

The relative impact of different classification schemes on mutual fund flows

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Abstract

Investors often choose between mutual funds on the basis of their relative performance with respect to some category that is widely publicized in the media. Yet, little is known about the relative impact of different classification schemes on fund flows. In this paper, I examine the relationship between flows to US mutual funds and their performance rankings within three types of categories: funds with the same stated objective, funds with the same Morningstar style, and funds within the same asset class. I find that the asset class ranking appears to be the most important relative performance measure for private investors of domestic stock funds as well as investors of taxable and municipal bond funds. Institutional investors of domestic stock funds attach approximately equal weights to the Morningstar style and stated objective rankings, while in the international stock class the flow-performance sensitivity is the highest for the stated objective ranking. In a joint model of ordinal and cardinal performance measures, the impact of raw returns on fund flows never exceeds the combined impact of performance rankings. The observed investor behavior creates adverse incentives for fund managers to maximize their category rankings rather than risk-adjusted performance.

Keywords: flow-performance relationship, fund classification, category rankings.

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