PhD Thesis

Chasing stock market returns.

Mutual funds extrapolative flow, performance and asset pricing implications

Keywords: mutual funds, extrapolation, market-timing

Alberto Cagnazzo

PhD in Economics

XXVIII Cycle

Department of Economics and Finance

LUISS Guido Carli

Supervisor: Prof. Nicola Borri

Roma, May 2017

Committee:

Prof. Nicola Borri, LUISS Guido Carli

Prof. Bruno S. Sergi, Harvard University

Prof. Domenico Curcio, LUISS Guido Carli

Date of defense:

May 30^{th}, 2017

Abstract

Survey evidence shows that investor expectations on future market realizations are highly correlated with inflows into mutual funds and tend to extrapolate information from past returns. This work investigates cyclical determinants of net aggregate fund flows in Emerging Markets, it measures the profitability of market-timing strategies of Italian investors in equity mutual funds and provides first insights about the effects of these strategies on asset prices.

Chapter 2 investigates how cyclical variables drive net aggregate fund flows towards Emerging Markets (EMs). Through the aggregation of net flows of all open-end dedicated funds, the analysis finds that flows in equity and fixed income are driven by recent past performance in both developed and emerging economies. Further analysis confirms that much of the evidence comes from US and EU larger mutual funds. A structural VAR shows that flows become more responsive through time to market uncertainty and rates. In particular, after the Great Recession flows exhibit a lower reaction to the S&P index, becoming more responsive to market volatility and to US interest rates. Furthermore the US consumer sentiment index has a key role in the explanation of fund flows and it increased through time with an effect that is more sluggish and persistent with respect to other cyclical determinants.

Chapter 3 shows that simple buy-and-hold strategies beat the market-timing strategies effectively used by Italian investors in equity mutual funds. Therefore, investors should reconsider their investment behavior and choose cheaper, in terms of fees, and simpler, passive strategies. The analysis estimates returns from market-timing strategies using aggregate data on a large sample of equity mutual funds' net flows and considers funds investing either in Europe and the Euro Area, or the US, or Emerging Markets. In all cases, buy-and-hold wins with extra returns that go from 0.24% per quarter (Europe and Euro Area) to 0.87% per quarter (US market). Differences in the performance of the two strategies are not explained by differences in risk and risk exposure.

Chapter 4 presents future research developing a discrete asset pricing model with het-

erogeneous agents. Some of them, called chasers, develop their demand of the risky asset relying on extrapolative subjective beliefs, in equilibrium this has effects on the asset price.