



ELSEVIER

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfecSmart money, dumb money, and capital market anomalies[☆]Ferhat Akbas^a, Will J. Armstrong^b, Sorin Sorescu^{c,*}, Avanidhar Subrahmanyam^d^a School of Business, University of Kansas, Lawrence, KS 66045-7601, USA^b Rawls College of Business, Texas Tech University, Box 42101, Lubbock, TX 79409-2101, USA^c Mays Business School, Texas A&M University, Department of Finance, 360 Wehner Building, College Station, TX 77843-4218, USA^d Anderson School, University of California at Los Angeles, 110 Westwood Plaza, Los Angeles, CA 90095-1481, USA

ARTICLE INFO

Article history:

Received 7 July 2014

Received in revised form

17 March 2015

Accepted 18 March 2015

Available online 1 August 2015

JEL classification:

G11

G14

G23

Keywords:

Stock return anomalies

Mutual funds

Hedge funds

Fund flows

Mispricing

ABSTRACT

We investigate the dual notions that “dumb money” exacerbates well-known stock return anomalies and “smart money” attenuates these anomalies. We find that aggregate flows to mutual funds (dumb money) appear to exacerbate cross-sectional mispricing, particularly for growth, accrual, and momentum anomalies. In contrast, hedge fund flows (smart money) appear to attenuate aggregate mispricing. Our results suggest that aggregate flows to mutual funds can have real adverse allocation effects in the stock market and that aggregate flows to hedge funds contribute to the correction of cross-sectional mispricing.

© 2015 Elsevier B.V. All rights reserved.

1. Introduction

In the popular press and in academia, financial market price movements are often justified by alluding to the terms “dumb money” and “smart money.”¹ Price pressure from the dumb money generally is presupposed to make prices depart from fundamentals (Lou, 2012), whereas

arbitrage by the smart money makes prices converge to fundamental values (Frazzini and Lamont, 2008). There is extensive documentation of stock market anomalies (McLean and Pontiff, 2013; Stambaugh, Yu, and Yuan, 2012, forthcoming), suggesting that prices could depart from fundamentals for periods of time, and the persistence of such anomalies indicates that smart money is not fully able to erase them. Even though these notions prevail in financial thought, no direct documentation yet exists of the role of dumb and smart money in causing or correcting anomalies. In this paper, we provide evidence that dumb money exacerbates stock market anomalies and smart money attenuates them. We use mutual fund flows as a proxy for dumb money (Lou, 2012) and hedge fund flows as a proxy for smart money (Jagannathan, Malakhov, and Novikov, 2010).

Flows to mutual funds have been shown to create distortions in capital allocation across stocks. Retail

[☆] We are grateful to an anonymous referee for insightful and constructive suggestions. We also thank Jason Chen, Yong Chen, Francesco Franzoni, Hagen Kim, Lu Zhang, Brad Gilbert from Teachers Retirement System of Texas, John Claisse from Albourne America LLC, Tom Tull from the Employee Retirement System of Texas, and Michael Mulcahy from Bridgeway for many useful comments.

* Corresponding author. Tel.: +1 979 458 0380; fax: +1 979 845 3884.

E-mail address: ssorescu@tamu.edu (S. Sorescu).

¹ See, for example, “The Smart Way to Follow Dumb Money,” by S. Jakab, available at <http://online.wsj.com/news/articles/SB1000142405270230454-3904577396361227824738>.

investors appear to contribute to these distortions in several ways. [Sirri and Tufano \(1998\)](#) show that retail investors tend to “chase performance” by directing money to mutual funds with strong recent performance, while failing to redeem capital from funds with poor recent performance. [Frazzini and Lamont \(2008\)](#) show that retail investors tend to direct dumb money to mutual funds that hold overvalued stocks. When mutual fund managers receive new flows from retail investors they usually increase positions in existing stock holdings. As a result, in the cross section of mutual funds, net money inflows are associated with higher contemporaneous returns and subsequent return reversal ([Coval and Stafford, 2007](#)).

[Lou \(2012\)](#) shows that high-performing mutual funds tend to attract relatively higher flows, which are then reinvested by fund managers into their existing stock holdings. Similarly, mutual funds with poor performance tend to liquidate existing holdings to meet redemptions. Price pressure from the purchases of recent winners (or liquidation of recent losers) causes return continuation. The combination of performance chasing by investors and tendency by mutual fund managers to invest into existing holdings leads to a positive contemporaneous relation between stock-level fund flows and individual stock returns. In turn, this relation allows an understanding of the well-known momentum anomaly: the tendency of past winners to outperform past losers.

Taken together, these studies imply that money flows to mutual funds could have a real allocation impact at the aggregate stock market level because they exert the wrong type of price pressure on stocks that are already mispriced—the type that exacerbates cross-sectional mispricing. This could explain the persistence through time of cross-sectional predictability in stock returns, in spite of significant arbitrage trading strategies carried out by quant-oriented hedge funds over the past two decades. Motivated by the above observations, we examine the inter-temporal relation between two time series: the aggregate mutual fund flows and an aggregate measure of monthly cross-sectional equity mispricing that includes several well-known equity return anomalies. Moreover, to understand the channel through which fund flows affect cross-sectional mispricing, we examine the relation between flows and returns to each individual anomaly.

We use, as a proxy for aggregate mispricing, the metric proposed by [Stambaugh, Yu, and Yuan \(2012, forthcoming\)](#). We identify each month stocks that are most likely to be overvalued or undervalued based on 11 characteristics that are known to predict the cross section of stock returns. We then compute the return on a hedge strategy that is long undervalued stocks and short overvalued stocks. This return is a time-variant metric of the aggregate level of cross-sectional mispricing.² The strategy should produce positive returns when aggregate mispricing is being corrected and cross-sectional stock prices move toward fundamentals. By contrast, the strategy should produce negative returns when

stock prices diverge from fundamental values and cross-sectional mispricing is exacerbated.

Aggregate flows to mutual funds vary through time as a result of changing investors' sentiment and aggregate fear (see, e.g. [Ben-Rephael, Kandel, and Wohl, 2012](#) and [Ederington and Golubeva, 2011](#)) or as a result of past returns to arbitrage strategies ([Akbas, Armstrong, Sorescu, and Subrahmanyam, forthcoming](#)). We take advantage of this intertemporal variation to evaluate the impact of fund flows on the aggregate cross-sectional mispricing metric, itself time-varying. If aggregate flows to mutual funds contribute to exacerbating cross-sectional mispricing, then we would expect to see a negative contemporaneous relation between the two time series.

Our results support this hypothesis. We find that cross-sectional mispricing increases with mutual fund flows, as evidenced by a negative relation between flows and returns to the Stambaugh-Yu-Yuan mispricing metric. In subsequent tests we find that mutual fund flows do not affect the returns of the long leg. By contrast, mutual fund flows are associated with a significant price pressure in the returns of the short leg component. Because stocks in the short leg are likely to be overvalued (by construction), we conclude that mutual fund flows exacerbate cross-sectional mispricing because they are invested disproportionately into stocks that are already overvalued.

If mutual funds disproportionately purchase stocks that are already overvalued, and if the resulting price pressure further exacerbates these stocks' overvaluation, we would expect the stocks to experience a price reversal following periods of high aggregate mutual fund flows, as prices converge toward the efficient market benchmark. This would yield positive future returns to the long-short hedge strategy (which remains short these overvalued stocks). Our results support this prediction as well. Moreover, we show that this relation once again comes exclusively from overvalued stocks (or the short leg of the hedge strategy).

We next ask if any smart money is present in the market. We define smart money as aggregate fund flows that take long positions in undervalued stocks or short positions in overvalued stocks, the opposite of what mutual funds do. The smart money description does not apply only to hedge fund investors but could also apply to hedge fund managers, in which better compensation incentives, combined with the ability to take short positions, could result in smarter investment decisions. The cross-sectional mispricing that is exacerbated by mutual fund flows should create an opportunity for more sophisticated investors to enter the market and take the opposite positions. As suggested by [Jagannathan, Malakhov, and Novikov \(2010\)](#) and by [Kokkonen and Suominen \(2014\)](#), hedge funds are one such group of sophisticated investors, and we expect that the effect of aggregate hedge fund flows on mispricing will be the opposite of mutual fund flows. We find that the effect of hedge fund flows on mispricing is significantly positive. This suggests that hedge fund flows exert the right type of price pressure on mispriced stocks—the type that brings price convergence toward fundamental value and corrects cross-sectional mispricing. This conclusion is corroborated by the

² Because our focus is on identifying stocks that are the most mispriced in the cross section, we use the [Stambaugh, Yu, and Yuan \(2012,2014\)](#) measure as a proxy for cross-sectional mispricing instead of as a performance measure.

Download English Version:

<https://daneshyari.com/en/article/959575>

Download Persian Version:

<https://daneshyari.com/article/959575>

[Daneshyari.com](https://daneshyari.com)