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Competition in Investment Products

ACADEMIC PERSPECTIVE

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A central belief of the market system is that competition improves outcomes for citizens. In an ideal and perfectly competitive market, (a) consumers have lots of choices and (b) products are competitively priced (at marginal cost), earning fair but not excessive profits for producers. When a consumer goes to the grocery store to buy cereal, she has an aisle full of choices competitively priced to reflect the product's attributes, with razor-thin margins for the producer. Is the market for investment products equally competitive?

Yale University Chief Investment Officer David Swensen, for example, has expressed concerns regarding the lack of competition and the late John Bogle warned of the concentration of assets in the "Big Three"— Vanguard, State Street and BlackRock—contending he did not "believe such a concentration would serve the national interest."[1] And in a 2010 landmark case before the U.S. Supreme Court, plaintiff investors argued that excessive advisor fees violated Section 36(b) of the Investment Company Act of 1940 (*Jones v. Harris Associates, L.P.*).[2]

An evidence-based view of competition is informative for both advisors and investors. One way to think about competition is to assess whether investors have adequate choices. A recent study from BlackRock's Ananth Madhavan, Aleksander Sobczyk and Andrew Ang points out that there are more equity mutual funds and exchange-traded funds (ETFs) than individual stocks.[3] This alone suggests investors have a plethora of choices and the market is competitive. But caution and care are warranted because not all choices are independent. If the grocery store stocks 40 different types of cereal produced by three firms, then the market is less competitive than one might think. Similarly, if the Big Three dominate investment vehicles, then the mere presence of choices does not necessarily imply that prices are competitive.

THE PRODUCT AND COMPETITION

The first step to understanding competition in investment products is to recognize exactly what the product is. A fund's portfolio is the product delivered to investors, the equivalent of the cereal box. The portfolio holdings are the key inputs (corn, wheat, sugar, etc.), and the set of returns delivered to investors represent the nutritional value of the cereal (vitamins, carbohydrates, protein, etc.). The price of that product is the fees charged to investors. In a competitive marketplace, we want to see (a) free entry so that new entrants can create products and provide more choices and (b) that entry affects the prices charged by incumbents.

It is easy to see that entry into the marketplace is relatively free. Although complex, it is not difficult for an organization to launch a mutual fund or an ETF. Understanding whether entry affects prices is a bit more complicated. In research that Albert Wang and I published, we studied the effects of the entry of a new mutual fund on incumbent funds.[4] Identifying an incumbent fund is tricky, so consider a simple analogy. When a new baseball team enters a metropolitan market, who does it compete with? Does it compete with the incumbent baseball team, all sports teams or all entertainment options for consumers? The answer is not obvious.

The solution that we employ to identify a fund's competitors is strikingly simple: Rather than look at the product itself, we look at the similarity of the product's inputs. In other words, funds that have higher overlaps in their holdings are more likely to be competitors. Returning to the cereal analogy, Kellogg's Frosted Flakes® is a bigger competitor to Kellogg's Corn Flakes® than to granola because the inputs are more similar. Armed with this measure of overlap, we ask what happens when a new fund enters the marketplace. The answer is that incumbent funds drop their prices (i.e., management fees) and have reduced flows. The former is price competition and the latter is quantity competition. Of course, one could also define competitor funds based on investment style. That is exactly what Hoberg, Kumar and Prabhala do in follow-up work, finding that competition reduces the original advantages that a fund may have relative to others.[5] The bottom line is that competition is a beautiful thing and works to investors' advantage.

IMPLICATIONS FOR INVESTORS

What does this mean for advisors and investors? As with any consumer product, it pays to pay attention to product quality and fees. Effective entrants reduce prices for investors because their new cost structures allow them to trim fees while providing similar or better quality products. Investors are better off. For investors, or advisors acting as fiduciaries, it is important to understand that not all products are created equal. Hortaçsu and Syverson (2004) and Elton, Gruber and Busse (2004) show that even for something as seemingly generic as an S&P 500® Index fund, there is large variation in attributes, fees and performance.[6] It is therefore important to pay attention to how products are built and their attributes, not just their fees. In the cereal analogy—read the packaging, understand the contents and look at the price.

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Sunil Wahal, Ph.D., is the Jack D. Furst Professor of Finance and Director of the Center for Investment Engineering at the W.P. Carey School of Business, Arizona State University. Before joining the ASU faculty in 2005, Dr. Wahal served on the faculty at Emory University and Purdue University.

His research focuses on short- and long-horizon investment strategies (momentum, profitability and others), trading issues (trading algorithm design, trading costs and high-frequency trading), and delegated portfolio management and asset allocation for large institutional investors. His work covers public equities, fixed income and private equity. He has published extensively in *The Journal of Finance, Journal of Financial Economics, The Review of Financial Studies* and numerous other journals.

He serves as a consultant to Avantis Investors and was previously a consultant to Dimensional Fund Advisors (2005-2019) and AJO Partners. He sits on the investment committees of several registered investment advisors. He is also a regular speaker at academic and practitioner conferences and has given numerous presentations to sovereign wealth funds, endowments, foundations, family offices, defined-benefit plans, defined-contribution plans, and registered investment advisors.

Endnotes

[1] Swensen, David F. 2005. "Unconventional Success: A Fundamental Approach to Personal Investment." 221-222. New York: Simon & Schuster, Inc.

[2] The Supreme Court, ruling unanimously, upheld the *Gartenberg* standard under which Section 36(b) is violated only when advisers' fees are so disproportionately large that they bear no reasonable relationship to the services rendered.

[3] Madhavan, Ananth, Aleksander Sobczyk, Andrew Ang. "What Happens with More Funds than Stocks?" (October 7, 2019). Available at SSRN: https://ssrn.com/abstract=3465888.

[4] Wahal, Sunil, and Albert Wang. 2011. "Competition Among Mutual Funds," *Journal of Financial Economics* 99: 40-59.

[5] Hoberg, Gerard, Nitin Kumar, and Nagpurnanand Prabhala. 2018. "Mutual Fund Competition, Managerial Skill, and Alpha Persistence." *The Review of Financial Studies* 31: 1896-1929.

[6] Hortaçsu, Ali, and Chad Syverson. 2004. "Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds." *The Quarterly Journal of Economics* 119: 403-456.
Elton, Edwin J., Martin J. Gruber, and Jeffrey A. Busse. 2004. "Are Investors Rational? Choices Among Index Funds." *The Journal of Finance* 52: 261-288.