Alpha and Performance Measurement: The Effects of Investor Disagreement and Heterogeneity

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ABSTRACT

The literature has not established that a positive alpha, as traditionally measured, means that an investor would want to buy a fund. When alpha is defined using the client's utility function, a positive alpha generally means the client would want to buy. When markets are incomplete, investors will disagree about the attractiveness of a fund. We provide bounds on the expected disagreement with a traditional alpha and study the cross-sectional relation of disagreement and investor heterogeneity with the flow response to past fund alphas. The effects are both economically and statistically significant.

Finance researchers have an easy familiarity with alpha, the most well-known measure of an investment’s abnormal return. Studies refer to Capital Asset Pricing Model (CAPM) alpha, three-factor alpha, or four-factor alpha, assuming that the reader hardly requires a definition. Investment practitioners discuss their strategies in terms of the quest for alpha. Alpha can be active, conditional, or portable. The number of investment firms with alpha in their names is staggering.

Despite this apparent familiarity with alpha, the current literature too often fails to think rigorously about how alphas can be interpreted. In this paper, we make three contributions to the literature. First, we offer extensions of existing results that motivate alpha as a guide to investment selection. Given

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