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Mutual Fund Alpha: Is It Managerial or Emotional?

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Abstract

This paper presents an examination on the impact of investor sentiment on mutual fund alpha. Using the Baker and Wurgler index, I find that investor sentiment plays an important role in explaining fund alpha, and the outperforming probability of funds rises as investor sentiment rises. Also, benchmark models adjusted by investor sentiment level can better explain the occurrence of fund alpha. This finding is confirmed by the cumulative distribution function (CDF) of the t values of the alpha estimates. Thus, the complete story of mutual fund alpha would be incomplete without incorporating investor sentiment.

Keywords:

Fund alpha | Investor sentiment | Outperforming probability | BW index

Notes

1 Mutual fund alpha is often used to measure manager skills. In academia, the literature with documented alphas is abundant. Many researchers have documented alpha in their studies, such as Ibbotson and Patel (2002), Avramov and Wermers (2006), Fama and French (2010), and Berk and Van Binsbergen (2015). Alpha is also used as one of the benchmarks to rank mutual funds in the industry.

2 Indro (2004) used sentiment indicators from the American Association of Individual Investors and Investors Intelligence.

3 Fund alpha is measured by a model's intercept term.

4 The BW index is multiplied by 5 to facilitate the comparison in Figure 1.

5 Brown and Cliff (2004) examined the relationship between investor sentiment and near-term stock returns. They found that sentiment measures differ from each other, though they are related to varying degrees. More research is needed on this topic.

6 The inclusion of an optional parameter could increase the variance of the parameter estimates and introduce bias into them.

7 The unreported test results indicate that the corrections between the BW index and the profitability factor, as well as the investment factor, are statistically significant.

8 The CDF gives the area under the curve of the PDF at and to the left of the given t value. The total area under the PDF is 1, and the maximum value for the CDF is 1.

9 The outperforming probability refers to the probability of earning positive alpha statistically significant at a 5% level.

10 I got similar results using other benchmark models.

11 This finding is consistent with the unreported results based on benchmark models adjusted by the BW index.

12 According to Bu (2019), the AAII bearish index can significantly reduce funds' underperforming probability, with a drop from 7.69% to 2.86% based on the Fama-French 3-factor model.

13 I use CAPM as the benchmark model.

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