract

This paper considers the nature of returns to scale in active management following Pástor, Stambaugh, and Taylor (2015) who fail to establish diseconomies of scale at the fund level. Using an enhanced empirical strategy, we find a significant negative impact of fund size on performance. This empirical evidence indicates that fund alpha and fund size are not independent entities. Consequently, skill, rather than being measured by the fund alpha, should be measured by the value that a fund extracts from capital markets. We also show that there exist sophisticated investors who correctly exploit positive net present value investment opportunities.

*Keywords:* Mutual funds, managerial skill, diseconomies of scale, investor rationality

*JEL classification:* G11, G23, J24

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## 1. Introduction

The traditional analytic framework of skill in active management builds on the assumption of constant returns to scale. That is to say, skillwise, a fund with \$1 million of assets under management is indistinguishable from a fund with \$1 billion of assets under management as long as they both achieve the same risk-adjusted return. Under this framework, skill and scale are independent, and fund size is regarded as uninformative and randomly paired with funds. If the nature of the returns to scale is not constant, fund size then is informative, and unobserved skill is reflected in two observable measures, return and size. Consequently, the traditional framework that studies managerial skill and ignores size fails to fully utilize the available information, which can have biased previous studies against finding differential ability in active management.

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