Available online at www.sciencedirect.com
ScienceDirect
Pacific-Basin Finance Journal 15 (2007) 494–513
PACIFIC-BASIN FINANCE JOURNAL
www.elsevier.com/locate/pacfin

How smart is money? An investigation into investor behaviour in the Australian managed fund industry

Philip Gharghori [a], Shifali Mudumba [b], Madhu Veeraraghavan [c,*]

[a] *Department of Accounting and Finance, Monash University, Clayton Campus, Victoria 3800, Melbourne, Australia*
[b] *Strategy and Marketing Group, ANZ Banking Group Limited, Level 16, 100 Queen Street, VIC 3000, Melbourne, Australia*
[c] *Department of Accounting and Finance, Monash University, Clayton Campus and Centre Associate, Melbourne Centre for Financial Studies, Melbourne, Australia*

Received 3 May 2006; accepted 30 October 2006
Available online 23 January 2007

Abstract

Gruber [Gruber, M., 1996. Another puzzle: the growth in actively managed mutual funds. Journal of Finance 51, 783–810] and Zheng [Zheng, L., 1999. Is money smart? A study of mutual fund investors' fund selection ability. Journal of Finance 54, 901–933] document that managed fund investors demonstrate fund selection ability as they invest in funds whose subsequent performance is greater than that of funds from which they divest. This phenomenon has been since been termed the 'smart money effect'. In contrast, Sapp and Tiwari [Sapp, T., Tiwari, A., 2004. Does stock return momentum explain the 'smart money' effect? Journal of Finance 59, 2605–2622] find that after controlling for stock return momentum, there is no evidence of a smart money effect. In this paper, we investigate whether a smart money effect exists in the Australian managed funds industry. The key findings of our paper are that there is a smart money effect in Australia and that stock return momentum does not explain this effect. We also find that the effect is not conditional on fund size. Our cross-sectional analysis indicates that investors are chasing funds that have performed well in the past and that cash flows to funds are persistent. However, we do not find any evidence that investors are pursuing funds that employ momentum trading strategies.

JEL classification: G10; G11; G15
Keywords: Smart money; Fund performance; Australian managed funds

* Corresponding author. Department of Accounting and Finance, Faculty of Business and Economics, PO Box 11E, Monash University, VIC 3800 Australia. Tel.: +61 3 9905 2432; fax: +61 3 9905 5475.
E-mail address: Madhu.Veeraraghavan@buseco.monash.edu.au (M. Veeraraghavan).

0927-538X/$ - see front matter © 2007 Elsevier B.V. All rights reserved.
doi:10.1016/j.pacfin.2006.10.002

1. Introduction

The exceptional growth of the managed funds industry over the past two decades has led to extensive research in the area. Preliminary studies focused on whether fund managers have superior skills that enable them to beat the market. A large amount of research has also centred on the concept of 'performance persistence', in which past fund performance reflects future performance.[1] More recently, the focus of research has shifted to studying investor behaviour and cash flows to funds.

The seminal paper on the relationship between fund performance and cash flows to funds is Gruber (1996). Gruber poses the mutual fund puzzle: Why are actively managed mutual funds in the US growing at such a fast pace compared with index funds when their performance, on average, has been inferior? Gruber investigates the performance of funds that receive new cash flows to identify whether managed fund investors are smart. He contends that sophisticated investors should be able to identify funds that are top performers by following signals in past performance that are likely to reflect future performance. He claims to have solved the puzzle: the cash flows in and out of funds closely follow the predictors of future performance, and the returns on funds with net cash inflows are higher than the average return for all funds.

In a similar vein, Zheng (1999) investigates investors' ability to select funds. Zheng coins the term 'smart money', which refers to the money which sophisticated investors direct into funds that subsequently perform well. Zheng's results are consistent with the smart money effect observed by Gruber, so Zheng concludes that investors have the ability to identify funds whose future performance will be superior. Zheng also finds that funds which receive net cash inflows outperform funds with net cash outflows. In particular, she finds that small funds with net cash inflows significantly beat the market, indicating that the smart money effect is influenced by fund size.

There are two competing explanations proposed for the smart money effect. Gruber (1996) and Zheng (1999) argue that sophisticated investors can identify funds which subsequently perform well, and invest accordingly. Sapp and Tiwari (2004), on the other hand, contend that the smart money effect is driven by stock return momentum.[2] They claim that the effect observed by Gruber (1996) and Zheng (1999) occurs because they are not controlling for return momentum in their performance tests. Sapp and Tiwari's findings support this claim, as a smart money effect is observed when the Fama and French (1993) model is applied, but when the performance of new portfolios is assessed using the Carhart (1997) model, the smart money effect disappears.[3] They also analyse the determinants of fund flows and conclude that investors are chasing funds that have performed well in the past rather than investing in funds that are known to pursue momentum trading strategies.

There is only one paper, to our knowledge, which examines the smart money effect in Australia, Sawicki and Finn (2002). They examine the performance–flow relationship by regressing cash flows into funds on variables that measure fund performance, size, age, and their

[1] See Brown and Goetzman (1995) and Hendricks et al. (1993).

[2] Stock return momentum, which refers to short-term persistence in stock returns, was first documented by Jegadeesh and Titman (1993). Additionally, Carhart (1997) shows that a momentum factor, constructed using the mimicking portfolio approach, is significant in explaining cross-sectional variation in stock returns and that persistence in fund returns is due to the momentum effect.

[3] The Carhart (1997) model is a four-factor asset pricing model formed by augmenting the Fama–French model with a momentum factor.