Adverse Selection in Mutual Funds

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Mutual funds broadly generate value either using picking (stock selection) strategy or timing (market forecasting) strategy. We find a strong evidence of pickers outperforming timers in terms of value. We provide a simple explanation through adverse selection story. A fund manager is better able to signal his skill through picking as he can invest in multiple independent bets which provides large independent signals to investors about the hidden skill of the manager. As against this, a timer is constrained in that he can signal his skill only through one broad market. We solve for a mixed strategy equilibrium where all the High skilled managers Pick while Low skilled managers Pick with low probability. We test various implications arising from the model in the data. Funds adding maximum value over a long term are more likely to be pickers. Pickers dominate timers. Cross sectional dispersion of value is higher for pickers given that population of pickers is more heterogeneous in terms of skill. Flows are higher and more sensitive for pickers than timers.