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Large mutual fund families: Bigger may not always be better

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LARGE MUTUAL FUND FAMILIES: BIGGER MAY NOT ALWAYS BE BETTER

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Size is not everything but it may be intuitive for the novice investor to place his money in a mutual fund from large fund families thinking that it will outperform the smaller ones.

Many large fund families, after all, have the fire power to spend on promotion and tend to receive more coverage in the media as they hold more investors, creating an impression that they are the guys to go to.

But over the past decade, various regulatory changes have been made to the mutual fund industry, changing the rules of the game. Does it still hold that a larger fund family size will perform better?

According to Cho Young Jun, an assistant professor at SMU's School of Accountancy, the advantage of being big is now “significantly weaker”.

Using a sample of mutual funds from the Center for Research in Security Prices’ Mutual Fund Database, Cho’s research paper “Mutual Fund Family Size and Mutual Fund Performance: The Role of Regulatory Changes” examines if the positive association between fund family size and fund performance is affected by significant regulatory changes in the last decade.

The explosive growth of the mutual fund industry in the US – the industry was worth $10 trillion in 2009 - has caused the performance of mutual funds to come under great scrutiny. Major regulatory changes including the Regulation Fair Disclosure (Reg FD),Global Settlement, and increased scrutiny resulting from the marketing timing and late trading scandals have since affected the industry.

Cho, who worked with two other academics on the paper, argues that these changes have had a greater effect on larger fund families and affected the ability of larger fund families to outperform their smaller peers.

The cowboy days before regulation

The Reg FD, implemented in 2000 and the first of various regulatory changes to affect the mutual fund industry, seeks to limit the selective disclosure of information by companies to analysts and institutional investors. This was to allay concerns that analysts and institutions enjoyed and profited from privileged access to companies.

Besides the analysts, mutual funds also enjoyed selective access to information prior to Reg FD. This access was likely to be more pronounced for funds belonging to large fund families whose members might be significant existing or potential investors with enough clout to command preferential treatment, the authors explained.

In addition, sell-side analysts gave preferential treatment to funds belonging to large fund families because their reports, with a larger audience, increases the potential for commissions.

This selective disclosure advantage suggests that, after controlling for fund size, funds belonging to large fund families should have higher returns, the authors said.

But the advantage was affected by Reg FD's reduction of direct flow of information from companies to funds and from companies to analysts. This, in turn, affects the quality of information flow from analysts to funds.

The implication is that the higher fund returns attributable to larger fund family membership should decrease after Reg FD was implemented, they wrote.

A second regulatory change was the Global Settlement in April 2003 which ordered investment banks to separate their research and investment banking departments, stopping the flow of information between the two groups so as to prevent any conflict of interest. One of the changes include prohibiting investment banking personnel from directing research personnel to engage in marketing or selling efforts to investors with respect to an investment banking transaction.

The regulatory change could mean lower compensation and greater legal oversight of the analysts, pointing to an "adverse impact" on the quality of research, said the authors who added that they expected a decline in larger fund families' performance to the extent which the fund families relied on sell-side research from large investments banks.

The third change in regulatory scrutiny was the restriction of late trading and market timing practices by fund families after trading scandals broke out in the US in September 2003.

About 24 large fund families were found to have allowed some customers to trade their funds after the 4pm market close or allowing select clients to trade more often in their funds.

The regulatory action limiting these practices could affect fund performance as fund families likely provided these opportunities due to the revenue received from the select clients, the paper suggested.

What the numbers say

To analyse the effects of the regulatory shifts, the authors divided sample periods of their mutual funds data into pre- and post-Reg FD periods.

Their data analysis reflected that fund family size is no longer associated with fund performance after Reg FD was introduced. They also used another approach to examine the family size advantage by using mutual fund holdings data from Thomson Financial to see if fund family size is related to a fund's stock-picking ability.

It was observed that funds belonging to larger fund families displayed greater stock-picking ability. But in the post-Reg FD days, the fund family size is no longer associated with stock-picking ability, providing further evidence in support of a decline in the ability of large fund families to outperform after the regulatory changes, the authors said.

“One argument suggests that since mutual funds and analysts enjoyed an information advantage through selective disclosure of information by firms, regulators chose to restrict this flow though the enactment of the Reg FD.”

They added: “Our findings support the information advantage explanation (of why larger fund families seem to do better) and reduces the likelihood of alternative explanations such as greater analytical skill and cost economies of scale.”

They also found that in the two years before Reg FD, trades by larger fund families are more positively associated with forecast revisions made by analysts from large investment banks than trades by smaller fund families. This effect disappeared in the two-year period after the Global Settlement.

“These results suggest that Reg FD and the Global Settlement jointly have a significant adverse effect on large fund family trades based on analyst information from large investment banks,” said the authors.

Is bigger always better?

With the regulatory changes in the past decade that has had “significant implications” for the mutual fund industry; the authors said the research paper “contributes to the literature on mutual fund performance and the effects of recent regulatory changes”.

They said the research “documents that the advantage of fund family size on fund performance has waned in recent years” and the change coincides with the introduction of the regulatory changes.

In addition, the paper also offers evidence that the "information advantage in the earlier period manifested itself in the ability of funds to forecast correctly and buy (sell) stocks with positive (negative) returns around the future earnings announcement date”.

The authors added that the research also lends support to Reg FD as a significant event that caused a decline in the ability of large fund families to perform. This is consistent with what is understood between the performance of large fund families and the extent of selective information flow.

On the paper’s final point of examining the role of large investment banks in providing an advantage to large fund families, the authors found that family size was positively associated with the extent to which funds traded in the same direction as forecast revisions by analysts from large investment banks in the period prior to the regulations.

This association declined significantly after the new regulations, calling into question "the performance benefits of fund family size (although other benefits, such as lower bankruptcy risk, better marketing of products and education of clients, could still justify the usefulness of large funds).”

But an investor may not have to rule out investing in mutual funds in large fund families. “Large fund families have other significant benefits that could still justify their usefulness including lower bankruptcy risk, better marketing of their products, education of clients and the ability to service and maintain retirement accounts of employees of large institutions,” they concluded.