

OVERRATED AT SCALE:

Analyst Expectations and Capital Allocation in Active Management

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Abstract

We recover the expected net-of-fee abnormal returns (alphas) behind Morningstar analysts' ratings of active mutual funds. Analyst alphas rise with fund size while realized alphas do not, so forecast errors fall with size: analysts are too pessimistic about the smallest funds and too optimistic about the largest, as if they underestimate decreasing returns to scale.

Ratings attract flows, so the bias steers too much capital to large funds. In an estimated model of learning about managerial skill and costly investor search, correcting the bias shifts capital from large to small funds and toward passive funds, raising the value-weighted net alpha of active funds by 10 basis points, approximately 20 percent of the industry's underperformance.