

The Price of Skill:

Performance Evaluation by Households

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ABSTRACT

Skilled investors make money off uninformed investors. By acting as intermediaries, they provide a hedge to the uninformed investors themselves. I present a model in which households have imperfect information about expected returns. Non-traded income shocks lead them to rebalance, sometimes at the wrong time. Active funds hedge this risk by trading on superior information. In equilibrium, they pay off when non-traded income disappoints, earning a premium that makes them appear to underperform index funds after fees. Empirical results using aggregate fund flows support the model. A corresponding asset pricing test can account for the apparent under-performance of active funds.

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Keywords: Mutual fund performance, active funds, index funds, fund flows.

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