

'Smart Money' Identifies Superior Mutual Funds

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A new study published in *The Journal of Finance* explores the economic significance of “smart money” in the U.S. and U.K. mutual fund marketplaces.

The “Smart Money” hypothesis states that investor money is “smart” enough to flow to funds that will outperform in the future, and that investors have genuine fund selection ability. The current study employs a British data set of monthly fund information differentiated between individual and institutional investors.

Research by Aneel Keswani at the Cass Business School in London, England, and David Stolin at the Toulouse Business School in Toulouse, France, documented a smart money effect in the United Kingdom using monthly data available from 1991 to 2000. Inflows, not outflows, gave rise to the smart money effect in the U.K.

The study also illustrates that money is comparably smart in the United States. In studying the role of data frequency for the U.S., researchers were able to estimate monthly money flows during the same time period as in the U.K. analysis. Overall, U.S. results were quite similar to those for the United Kingdom. U.S. and U.K. funds both exhibited a link between money flow and future performance.

The study shows that within the realm of actively managed funds, investors consistently find funds that will perform better than average in the future.

“In recent years, legislators around the world have been considering whether investors should be protected from hurting themselves with poor mutual fund investment decisions,” the authors conclude. “Underlying such initiatives appears to be the assumption that investors are unlikely to make good mutual fund decisions on their own. Our empirical findings contradict this assumption.”

Source: Blackwell Publishing

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