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ARTICLE

Mutual Fund Performance and the Incentive to Generate Alpha

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ABSTRACT

To rationalize the well-known underperformance of the average actively managed mutual fund, we exploit the fact that retail funds in different market segments compete for different types of investors. Within the segment of funds marketed directly to retail investors, we show that flows chase risk-adjusted returns, and that funds respond by investing more in active management. Importantly, within this direct-sold segment, we find no evidence that actively managed funds underperform index funds. In contrast, we show that actively managed funds sold through brokers face a weaker incentive to generate alpha and significantly underperform index funds.

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