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Do financial experts make better investment decisions? ☆

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ABSTRACT

We provide direct evidence on the effect of financial expertise on investment outcomes by analyzing private portfolios of mutual fund managers. We find no evidence that financial experts make better investment decisions than peers: they do not outperform, do not diversify their risks better, and do not exhibit lower behavioral biases. Managers do much better in stocks for which they have an information advantage over other investors, i.e., stocks that are also held by their mutual funds. More experienced managers seem to be aware of the limitations to their investment skills as they increase their holdings of mutual fund-related stocks following poor performance of their portfolios. Our results suggest that there are limits to the value added by financial expertise.

0. Introduction

The general consensus in the academic literature is that a vast majority of individual investors would be better off putting their money in an index fund.[1] Poor investment decisions by individual

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[1] For an overview of empirical findings on individual investors' behavior see, for example, Barber and Odean (2011).

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investors are often blamed on their lack of financial sophistication, defined as the ability to avoid making investment mistakes (Calvet et al., 2009). Indeed, sophistication has been related to higher stock market participation (Mankiw and Zeldes, 1991; Haliassos and Bertaut, 1995; Vissing-Joergensen, 2003; Christiansen et al., 2008; Grinblatt et al., 2011); broader portfolio diversification (Goetzmann and Kumar, 2008; Calvet et al., 2007); better performance (Seru et al., 2010; Grinblatt et al., 2012); and reduced behavioral biases (Feng and Seasholes, 2005; Calvet et al., 2009).

Investors may avoid mistakes by having high cognitive abilities and/or by having financial expertise, where the latter is defined as a comprehensive knowledge of financial markets based on prolonged experience through practice and education. While one does not preclude the other, proxies, used in the literature to identify more financially sophisticated investors, appear to be good at capturing investors' general intelligence, but do not seem to measure financial expertise well.[2]

In this paper we provide *direct* evidence on the effect of financial expertise on investment outcomes. We identify a group of individual investors who have the extensive knowledge of finance attained through prior training and day-to-day experience with financial markets: mutual fund managers.[3] We compare private investment decisions by these financial experts to those made by individual investors which are similar to them along a number of socio-economic characteristics, but presumably lack financial expertise. We observe personal portfolios of 84 mutual fund (MF) managers in Sweden, as well as the portfolios of their mutual funds and peer individual investors. We have for these managers information on their real estate, total wealth, and personal characteristics.

We find that financial experts do not exhibit superior security-picking ability in their own portfolios. Private investments of fund managers perform on par with investments of investors similar to them in terms of age, sex, education level, income, and wealth. Even more striking, mutual funds managers' investments perform more poorly than the private investments of the wealthiest 1% of investors.

Our financial experts (mutual fund managers) are likely to have superior access to information and/or analysis about certain companies gained in the course of their work. To disentangle the effect of financial expertise from that of information advantage we conduct the following robustness analysis. We reason that if a security is held by the mutual fund run by manager, *ceteris paribus* he is more likely to have information advantage in that security. To control for these information differences, we split portfolios of managers into positions that are held by the mutual fund of the manager (MF-related), and those which are not (non-MF-related) and investigate them separately.[4] We find that non-MF-related investments of managers significantly underperform their MF-related investments. This suggests that a part of overall managerial performance should be credited to access to mutual fund's resources.

Financial experts also do not appear to be better than peers at diversifying risks. Managers invest a higher percentage of their wealth in mutual funds, but hold a similar number of individual stocks and exhibit similar levels of portfolio concentration. As a result, the Sharpe ratios of their investments are similar to those of control investors.

Nor do we find evidence that financial experts are less affected by behavioral biases. There is some evidence that managers exhibit a lower (in fact, negative) disposition effect, but only in MF-related positions. They also turn over their portfolios as often as control group.

[2] Proxies of financial sophistication used in the literature include (disposable) income and wealth (Dhar and Zhu, 2006; Vissing-Joergensen, 2003; Calvet et al., 2007, 2009), portfolio diversification (Goetzmann and Kumar, 2008; Grinblatt and Keloharju, 2001), prior investment experience (Goetzmann and Kumar, 2008; Nicolosi et al., 2009; Seru et al., 2010), educational attainment (Christiansen et al., 2008; Calvet et al., 2007, 2009), investment in more complex financial instruments (Genesove and Mayer, 2001; Goetzmann and Kumar, 2008), and IQ (Grinblatt et al., 2011, 2012).

[3] We must emphasize that in this paper we consider mutual fund managers as individual investors with a high level of financial expertise and use them as a study group to investigate the relation between financial expertise and the quality of investment decisions of individual investors. Whether fund managers have skills to create value for mutual fund investors is intentionally left outside of our analysis as well as any cross-sectional performance variation within the manager group.

[4] It is subject to a debate whether financial expertise is defined only by the knowledge of financial markets or it also involves access to information that is not available to general public. By analyzing overall private portfolios of fund managers and sub-portfolios of their non-MF-related positions we provide evidence on the quality of experts' decisions which is consistent with both interpretations.