Capital Idea #38

How trading more can lead to higher returns

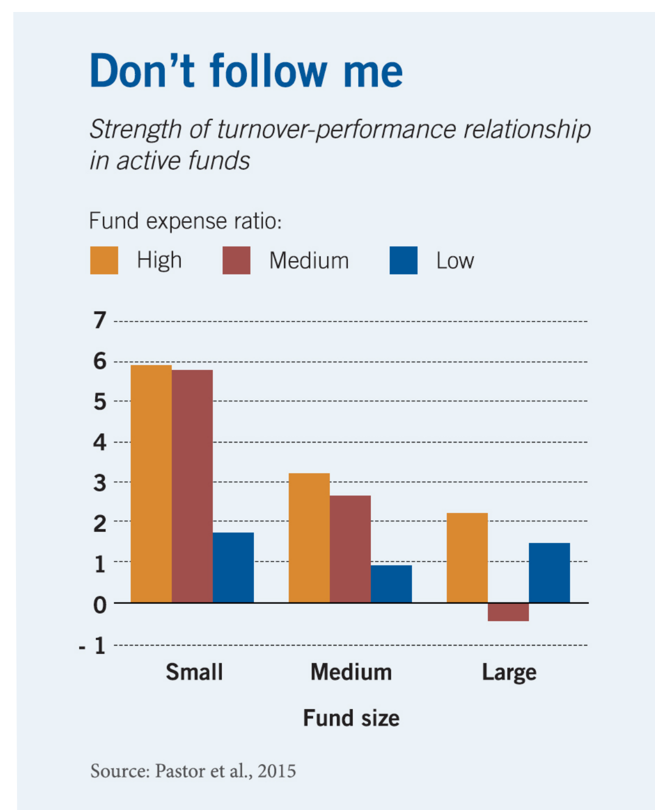
Active managers, particularly those running smaller or high-fee funds, are skilled at exploiting profit opportunities

- Actively managed funds hold the lion's share of money invested in US equity mutual funds. They charge higher fees than passive funds, but research by Chicago Booth's **Lubos Pastor** and the Wharton School's Robert F. Stambaugh and Lucian A. Taylor suggests funds that charge more—particularly smaller funds—also earn higher returns from trading more.

- The researchers—who studied a sample of 3,126 active US equity mutual funds from 1979 through 2011—find that when active portfolio managers trade more than usual in a given year, exceeding the fund's average level of trading, they generate higher returns the following year.

- The connection between trading turnover and future fund performance is stronger for both smaller and high-fee funds (see chart). Managers of these funds tend to be more skilled at recognizing market inefficiencies and trading on them. Smaller funds specifically can more easily increase their trading without moving prices.

- Trading more is better, but only if the rest of the market doesn't move at the same time. Prices move when large numbers of active funds chase the same opportunities simultaneously—at which point the positive relationship between trading turnover and future returns weakens.



Funds that charge more—particularly smaller funds—earn higher returns from trading more.

Lubos Pastor, Robert F. Stambaugh, and Lucian A. Taylor,
"Do Funds Make More When They Trade More?"
Working paper, February 2015.

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