

For Mutual Funds, Competition Doesn't Mean Lower Fees

Competition is usually associated with lower prices. The exact opposite pattern is occurring within the mutual fund industry. Expense ratios for U.S. domestic equity funds operating in more competitive market segments “charge significantly higher annual expense ratios than funds operating in less competitive market segments.”

Among the better-known measures of cost is the expense ratio. The expense ratio is the management fee that fund providers charge to operate each fund. This fee rises with the competition, the opposite trend of what one would expect.

The study's authors found that expense ratios tend to be inelastic. In competitive segments, performance-sensitive investors pull out of or avoid underperforming funds, leaving only investors who are generally insensitive to performance as shareholders of such funds. This allows funds to increase their management fees with little concern of incurring outflows. In other words, the performance-insensitive investors don't shift their dollars elsewhere in the face of higher fees.

At the same time, higher fees do not attract more competition. An analysis of untabulated results found high-fee segments experience no faster growth in the number of funds within them than low-fee segments do. This may suggest the existence of barriers to entry. At the same time, when new funds enter a segment, competition within the segment does not necessarily increase.

The analysis found other notable trends in fund fees. Lower fees tended to be found most frequently among younger funds and larger funds. Funds with more volatile returns and higher levels of turnover have higher fees. Fund fees tend to be sticky, meaning they don't change much. The study's authors attribute this either to the existence of long-term strategies used for setting fees or to the potential costs of changing the fee structure.

This analysis was done on a sample of domestic equity funds over the period of 2000 through 2015. Funds were grouped by the Lipper Classifications. Competition was measured by using the inverse of the Herfindhal-Hirschman index. This index is typically used to measure concentration within an industry; the inverse of the ratio indicates less concentration and thereby competition.

Source: “**Price Competition in the Mutual Fund Industry**,” Sitikantha Parida and Zhenyang Tang; *Economic Modelling*, 2017.