“Does herding behavior reveal skill? An analysis of mutual fund performance”

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Abstract:
This paper finds that fund herding, defined as the tendency of a mutual fund to follow past aggregate institutional trades, is an important predictor of mutual fund performance. Examining actively managed U.S. equity mutual funds over the period 1990-2009, we find that funds with a higher herding tendency achieve lower future returns. The performance gap between herding and antiherding funds is persistent over various horizons and is more pronounced in periods of greater investment opportunities in the active management industry. We show that fund herding is negatively correlated with recently developed measures of mutual fund skill and provides distinct information for the predictability of mutual fund performance. Overall, our results suggest that fund herding reveals information about the cross-sectional distribution of skill in the mutual fund industry.