Financial Services

Perspectives and Challenges

Edited by Samuel L. Hayes, III

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CHAPTER 7

COMPETITION AND CHANGE IN THE MUTUAL FUND INDUSTRY

Erik R. Sirri and Peter Tufano

Introduction

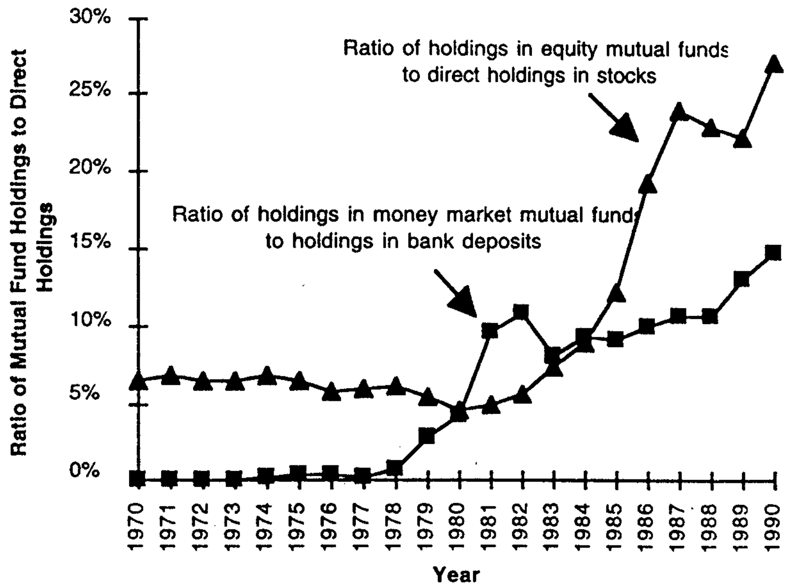
During the past two decades, mutual funds have become an important investment vehicle for individuals. In 1970, the U.S. mutual fund industry managed assets of roughly $50 billion, but by 1990 this figure had grown to $1.1 trillion, a twentyfold increase.[1] By any measure, mutual funds have become a major force in the United States and global financial economies.[2] As an example, Figure 7-1 shows that in the United States, money market funds have captured a material share of the deposit market, and equity mutual funds have grown large relative to households' direct holdings of common stock. The growth took place as literally thousands of funds, offered by hundreds of different firms, competed among one another and against all of the other investments available to consumers.

This chapter examines the ways in which funds have competed in the past and how competition is likely to change in the future. In particular, we describe a variety of strategies that funds have employed in their battle for consumers' monies, and we comment on the apparent effectiveness of the strategies. We also identify the effects of these competitive strategies on the structure of the industry. Finally, we discuss possible scenarios for competition in the future, not only narrowly within the mutual fund industry but also broadly within the entire financial services sector.

1. Investment Company Institute (ICI), *Mutual Fund Fact Book* (Washington, D.C.: ICI, 1991), p. 74.
2. It is interesting to note that 1991 was the first year in which total net assets of mutual funds owned and operated outside the United States exceeded those of U.S.-operated funds. See ICI, 1991, p. 57.

Figure 7-1

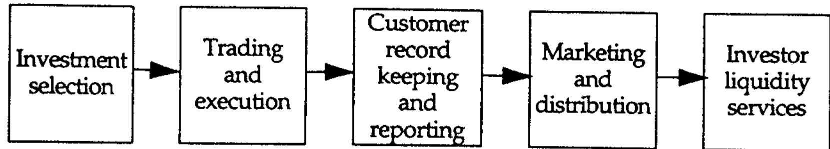
Consumer holdings of mutual funds relative to their direct alternatives. Each series represents the ratio of the household sector's holdings of mutual funds compared to their holdings of non-mutual fund substitutes.



Source: Federal Reserve Board Flow of Funds data.

At one level, mutual funds are simple and transparent financial intermediaries. Participants pool their resources, each owning a share in the pool, and empower a management company to make investment decisions within broad guidelines. Though simple in concept, mutual funds as configured in practice are complex, even from the perspective of a reasonably sophisticated investor. The Investment Company Institute has classified more than 21 types of funds offered by mutual fund families; they range from growth funds to precious metals funds to single-state municipal bond funds. Funds are promoted through advertisements, direct mailings, dedicated sales forces, telephone solicitation, and defined-contribution pension plans. A variety of fee structures are used to charge customers for fund services. Finally, even after the fact, measuring how well a fund has performed may seem to many consumers a mystical science.

Figure 7-2
Elements of the Value Chain for a Mutual Fund



Part of the confusion the mutual fund consumer faces is the result of funds' efforts to differentiate themselves from one another. In its basic form, a mutual fund has characteristics of a commodity product; within regulatory bounds, almost any financial services firm can aggregate a group of traded securities and sell shares in the pool. If the product is marketed as a commodity, funds must compete on the basis of price. If it is marketed as a differentiated product, however, price competition tends to be less severe. As a result, most funds attempt to differentiate themselves on the basis of non-price factors.

We begin by discussing two frameworks through which to view the mutual fund industry. One divides the industry into a set of activities, whereas the other reduces it to the economic functions it serves. The two views provide structures to organize our thoughts about how funds can and do compete and about where future threats and opportunities lie.

Two Definitions of Mutual Funds

An Institutional, or Activity-Based, View

As a business organization, a mutual fund management company or fund complex (firm) undertakes a series of activities designed to generate value for its customers. By arraying a firm's strategically important activities, one can construct a firm's value chain representation. This analytic tool has been advanced by Michael Porter.[3] In grouping a firm's activities the analyst must consider the manner in which the economics of various activities differ and how rivals distinguish themselves on the basis of these activities. We identify five links in the value chain for a typical mutual fund, as shown in Figure 7-2.

The first activity is the *investment selection*. Mutual funds implement their investment strategy through their selection of security holdings.

3. Michael E. Porter, *Competitive Advantage* (New York: The Free Press, 1985).

Funds vary in the amount of latitude they grant to portfolio managers. Investments may be dictated completely by fund charter, as is done in an S&P 500 index fund, or security selection may be left completely to the fund manager's discretion, as in a growth fund. To support this function, funds require research which may be conducted in-house or purchased from vendors either with cash or with soft-dollar payment from brokers.

The next activity is *trading and execution*. Once the decision has been made to buy or sell a particular security, a trade must be executed in the capital markets. This process involves not only getting the best price for the security, but also administering back-office functions such as custodial services. Though this particular link in the chain may seem minor at first glance, trading and execution expertise are increasingly being recognized as critical activities. For instance, for index products in which a performance benchmark is perfectly observable, mutual funds will try to minimize the drag on fund performance caused by positive cash balances through use of futures contracts, thereby obtaining portfolio returns that closely match the benchmark's value.

The third item in the chain is *customer record keeping and reporting*. This refers to the tasks performed by transfer agents and to the activities and resources required to produce periodic statements for fund shareholders. Like trading and execution, they are what Porter refers to as indirect activities and therefore may seem to be minor functions for funds. However, fund complexes do differentiate themselves along this dimension, especially in the defined-contribution retirement market, and failure to manage this activity can damage consumer satisfaction.

The fourth activity, *marketing and distribution*, describes how the funds communicate with potential customers and sell their products. Traditionally, open-end mutual funds were categorized as either no-load or load funds, and the distinction was relatively simple: no-load funds used print and electronic media, word of mouth, and mailings to appeal to consumers directly, whereas load funds hired salespeople to market and sell their products. To pay the salespeople, load funds charged customers one-time fees, called "loads."[4] Brokerage firms are the biggest vendors of load funds, although banks, insurance companies, and financial planners also sell them. In a reference to their different distribution channels and clienteles, it is often remarked that no-load funds are "bought" while load funds are "sold."

4. Sales charges traditionally were levied at the time a consumer first bought a fund; however, more recent pricing strategies have levied the equivalent of sales charges throughout the life of the consumer's holding, or at the termination of the investment.

Today, the traditional relationship between distribution method and fee structure has broken down. A fund complex may sell directly to consumers or may use a sales force to call on potential customers. Funds that use direct sales techniques may or may not charge a load or other selling commission. We will use the terms "direct" and "brokered" to denote different distribution methods, reserving the load/no-load distinction for funds that do or do not charge one-time sales fees.

The final activity in our value chain is *investor liquidity services*. By this we mean the activities funds undertake to permit investors to switch among various investments or to liquidate their portfolios. For example, the open-end mutual fund provides an important liquidity service by offering to redeem shares at any time at the fund's current net asset value. Fund complexes provide liquidity services by offering investors a broad range of investment alternatives, including money market funds, and convenient telephone transfers among these alternatives.

Having broken down a mutual fund into a set of activities, one could in principle identify for each activity how a firm might differentiate its product or achieve a low-cost position. With appropriate data, the relative costs of each of the activities can be estimated for each firm.[5] Although we lack specific data to conduct this cost breakdown, we attempt to estimate the relative magnitude of the costs of various activities using raw industry data averages (see Figure 7-3). We identify four related equity-investment products—institutional money management, 401(k) plan management, no-load funds, and load funds—each of which provides a slightly different bundle of activities. Although all four perform comparable investment management, trading, and execution functions, they differ in the extent to which they provide costly customer record keeping and marketing. For example, the primary difference between institutional money managers and 401(k) plan managers is that the 401(k) manager provides extensive record keeping for each of the thousands of individual participants. The difference between 401(k) plans and no-load funds lies primarily in marketing: retail no-loads sell directly to consumers, and 401(k) vendors sell to businesses, which in turn make the funds available to their employees through defined contribution plans. Comparing no-load and load funds, we find the apparent primary cost difference to be that load funds still rely on brokered distribution.

5. Activity-based analyses of firms have recently proved to be powerful tools in management accounting in which cost allocations are made on the basis of firm activities. See Robert Kaplan and Robin Cooper, *The Design of Cost Management Systems* (Englewood Cliffs, N.J.: Prentice Hall, 1991).

Figure 7-3

Functions Served and Fees Charged for Managed Equity Investment Products

	Institutional Money Manager	401(k) Manager	Average No-Load Fund	Average Load Fund
Investment Advice, Trading, and Execution	●	●	●	●
	same			
Customer Record Keeping and Reporting	○	●	●	●
	few accounts	many accounts		
Marketing and Distribution	○	○	●	●
	business to business		consumer marketing	
Estimate of Average Annual Fees Charged, in basis points	50[a]	100+[b]	100+[c]	200+[d]

Key: ● = many services provided ○ = few services provided

Sources:

[a] Median fees charges for $50 million account in actively managed equities from Josef Lakonishok, Andrei Shleifer, and Robert W. Vishny, "The Structure and Performance of the Money Management Industry," in *Microeconomics 1992*, edited by Martin Neil Baily and Clifford Winston (Washington, D.C.: The Brookings Institution, 1991), pp. 339–392.

[b] 401(k) fees from *CFO Magazine*, May 1992.

[c] Average fees of no-load equity funds in 1990, calculated by authors.

[d] Average fees of load equity funds in 1990, calculated by authors. Investors assumed to hold load funds for seven years.

If the differences in fees charged for these products are proportional to the costs of the marginal activities provided, then we can roughly estimate the relative magnitudes of the costs of various activities. Based on the data in Figure 7-3, the breakdown in fee differences for equity products translates into 50 basis points for investment management, 50 basis points for record keeping, and up to 100 basis points for person-to-person marketing. If fees are related to costs, the findings suggest that for a load fund, costs might be split 25% for investment management, 25% for record keeping, and 50% for marketing.

A Functional View

An activity view is most useful in identifying where a firm can lower its costs and differentiate its product. Where the value chain concept breaks

a firm into a set of activities, functional analysis proposed by Robert C. Merton and Zvi Bodie[6] considers the most basic functions that a financial system, financial institution, or financial product satisfies. By focusing on functions common across countries and over time, they encourage the analyst to go beyond institutional analyses, which might fail to recognize competition from very different institutions. Merton and Bodie identify six functions that can be used to characterize any financial product, institution, or system:[7]

- A payments system for the exchange of goods and services
- A mechanism for the pooling of funds to undertake large-scale indivisible enterprises
- A way to transfer economic resources through time and across geographic regions and industries
- A way of managing uncertainty and controlling risk, as through selling, hedging, or diversifying
- A body of price information to help coordinate decentralized decision making in various sectors of the economy
- A way of dealing with the agency problems created by asymmetric information

In aggregate, the mutual fund industry provides many of these functions. For example, by providing investment liquidity, especially check-writing services, the industry permits individuals to buy goods and services. Funds that invest in large-denomination instruments (such as commercial paper) and sell shares to consumers in small denominations provide pooling of funds. By buying securities from various parts of the world, international equity funds facilitate the transfer of resources across geographic regions. With large holdings in individual firms, subject to regulatory constraints,[8] mutual funds could in principle satisfy a desire to control agency problems (caused by the separation of ownership and control of the modern corporation) by actively monitoring the actions of managers and boards of firms in which they invest.

Of the functions satisfied by mutual funds, perhaps the most obvious is helping households to manage risk efficiently. Modern financial

6. Robert C. Merton and Zvi Bodie, "A Framework for Analyzing the Financial System," unpublished manuscript, 1992.
7. The following discussion draws heavily from Merton and Bodie, 1992.
8. However, mutual funds are subject to regulatory constraints that inhibit their ability to monitor the firms in which they have holdings. See Mark Roe, "Political and Legal Restraints on Ownership and Control of Public Companies," *Journal of Financial Economics* 27 (1990), pp. 1–42.

theory, pioneered by Markowitz, Sharpe, Lintner, Treynor, Mossin, and others, suggests that individuals should hold well-diversified investment portfolios. Mutual funds, which are able to buy and sell securities much more cheaply than individuals can, provide diversified portfolios at low cost. As institutions transacting in large lots, mutual funds pay lower commissions, approximately $.08 per share of common stock as compared with $.54 a share for a consumer buying 100 shares of a $40 stock through a retail broker. Funds can also spread fixed costs of research over a larger block of securities. As a result, the individual acting alone and attempting to create a diversified portfolio would face excessive costs and inconvenience. For example, an individual wishing to invest $10,000 in the S&P 500 index, an amount roughly equal to the average mutual fund account,[9] would invest approximately $20 per firm, buying one-half of one share on average. Even if the individual purchased $100,000 worth of the S&P stocks, he or she would not only pay exceptionally high commissions on odd-lot trades, but also face the task of reinvesting small dividends and rebalancing the portfolio with changes in the market value of the 500 stocks, making this direct attempt at diversification infeasible.

Competition: Past and Present

Mutual funds can compete with one another either by satisfying different economic functions or by configuring the activities in the value chain so as to produce either a low-cost or a differentiated product. In this section, we analyze how funds and fund complexes have chosen to compete and the apparent success and failure of their competitive strategies.

Competitive Alternatives

Generically, a firm can compete either by charging lower prices sustained by its low cost or by differentiating its offering. If an industry's products are perfect substitutes or commodities, a low-cost strategy may be a firm's only viable option. A firm may lower its costs by investing in technology, achieving scale economies by increasing output or spreading costs over a broad product line through scope economies. Decomposing a firm into a set of value chain activities is useful in implementing low-cost strategies because the value chain identifies the individual cost elements by which a firm can achieve a cost advantage over its rivals.

9. ICI, 1991, p. 70.

In an industry selling products that are near but imperfect substitutes, firms engage in what economists call monopolistic competition. To avoid price competition, they strive to distinguish themselves by differentiating their products from those offered by rivals, thereby allowing themselves to set prices or act like monopolists within a market niche. To pursue a product differentiation strategy, a firm must determine some dimension along which it can set itself apart from its rivals. Either a functional or value chain analysis can identify the choices available.

In most products, competition takes place at more than one level. For example, in the breakfast cereal business, individual brands (e.g., Cheerios, Wheaties) compete for consumers, but the firms that offer these products (e.g., Kellogg's, General Mills) market multiple brands and compete against one another for supermarket shelf space. Similarly, in the mutual fund business, both brands (funds) and firms (complexes) compete. Complex-level competition is especially critical in the mutual fund business because one function, or value chain element, satisfied by mutual funds is what we have called investor liquidity. A complex delivers these services to consumers by offering a variety of funds, liquidity services (in the form of check writing and a money market fund), and easy transfer privileges to other investments.

In the breakfast cereal business, we observe the coexistence of firms pursuing low-cost strategies (with generic or private-label brands) and differentiated product strategies (with brand-name cereals). The mutual fund industry also supports both low-cost and high-differentiation strategies. The low-cost strategies have focused on selling the most commodity-like products, especially indexed products, with low fees. Differentiation strategies have been more varied, with firms setting themselves apart along at least three dimensions: fund performance, marketing efforts, and new-product development. In the late 1980s, no single dominant strategy appeared, at least when measured by growth in assets under management. In the following section, we examine the strategic decisions taken by complexes and funds and their impacts on the amount of assets under management.

Performance-based Differentiation Strategies

In the investment selection dimension, funds may attempt to differentiate themselves on the basis of their investment performance. Beginning with Michael Jensen,[10] academic studies of more than two decades have failed to demonstrate that fund managers can consistently earn superior risk-adjusted returns. Nevertheless, funds that realize exceptional historical

10. Michael Jensen, "The Performance of Mutual Funds in the Period 1945–1964," *Journal of Finance*, May 1968, pp. 389–416.

returns use this performance record in their marketing to try to differentiate themselves from their rivals.[11]

In other research, we examine the impact of historical performance on fund growth by studying the returns and growth rates of 632 equity mutual funds (partitioned by investment objective into funds with similar goals) from 1970 to 1990.[12] Specifically, we explore the effect of high relative performance on the inflows of new money into the fund. Our results are somewhat surprising. Briefly, we find that performance matters, but only for star performers. Top-performing mutual funds receive net inflows of new money, yet funds that perform poorly do not lose very many assets. This asymmetry between consumers' reactions to very high performance and very low performance suggests a possible "heads I win, tails I don't lose" strategy: manage funds for high dispersion in returns. Once a fund does well and captures assets, it does not appear to lose them through subsequent poor performance.

At least in the equity sector, these findings suggest that fund complexes that strategically encourage higher-risk investment strategies may be able to grow faster than complexes encouraging more conservative bets. Note that we do not advocate this strategy, nor do we suggest it would work for nonequity funds. Furthermore, performance differences among funds explain only a modest portion of the growth rates of equity mutual funds, leading us to consider how other strategic choices affect funds' assets and profitability.

New-Product Differentiation Strategies

New-product introductions could enable a complex to benefit in two ways. First, given the asymmetric response of consumers to high- and low-performing funds, introducing many new funds with varying performance is the complex-level analog of a fund making higher-risk investments. The high-performance fund will attract money, but the losers will not necessarily be penalized. Second, by offering a wide variety of funds, a complex can deliver greater investor liquidity services.

However, introducing new products is not costless. A complex must incur the direct costs of lawyers and accountants plus its time and expense to educate salespeople and consumers. In addition, new funds may cannibalize existing complex accounts. Finally, brand extensions

11. Anecdotal evidence suggests that complexes do indeed follow this strategy. In a recent issue of *Money* magazine (May 1992), nearly 75% of the advertisements for equity mutual funds prominently displayed the historical performance of the fund for some time period, either in absolute terms or relative to a selected benchmark.
12. Erik R. Sirri and Peter Tufano, "Buying and Selling Mutual Funds: Flows, Performance, Fees and Services." Working paper, Harvard Business School, 1992.

may attenuate the value of the consumer franchise. One senior mutual-fund executive expressed his fear that a new fund that performed disastrously and received media attention could harm the sales of existing funds.

Nevertheless, the top 20 mutual-fund complexes introduced more than 500 new funds in the period from 1985 to 1990, although not all firms engaged in product innovation at the same pace. On average, independent load fund complexes introduced about half as many new products as no-load and captive-broker complexes, and the five largest complexes in 1985 introduced about twice as many funds per complex as did the next fifteen firms (see Figure 7-4).

In the aggregate, products introduced from 1985 to 1990 accounted for one-third of the dollar growth in total net assets (TNA) of the top 20 complexes from 1985 to 1990. The most prolific complexes that created the most new products grew faster on average, but we must be careful not to infer causality. One cannot distinguish whether faster growing fund complexes added products or whether complexes that added products grew more rapidly. However, there is a strong positive association between growth and a strategy of differentiation through new-product introductions.

We find no evidence from the past 10 years that new products dramatically cannibalize existing products. If new funds cannibalize older funds, then complexes introducing many new products should slow the growth of their older funds relative to the growth rate of complexes that introduce fewer new funds. Figure 7-5 fails to show this pattern. Older funds in complexes introducing more new products grow no more slowly than older funds in complexes offering fewer new products.

Distribution Method Differentiation Strategies

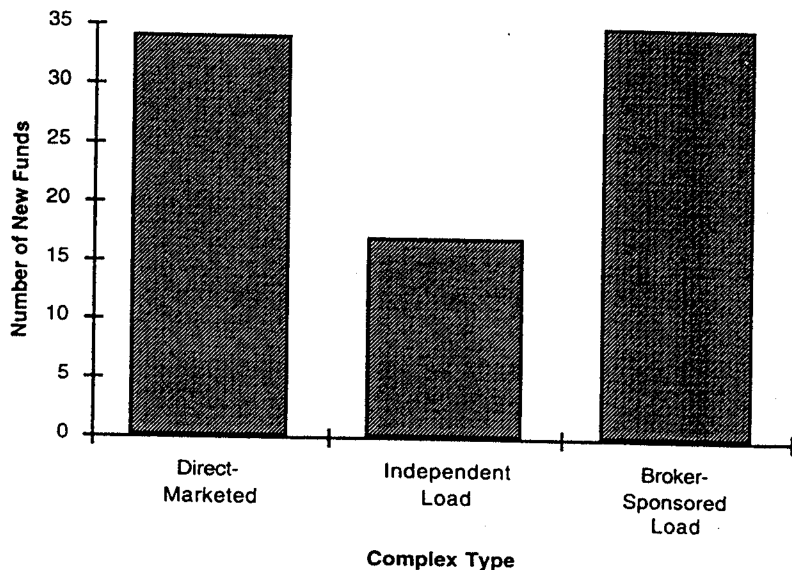
Load and no-load funds offer similar investment management, record-keeping, and investor liquidity services. Complexes in the higher-fee load sector typically differentiate their fund products from those offered in the no-load sector by bundling costly person-to-person selling and investment advice. As a result, the fees that funds charge consumers vary dramatically for relatively similar investment products sold through varied distribution channels. For example, among aggressive growth equity funds, no-load funds charged annual expenses averaging 1.32% of TNA (or assets under management) in 1990, but load funds charged annual expense ratios of 1.12% in addition to loads of 4.07%. *Ignoring discounting,* a consumer would have to hold a load fund for more than 20 years for it to have the same total annual fees as the no-load.

Figure 7–4

Number of new mutual funds introduced from 1985–1990 by the largest 20 mutual fund complexes. Complexes are ranked on the basis of total net assets in 1985.

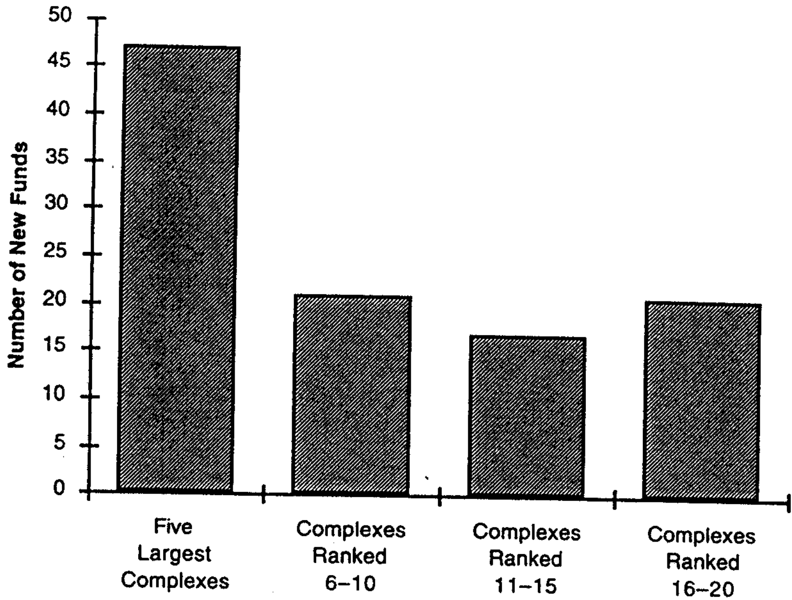
New Funds Introduced	
Total	518
Maximum for one complex	85
Minimum for one complex	2
Average per complex	26
Median per complex	21

Mean number of new funds introduced in 1985–1990 by type of mutual fund complex.



Complexes were grouped according to categories defined by Michael Goldstein and Lili Linton in "The Future of the Money Management Industry," Bernstein Research, 1992. Direct-marketing complexes sell funds directly to investors without a broker. They tend to sell no-load funds, although many funds in such a complex may carry loads. Examples include Fidelity and Vanguard. Independent load complexes rely on brokers to sell their mutual funds but are not themselves a unit of brokerage. Examples include Franklin and Kemper. Broker-sponsored load complexes are units of brokerage firms and tend to sell load funds through brokers. Examples include Merrill Lynch and Prudential-Bache.

Figure 7–4 (cont.)
Mean number of new fund introductions by complexes of different size. Complexes are ranked on the basis of total net assets in 1985.



Source: Authors' estimates.

This difference in fees may explain why the no-load sector grew from 5.7% of mutual fund assets in 1960 to 28.6% in 1990. Although a large number of mutual fund buyers are willing to forego costly direct marketing for lower fees, many consumers still appear to value the services provided by load funds. These services include marketing that reduces consumer need to search for funds, advice that simplifies buying decisions, and possibly nonmutual fund services also offered by brokers and financial planners.[13]

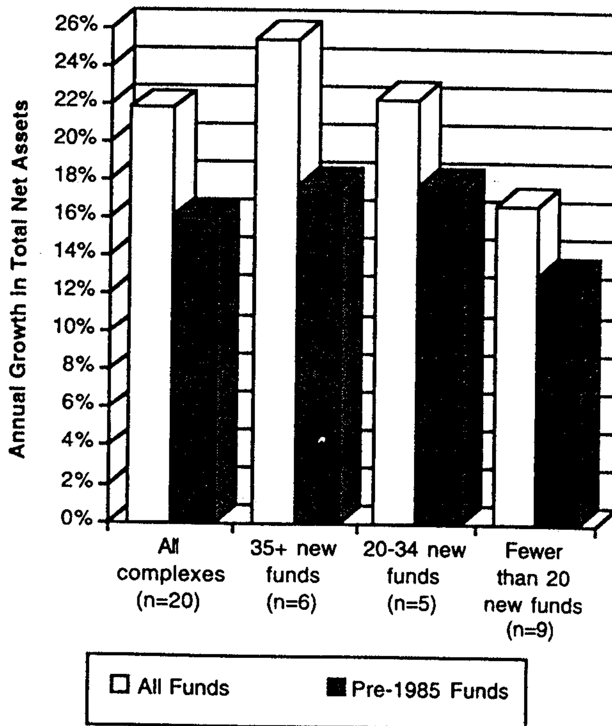
13. Consumer preference for these services is evident in the ICI survey of mutual fund buyers, summarized in its 1990 *Mutual Fund Fact Book*. For instance, "personal-guidance-oriented consumers" account for 13% of those surveyed, and they seek "personal contact in making investments." In contrast, "fee-sensitive independent consumers" account for 11% of those surveyed and presumably are the predominant purchasers of no-load funds.

Figure 7–5

Source of growth for the 20 largest fund complexes, 1985–1990. The growth in total net assets is decomposed into two categories: growth due to products introduced prior to 1985, and growth due to funds offered first in 1985–1990.

Category	(in $ billions)	Share
Total	381.3	100%
Due to funds introduced prior to 1985	252.3	66%
Due to funds introduced subsequent to 1985	129.0	34%

Growth in "old" funds as a function of new-product introductions. This chart shows the mean growth in total net assets from 1985 to 1990 of funds introduced prior to 1985, broken down by the number of new products introduced by the complex in the period 1985–1990. Growth rate of all funds is shown for comparison.



Source: Authors' estimates.

Complexes employing these different distribution strategies—funds bundled with and without direct marketing—coexist and have thrived in the mutual fund industry. Of the five complexes that gained the greatest share of the mutual fund industry from 1985 to 1990, three employed direct distribution and two were distributed primarily by brokers. Overall during the five-year period, complexes using these two distribution methods grew at roughly equal rates. Thus no one distribution strategy has proved dominant.

Low-Fee Strategies

Even *within* the load and no-load sectors, complexes charge different fees for comparable funds. If funds can convince consumers that they offer highly differentiated products, then consumers may tolerate paying higher prices. If not, firms charging lower fees should dominate and grow faster than funds charging higher fees.

A firm selling an otherwise equal but lower-fee product must enjoy a cost advantage that may stem from economies in any or all of the value chain activities as shown in Figure 7-6. Mutual funds may achieve economies of scale in record keeping/reporting and marketing/distribution, and economies of scope in marketing/distribution and liquidity services. Below a relatively small, minimally efficient scale, funds may also enjoy economies in investment selection.[14] Both our own study of fund growth and the research of others support the notion that complexes can achieve scale and scope economies, and that fees charged are statistically related to proxies that measure these economies.[15]

If some complexes enjoy economies and pass their savings on to consumers in the form of lower fees, low-price strategies should be successful. One might expect to find that *after holding constant* fund type, distribution method, and variables measuring services provided, lower-fee funds should gain share at the expense of higher-fee funds. Our work on 632 equity mutual funds from 1979 to 1990 supports this hypothesis. Mutual fund consumers are slightly cost sensitive. In our work on equity mutual funds, we find that funds charging fees 10% higher than the mean fee (or approximately 15 basis points higher),

14. André Perold and Robert Salomon, "The Right Amount of Assets Under Management," *Financial Analysts Journal*, May/June 1991.

15. J. Dermine and L. Röller, "Economies of Scale and Scope in the French Mutual Funds (SICAV) Industry," *Journal of Financial Intermediation*, vol. 2 (1992), pp. 83–93, documented scale and scope economies in the mutual fund industry. Our unpublished work provides additional evidence supporting the existence of scale and scope economies at the account, fund, and fund complex level.

Figure 7-6
Strategies for Mutual Fund Rivals

This figure identifies the value chain elements, and for each, how low cost or differentiation strategies could be implemented.

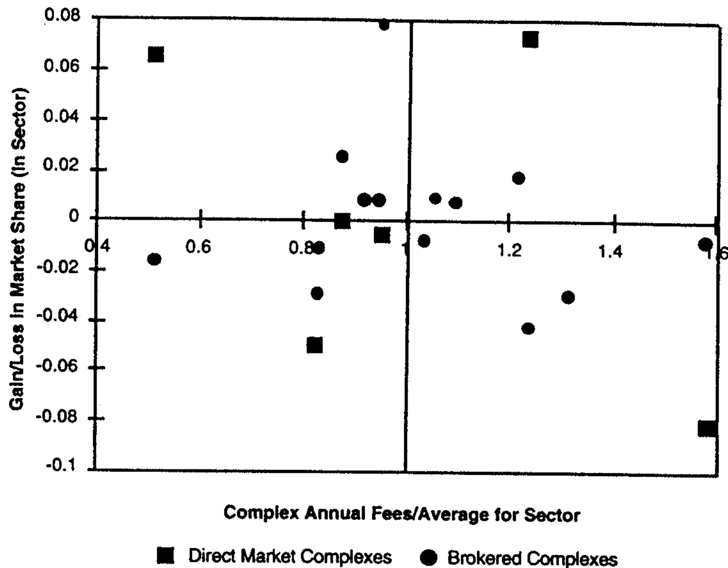
Value Chain Element	Cost-Based Strategies	Differentiation-Based Strategies
Investment Selection	Scale—assets under management over a narrow region (fund)	Superior performance (fund) Product choice—passive strategies (fund)
Trading and Execution	Economies at large-scale (complex)	Superior trading skills translating into higher performance
Customer Record Keeping and Reporting	Scale—number of accounts (complex)	Superior technology—quicker reports, fewer mistakes (complex)
Marketing and Distribution	Scale—national advertising economies (complex) Scope—spread costs over many funds (complex)	Superior marketing and advertising (complex)
Investor Liquidity Services	Scope—economies in new-product development (complex)	Wide selection of funds, exchange privileges, related financial services, check writing (complex)

experience a growth rate 1.2 percentage points lower than do funds charging the average fee.

Figure 7-7 shows a similar analysis for mutual fund complexes. We compare the gain or loss in market share from 1985 to 1990 among the top 20 complexes with the average fees they charged for equity products. A complex's market share and fees are compared with other complexes employing a similar distribution method. Complexes gaining market share in their sector appear above the horizontal line, and complexes with below-average fees appear to the left of the horizontal line.

Figure 7-7 shows that complexes that gained the greatest market share followed very different pricing strategies. Among directly dis-

Figure 7–7
*Change in market share and total fees charged relative to sector average from 1985–1990. Sample includes 20 largest mutual fund complexes, on the basis of total net assets in 1990.**



* The 20 largest mutual fund complexes in 1990 were separated by method of distribution into two sectors: direct marketing or brokered. See Figure 7-4 for a fuller description of the criteria used to separate complexes. Within each sector, the change in each complex's market share from 1985 to 1990 was calculated and is shown along the vertical axis. Along the horizontal axis is shown each complex's average total fees charged per dollar of total net assets using equity fund fees as a benchmark. This measure is calculated by adding the expense ratio to the load annualized over a seven-year holding period (ignoring discounting) and dividing by the mean total fees for the appropriate sector.

tributed complexes, one top gainer charged fees nearly half of the average, whereas another charged fees 20% above the average for the group. These two complexes, with very different pricing strategies, gained roughly comparable share among the largest no-loads. In the brokered sector, the complex with the greatest gain in market share charged fees very close to the load fund average. Perhaps the results are most remarkable for what we do *not* observe: there is no strong downward-sloping mass of points. These results suggest that the industry has been successful in communicating a message of differentiation to many consumers. It appears that firms have successfully convinced many consumers to pay for marketing, a major component of

costs for a fund complex.[16] However, the rapid growth of a large low-fee, no-load product suggests that at least some consumers are not convinced of this message.

Industry Implications of Complex-level Strategies

We may each act to advance our own self-interest, but our joint actions can leave everyone worse off. For example, on a hot summer day, we may all start off for the beach in our cars, looking forward to a refreshing swim. However, as any New Englander can attest, if everyone acts on this impulse at the same time, we all spend more time on the highway or searching for parking places than enjoying the beach, and we may wish we had stayed home.

This example reminds us that it is important to examine the collective impacts of individual actions. In the mutual fund industry, the competitive choices of low-cost and differentiation strategies must be studied in the aggregate. We examine the impact on the mutual fund industry structure of different strategies adopted by fund complexes: offering many new products, marketing extensively, and offering funds with low fees.

Consumer Confusion

As a group, mutual fund complexes have introduced more than 2,500 new funds during the past 15 years. When compared with the total number of securities listed on the New York and American Stock Exchanges and the NASDAQ, this sheer increase in the number of funds offered is staggering (see Table 7-1). At this rate, in a few years there would be more mutual funds than listed securities to choose from.

The potential mutual fund purchaser must not only cope with an exploding set of alternatives, but also track funds that change names, merge out of existence, or merely liquidate. For example, there were 1,882 long-term mutual funds in 1989, as reported by IBC/Donoghue. Of these, 102 changed names, 44 were merged out of existence, and 17 dissolved by year-end. Thus 163, or nearly 9%, of the old funds changed status during the year. In addition, 147 new long-term funds were added, or 7.5% of the total funds as of 1990.[17]

Although mutual fund complexes attempt to compete against one another by launching new products or repositioning old ones, in aggre-

16. This assertion is borne out in the no-load sector, where we find a positive relationship between advertising expenses and total fees charged.

17. IBC/Donoghue, *Mutual Fund Almanac 1991*. Long-term funds exclude money market mutual funds and short-term tax-exempt funds.

Table 7–1
Number of mutual funds versus the number of publicly listed securities on the NYSE, AMEX, and NASDAQ.

	1975	1980	1985	1990
Number of mutual funds	423	564	1,528	3,108
Number of listed securities on NYSE, AMEX, and NASDAQ	5,957	6,251	8,022	8,053

Sources: ICI *Mutual Fund Fact Book, NYSE Fact Book; AMEX Fact Book; NASDAQ Fact Book*, 1991.

gate they may be heightening consumer confusion. Reaching consumers, let alone communicating a message, is more difficult and costly in an increasingly crowded marketplace. Consistent with this conjecture, we observe large increases in marketing expenditures among no-load funds. In the second half of the 1980s, no-load TNA rose by 19% annually, and magazine advertising grew 30% per year.[18]

The advertising content of such no-load funds may also produce confusion. Earlier, we commented on a sample of equity fund advertisements taken from a recent issue of *Money* magazine. With nearly three-quarters emphasizing performance claims, the average consumer may find it difficult to understand how so many funds can claim to be top performers (albeit during different time periods and relative to different groups). If the various claims are difficult to interpret—and even more difficult to reconcile—then the advertising itself may merely confuse consumers.

Confusion, whatever its source, may make consumers seek advice or seek simpler products. Such a step would make the bundled marketing and advising services provided by brokers of load funds more valuable. Alternatively, it could force directly distributed funds to provide advice to consumers. We conjecture that, in the aggregate, extensive product development and advertising by no-load complexes that brings in new monies may have inadvertently caused at least some of the slowdown in the growth of this sector. Furthermore, heightened consumer confusion may increase the need for even costlier marketing. Lastly, the conflicting claims and product proliferation may have hastened the acceptance of index funds, whose investment strategy is easy to communicate.

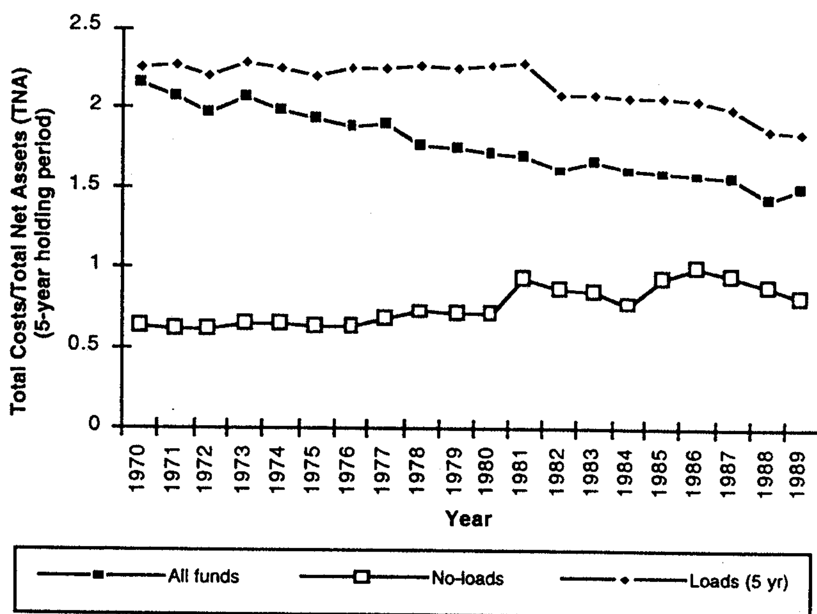
Aggregate Price Competition and Economies

No-load complexes' increased marketing expenditures raise their costs and the fees they charge consumers. We find that fees charged

18. Leading National Advertisers, *Ad $ Summary* and *Class Brand Report*, 1980, 1985, 1990.

Figure 7-8

Total mean annual fees charged by equity mutual funds, 1970–1990. Total annual fees equal expense ratios plus the load amortized over seven years. These fees are weighted by fund assets under management in each year.



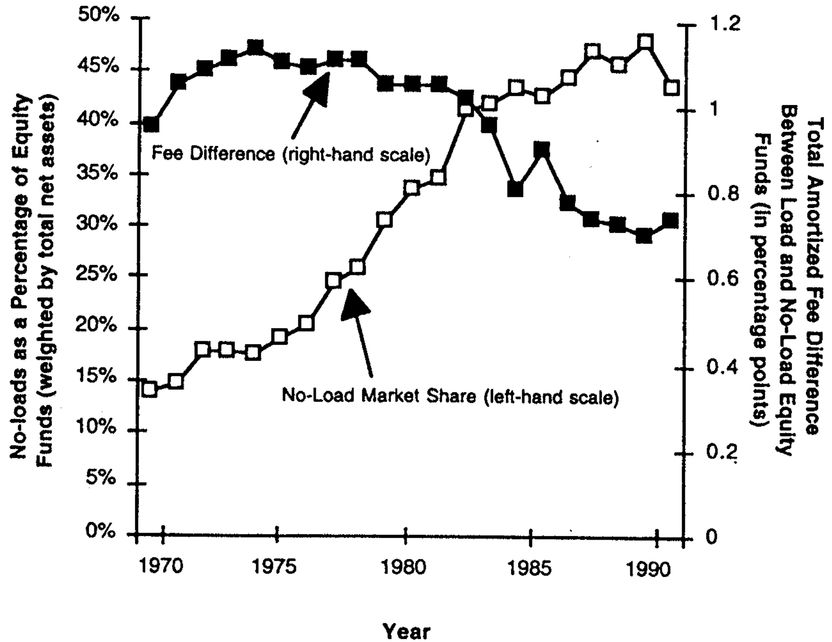
Source: Authors' estimates.

by no-load funds have risen markedly during the past 20 years[19] despite the aggressive efforts by some no-load mutual fund complexes to differentiate themselves by offering extremely low-fee products (see Figure 7-8).

Although fees on equity no-load funds have risen, as a group they remain lower priced than equity load funds, making it reasonable to assume that no-loads exert pressure on the load sector to reduce fees. Consistent with this conjecture, we find that total fees charged in the load sector have fallen in the past two decades, especially in the 1980s. Whereas loads charged by load funds have fallen, the expense ratios of load funds have risen. Using reasonable assumptions about how long consumers hold equity load funds, we estimate that total annualized fees

19. The analysis of fees in this section refers to fees for equity mutual funds with investment objectives including aggressive growth, growth and income, and long-term growth.

Figure 7-9
The growth of no-load equity mutual funds as a percentage of all equity mutual funds (asset weighted), and the difference in total costs between no-load and load equity mutual funds. Total fees are defined as the expense ratio plus the load amortized over seven years.



Source: Authors' estimates.

per dollar invested—including annual expenses plus loads—appear to have fallen in the past two decades in the load sector.[20] (See Figure 7-8.)

Thus even though fees are rising in the no-load sector, they are falling in the load sector. Figure 7-9 shows that as the gap has narrowed and the relative benefit of no-load over load funds has been reduced, the no-load sectors' gains have moderated. If no-loads continue to market heavily and introduce many new products, the price differences between load and no-load funds will shrink even more, and no-load funds may find it more difficult to capture greater share from the load sector. As we have noted, rising consumer confusion may also moderate the growth of the no-load sector.

20. Ideally, to calculate the true annualized fees paid by load customers, we would need information on the length of their average holdings. In 1990, the ICI reported that for the three classes of equity funds we are studying, redemptions averaged 14% per annum, implying on average a seven-year holding period horizon in aggregate.

Given the changing mix of load and no-load funds and their different fees, competition has benefited the consumer; in aggregate, consumers of all equity mutual funds have enjoyed lower total fees over time (see Figure 7-8). This conclusion is somewhat at odds with those recently reported in the popular press that discuss only the rise in expense ratios, without considering either the changing level of loads or the mix of load and no-load funds. However, our calculations suggest that consumers of equity funds as a group paid less for mutual fund services in 1990 than they did in 1970.[21]

While competition may encourage complexes to reduce their fees, falling costs permit them to sustain lower fees. In this regard, the growth of large fund complexes that can reap benefits of cost economies may permit the industry to continue to lower its fees. The industry is becoming more concentrated as the largest complexes capture an increasing share of the market.[22] Not only have these large firms gained more retail mutual fund business, but they also have been able to capture scale economies in investment management and record keeping by selling their services to 401(k) plans.

Summary: Competition in the Aggregate

Like the New Englanders sitting in traffic on a beautiful July weekend when they had thought they would be enjoying the beach, mutual fund complexes must consider the impacts of their collective actions. New-product strategies may promise to differentiate a complex, but if rivals follow similar strategies, no one will appear distinctive and consumers may merely be confused. A no-load fund's high marketing strategy may gain customer accounts, but if other complexes respond in kind, an

21. This conclusion must be qualified somewhat in that the equity fund product has actually changed over time, because indexed products—with reportedly small investment management costs—were not offered in the early 1970s. Vanguard claims to have introduced in 1976 the first retail mutual fund that contractually aimed to track a broad market index. By 1990, we calculate that broad-based index funds (excluding gold-index funds, single-state index funds, and sectoral-index funds) accounted for approximately 2.6% of the total net assets of the equity mutual fund sector. Given the relatively small size of broad-based indexed-equity products in the aggregate, this change in product mix cannot account for the fall in total fees.

22. In 1985, the top four complexes accounted for 17.5% of industry TNA; but by 1990, their share had risen to 25.5%. During the same period, the share of the top 12 complexes rose from 38% to 49% of TNA. This increase in concentration halted the downward slide in concentration throughout the 1970s and early 1980s. In this earlier period, massive entry in the business apparently reduced the concentration of the largest complexes. For example, the top four complexes held more than one-third of industry assets in 1970 before falling to 17.5% in 1985. All of these concentration figures were calculated using aggregate data from the Investment Company Institute (ICI) and the Investment Company Data Institute (ICDI).

advertising war may leave all firms worse off. Finally, responses to price competition may leave the low-price firm with a smaller price advantage.

In the absence of cost economies, these forces drive prices down and costs of new-product development and marketing up. However, at the same time, economies may reduce costs so that the total impact on profit is not clear. Whether the profitability of the industry in the aggregate rises or falls will depend on the rate at which revenues fall relative to costs.[23]

The Future of Mutual Fund Competition

The previous sections discussed the current structure of the mutual fund industry and the nature of the competition between funds and fund complexes over the last two decades. In this section, we analyze possible threats and opportunities that vendors of mutual funds may face in the years ahead. If impenetrable walls separate the mutual fund industry from the rest of the financial services sector, or if boundaries clearly partition different niches within the industry, we would need to consider only rivalry among existing firms selling existing products. However, it is likely that the industry will find traditional boundaries increasingly blurred.

The load/no-load distinction has been compromised as no-load complexes offer funds with sales commissions and 12b-1 fees. Recent SEC proposals will allow other traditional boundaries to become much more porous. Funds historically classified themselves as either open end or closed end, but the SEC proposes approving a hybrid of the two: an interval fund. Interval funds would permit shareholder redemptions, much as an open-end fund would, except that the redemptions could take place only at specific times—for example, one day a month or even once a year. Between these redemption dates, the fund would effectively be closed, blurring the traditional open/closed distinction. Another SEC proposal would place mutual funds and hedge funds in greater competition. Traditionally, retail mutual funds have been somewhat distinct from hedge funds—which have greater flexibility in their investment charters—in that the latter could have no more than 99 investors and were exempt from SEC oversight. The SEC proposes that funds with unlimited numbers of "qualified investors" have latitude similar to that of hedge funds. Thus the SEC proposal would create a class of products

23. At least one analyst has predicted that margins in the money management industry will continue to fall over time due to forces similar to those discussed in this chapter. See Michael L. Goldstein and Lili Linton, "The Future of the Money Management Industry," Bernstein Research, March 1992.

falling somewhere between mass-marketed mutual funds and boutique investment management services.

As boundaries shift or are erased completely, merely focusing on yesterday's threats and opportunities will leave a firm at risk. Similarly, remaining fixated on one potential threat may leave a firm exposed to many others. Therefore the goal of this section is not to outline a single scenario for the future, but to point to some directions in which competition may develop. We liberally draw on our analyses of the activities funds perform and the functions they satisfy to identify the most likely competitive threats and opportunities to the existing competitive structure of the fund industry.

To organize this discussion, we will divide likely competitive developments into one of four categories, as shown in Table 7-2. First, we discuss existing rivals selling traditional fund products (box I). Here we focus on the ways in which competition among existing mutual fund vendors might unfold, briefly discussing competition involving new distribution channels, technology, pricing, and scale economies. Second, we recognize that mutual funds can be and are sold by organizations other than traditional fund rivals (box II); we discuss the competition from organizations such as banks or other service firms. Third, competition may change as current mutual fund vendors continue to expand their product lines beyond traditional mutual fund services (box III).

Table 7–2
Future Competitive Structure of the Mutual Fund Industry

		Organization/Institution	
		Existing Fund Rival	Other Rivals
Product	Traditional fund product	I	II
	Other products	III	IV

Finally, we recognize the competitive threats and opportunities arising from nontraditional mutual fund products, perhaps sold by nontraditional rivals (box IV). When reduced to the basic consumer needs or economic functions they satisfy, mutual funds, both now and in the future, will compete with a broad range of alternatives.

Rivalry among Existing Mutual Fund Complexes

New distribution channels. The preceding discussion demonstrates the important role played by marketing and distribution. Distri-

bution-based differentiation is likely to continue, if not intensify. For example, mutual fund complexes also have tapped into organizations such as the American Medical Association (AMA) and the American Association of Retired Persons (AARP) as conduits to reach consumers. These targeted distribution attempts offer lower costs of simply reaching potential buyers. Furthermore, funds may be able to appeal more to these targets by receiving informal certification by groups like AARP and by tailoring their products to the particular needs of the target niche. For instance, because of the age and risk profile of AARP members, fixed-income or high-yielding funds may be particularly attractive. Targeted distribution of this type is likely to continue.

In a similar fashion, funds are likely to continue to leverage existing group distribution returns by extending their employer-targeted marketing efforts beyond 401(k) tax-advantaged investing for retirement. Employers who provide 401(k) or 403(b) plans typically select a handful of funds in which tax-advantaged contributions can be made as part of a self-directed, defined-contribution retirement program. Apart from its tax advantages, this type of plan is attractive to consumers because its administrator narrows the choices from which the employee may select, thereby providing an informal certification function, not of the likelihood of favorable investment returns, but of the soundness of the complex's offerings and policies. For each successful marketing call, the 401(k) vendor receives the benefit of a large inflow of dollars from a large number of individuals. Provision of 401(k) services also allows the vendor to supply employees with non tax-advantaged investment vehicles. It can pass some of these same reductions in marketing costs along to the employees. The corporation could provide its employees with the same investment management advice available through a retail-marketed fund, but at a lower cost.[24]

These and other attempts to distribute similar investment management services simultaneously through varied distribution channels would be facilitated through a proposed investment-company organizational form called hub and spoke, which broadens the notion of a commingled fund.[25] Shares in a central or "hub" fund are purchased by a collection of other unique "spoke" funds, shares of which in turn are purchased by consumers. The advantage is that each spoke fund can be

24. We recognize that corporations might be unwilling to participate because of fears of *implied* liability if the employees lose money in a non-tax-advantaged savings plan in which the investment alternatives were in some sense screened by the corporation. Current SEC proposals, which would permit funds greater flexibility in charging different consumers different fees, might facilitate this type of marketing program.

25. See Christopher P. Harvey and Richard M. Tardiff, "Hub and Spoke: An Alternative to Multiple Class Distribution," *FACS of the Week*, April 20, 1992, pp. 6, 7, 12.

distributed, marketed, and priced differently because it is sold to a distinct consumer group. For instance, one spoke may be a no-load 401(k) plan, and another may be a load fund distributed through a bank. The manager of the hub may benefit by eliminating redundant overhead and administrative costs. Such a flexible structure would completely sever the link between investment management and the marketing/distribution activity, enabling complexes to capitalize on a variety of distribution opportunities.

Trading and execution. Trading and execution are activities in which technology plays an important role. By investing in the latest information-gathering and data-processing technologies, a fund complex may engage in both a differentiation and a cost-reduction strategy. Funds can use technology to speed order processing, eliminate personnel from customer interactions, and streamline back-office operations. Furthermore, quantitative management styles frequently require investment in sophisticated computer hardware and software to run complex portfolio or security models. However, because of the long lead time for new activities derived from technology, funds may be uncertain as to whether they are investing enough for the future. The temptation to reduce technology spending in favor of boosting current profits is powerful, but in the long run may be costly. Undercapitalized fund complexes may be especially disadvantaged if the failure to invest places them at a cost or quality disadvantage.

Pricing. The industry's current experimentation with "A" and "B" funds, otherwise identical funds with different fee structures (no-load and high annual fees versus load and low annual fees), along with the SEC proposal to allow different fees to be charged to different customers, may ultimately lead to other innovative pricing plans. For instance, funds could unbundle their services and charge consumers for the services they value most highly. This pricing practice is common in the software industry. Whereas virtually all software companies offer technical assistance, some provide it completely free of charge, others charge users for the telephone call, and still others permit users to buy service contracts. In the same fashion, mutual funds could charge consumers for exactly those services they demand and receive.

Even if regulation forced funds to charge consumers the same fees, funds could effectively set differential prices by providing consumers with customized bundles of services. As an analogy, institutional investors that trade through certain brokers earn soft-dollar credits that can be used to purchase research and trading hardware from third-party vendors. In a similar fashion, a fund complex could allow customers to earn credits that could be spent on services such as independent financial planning, data services, or tax preparation, offered either within or out-

side the fund complex. By effectively charging different prices for different quantities of mutual fund services purchased, the rebate structure would allow funds to set prices closer to value perceived by the consumer.

Scale economies. Record keeping and distribution are activities for which complex-level scale economies exist, placing smaller complexes at a disadvantage. However, the unbundling of activities permits smaller complexes to gain some economies of scale at a cost. Historically, small load complexes have unbundled distribution activities by engaging brokers to sell their products, but they must pay dearly for this customer access. In a similar fashion, smaller fund complexes providing mainly investment advice have joined forces with independent turnkey 401(k) service providers that deliver record-keeping services. Even if smaller complexes can tap into larger firms' distribution and record-keeping skills *at cost*, this development would not ensure parity, let alone success. Especially in a crowded market, a low structure cost and lower fees do not guarantee success. Smaller complexes are more and more likely to be overpowered by the increasingly expensive marketing of large complexes with established brand franchises.

Entry by Mutual Funds into Other Businesses

The most notable recent example of the entry of mutual funds into another line of business is the 401(k) market. This class of defined-contribution plans is the perfect client from the viewpoint of the fund's management. The owner base is steady and does not withdraw funds. The marketing and distribution effort is centralized and emphasizes a single employer rather than many employees. Moreover, retail products do not need to be retailored to fit this class of user. In fact, some of the funds most in demand are brand-name products that can be bought outside of any 401(k) plan.

It is also a feature of this market that success in entering the business hinges on reliable and thorough shareholder reporting. The 401(k) system places requirements on record keeping above those for a normal fund product. If these functions are not handled seamlessly, the fund sponsor will suffer the cost of pacifying thousands of irate employees who receive erroneous periodic statements. Yet the defined-contribution nature of the plan means that employees bear the risks of performance, so that at the margin there may be incentives for sponsors to select a 401(k) vendor with better reporting than investment skills. This in turn intensifies the competition on the record-keeping activity in the value chain and makes this aspect of differentiation important for success in this growing market.

Mutual funds do more than repackage investment advice; they also sell nonfund financial products to their existing retail customers. Examples include large fund complexes that offer check-writing services (through money market mutual funds), credit cards, brokerage services, and insurance. Such strategies explicitly recognize that a complex's distinctive competence may be its brand- name and customer base, not necessarily its investment management skills. Brokerage firms, which distribute a variety of independently managed load funds as well as captive mutual fund offerings, have always offered a wide variety of financial products to their customers. In fact, their entry into the captive-fund management business did not come until the 1970s, when they recognized the growing importance of mutual funds as a vehicle for the small investor. Until that time, the wire houses distributed only other independent firms' offerings.

As we look forward, the interesting questions continue to center on the viability of some version of the financial supermarket. While some past attempts to create one-stop shopping for financial services have been unsuccessful, the distinctive trend seems to be for firms to offer more, rather than fewer, services. As that trend continues, the question becomes this: From what basic product or basic clientele is extension into other product areas more feasible? As vendors offer more financial products, we must define much more precisely what "product" a mutual fund or retail financial services vendor sells.

Merton and Bodie's perspective suggests that investors demand intertemporal wealth shifting, diversification, and hedging attributes in their investments. Interestingly, mutual funds are particularly good at the first and second functions and noticeably lacking in the third. While the needs of an investor change predictably over time as he or she progresses through the life cycle, mutual funds as *final products* do little to help investors meet their hedging or life cycle needs. Rather, mutual funds provide consumers with the raw materials they can use to fashion investments that satisfy these hedging or life cycle needs.

This customizing function has been satisfied by financial planners or by full-service brokers who offer investment advice in exchange for a fee. Yet mutual funds could more aggressively serve these consumer needs for customizing. One recent attempt at giving customized advice was introduced by Fidelity Investments.[26] Consumers fill out a short questionnaire that they submit to Fidelity; then they receive a recommended portfolio that can be constructed from Fidelity products. The

26. Jonathan Clements, "Fidelity Investments Plans to Move Into Advice-Giving," *The Wall Street Journal*, December 9, 1992, p. C1.

existence of the program is both a response to consumer confusion and an attempt by a no-load fund complex to encroach on the province of broker-distributed funds. This latter class of funds often bundles the investment advisory function with the mutual fund through the selling efforts of the agent or broker.

Fund complexes also have the basic building blocks with which to develop products to satisfy investors' life cycle needs. As an example, consider a young couple currently renting an apartment. Likely to be saving money toward the purchase of their own house, they are particularly exposed to changes in housing prices and financing costs. Mutual fund complexes or other financial services vendors could easily tailor an investment vehicle designed to hedge such a risk. The product may consist of traded securities, derivatives written on an underlying housing index, or both. It could be offered on an agency or a principal basis (with a regulatory change), according to the fund's ability to sell off or hedge the resulting net position. Such a fund offering would solve a particular investment problem many consumers face in their lifetime. If the product can be offered at lower cost than investment advice, it will dominate and allow the fund complex to gain market share at the expense of investment advisers. In such a case, a financial product supplants a service in the marketplace, where both are capable of fulfilling the same function for investors.

Near-Term Threats from New Rivals

Even if mutual fund complexes stay within the narrow bounds of producing and marketing what we call mutual funds, they are likely to face increasing competition from other firms. Because marketing and distribution constitute not only a major cost but also a key method of differentiation, successful new mutual fund entrants are likely to be firms with broad consumer franchises that can merely purchase investment management skills.

Although the most obvious candidates are financial services firms such as banks and insurance companies, it would be myopic to limit a scan of potential entrants to existing financial services vendors. Perhaps the best analogy is the credit-card business. Banks were the traditional vendors of credit cards, building on their other consumer credit activities. However, today's fastest-growing cards are Discover, sold by a subsidiary of Sears, and the AT&T Universal Card. Sears and AT&T used their distribution power aggressively to succeed in the credit card business.

The potential rivals most frequently mentioned are commercial banks. Banks maintain ties to consumers through both their lending and deposit activities and, in the wake of declining profitability, are

aggressively seeking to enter new businesses. It would be imprudent to dismiss the will and capacity of banks—such as Citicorp, with its consumer banking and brokerage business—to enter the mutual fund business, whether as a distributor of its own or others' funds.[27]

Even though banks seek greater fee income, doubts remain about their effectiveness in entering the mutual fund business. Their relatively high-cost structures could confer a significant disadvantage in price-sensitive segments of the mutual fund business. Furthermore, it remains to be tested whether most banks and their staffs can sell noninsured, nondeposit products as well as they are able to sell commodity-like insured bank deposits. Finally, we speculate that although banks have long customer lists, the most valuable of these customers are already served by mutual funds or brokers who offer mutual funds. If so, the banks' only competitive distribution advantage may be in reaching smaller, less-profitable mutual fund accounts.

If not traditional financial services providers, who might enter this industry? Firms that quickly come to mind are those with strong consumer franchises and distribution networks such as AT&T and Sears. Still other rivals may be drawn from industrial firms, where pension fund managers may seek to parlay their investment-manager-picking skills into profits. It seems unlikely that these skills alone—absent strong distribution and record-keeping skills—will permit them to succeed broadly in the mutual fund business.

Threats from Substitutes

The mutual fund industry may encounter increasing competition from substitute products—that is, products that provide many of the same economic functions as mutual funds but are not narrowly mutual funds. The institutions that deliver such products may be existing fund rivals or firms that seem quite distant and nonthreatening at present.

Consider imminent threats to sellers of indexed mutual funds products. As a group these passive funds, the returns of which are designed to track the performance of a broad index, all provide roughly equal security selection services to consumers. Because of their commodity nature and the ease with which performance can be measured, price competition is likely to be intense, and the lowest-cost providers of this service will prevail.

In the very near future, mutual funds may compete with exchanges offering indexed products. Consider the recent proposal by the American Stock Exchange to list S&P 500 Depository Receipts, or SPIDERS. These

27. Goldstein and Linton (p. 49) report that currently 87% of the banks with more $1 billion in assets sell mutual funds.

securities will represent an interest in a trust holding shares of stock in the S&P 500 Index and will provide investors with returns of that portfolio. SPIDERS are expected to compete directly against mutual fund index funds, and, according to some observers, their low fee structure may enable them to capture share against all but the lowest-fee index funds.[28]

In a similar fashion, mutual funds have recently succeeded in marketing sector funds that invest exclusively in defined classes of firms (e.g., biotechnology and high technology). Recent exchange-traded securities (bearing service marks like TIPS, STEPS, and STAIRS) also allow consumers to make bets on specific sectors of the economy.[29] Although no one of this menagerie of branded products poses a current threat to the mutual fund industry, as a class they provide consumers with an alternative to sector funds.

Mass-produced, exchange-listed products may chip away at the passive end of the mutual fund industry, but the more actively managed funds may face competition from another set of rivals. As noted at the beginning of this section, the SEC proposes to let funds with any number of "qualified" buyers have wide latitude in their investment decisions, thus allowing sellers of hedge funds to broaden their clienteles and market more aggressively against retail mutual funds. We note also that plans to create an active market in traditional partnerships, including investment partnerships, may make this traditionally illiquid investment much more attractive to potential mutual fund buyers who also demand liquidity services.[30]

Perhaps the most interesting long-run threats and opportunities may arise from a more fundamental redefinition of the mutual fund and the other investment vehicles with which it competes. The mutual fund industry self-categorizes its offerings crudely by the type of securities a fund holds—aggressive growth equity funds, single-state municipal bond funds, money market funds, and so on—forcing consumers to determine which portfolio of investments will solve their *real* problems: saving for children's education, planning for retirement, or generating current cash flow to meet living expenses.[31]

28. See Robert Steiner, "New Amex 'Spiders' Mimic S&P Index," *The Wall Street Journal*, March 12, 1992, p. C1.

29. For example, see Tom Pratt, "Goldman on Bandwagon with Another Steps Clone," *Investment Dealers Digest*, March 23, 1992, p. 21. These products offer capped appreciation and, in essence, are covered call-writing strategies.

30. Karen Slater Damato, "Investors to Find It Easier to Sell Partnership Stakes," *The Wall Street Journal*, December 2, 1992, p. C1.

31. Some have suggested that even as guides to what the fund invests in, these labels are uninformative or misleading. See Barbara Donnelly, "What's in a Name? Some Mutual Funds Make It Difficult for Investors to Judge," *The Wall Street Journal*, May 5, 1992, p. C1.

Such consumer needs have not fundamentally changed over time. However, the mutual fund industry—and the financial services sector more broadly—seems content to deliver an increasing number of new products, few of which address these needs *directly*. There are a few obvious exceptions. Insurers, having long recognized consumers' desires to hedge against death, illness, and disability, accordingly created contracts with payoffs contingent on these unfortunate events. One savings institution has patented a product that promises to deliver consumers a payoff indexed to college tuition costs, thus attempting to meet a common consumer requirement.[32] This product is structured as a certificate of deposit, but it could have been set up as a mutual fund.

As we have argued earlier, a mutual fund could offer consumers a limited set of investment vehicles, each targeted at a well-defined set of consumers with common investing needs determined by their age, family circumstances, and wealth—that is, by their life cycle. This small set of what could be called "cycle funds" would not be defined by what they held, but rather by what need they really satisfied. One might seek to deliver a return producing a constant standard of living over time. Another might be indexed to college costs. A third might be indexed to health care costs. Such products could be structured as mutual funds, CDs, insurance contracts, or other financial claims.

By drawing on its investing and marketing expertise, a financial institution might be able to appeal both to the timeless needs of consumers and to the current confusion faced by investors who need to sift among thousands of varied and increasingly complicated financial products. If successful, the organization selling these claims could capture market share from a variety of broadly competing investment alternatives, including mutual funds.

Conclusions

Over the past two decades, the open-end mutual fund industry has become an increasingly important component of the financial services sector. Consumers have entrusted the industry with more than a trillion dollars. Mutual funds have siphoned short-term funds away from bank and thrift deposits, and long-term funds have supplanted consumers' direct equity holdings. Within the industry, rivalry has been intense as firms struggle to differentiate themselves. As a result, today's consumer enjoys lower prices and more investment choices—but likely faces greater confusion. This confusion allows funds to divide and conquer

32. See Ellen Schultz, "CDs Pegged to College Costs Look Good to Parents, but Do They Make the Grade?," *The Wall Street Journal*, March 29, 1992, p. C1.

the market, conferring a comparative advantage to distribution methods that provide consumers with either credible advice or a prescreened yet comprehensive set of alternatives.

In pondering the industry's future prospects, we find it useful to look beyond the mutual fund to consider the activities a fund undertakes and the economic needs it satisfies. Activity-based analyses highlight how vendors can succeed by capitalizing on distribution strength and low costs arising from the scale of their businesses. Functional analyses of the industry lead us to consider the threat of substitutes in the form of non-mutual fund products.

Although predicting the future is a task best left to mystics and consultants, it seems likely that rivalry will continue to be intense, marketing and distribution will be critical, and natural economies will tend to favor larger competitors. The mutual fund industry will continue to attract new rivals—banks, insurance companies, exchanges, and possibly non-financial services sector distributors—that seek the growth and profitability that characterizes the industry. At the same time, mutual fund complexes will look beyond their traditional offerings and seek to capitalize on their distribution capability by offering insurance products, credit cards, check-writing services, and perhaps services that currently appear to be only distantly related.

The result is that the mutual fund industry may cease to exist *as an industry* and may simply become a class of products sold by different types of institutions or, more broadly, a set of economic needs satisfied through a variety of seemingly dissimilar alternatives. The lines between different financial services firms—and between different products—will become increasingly blurred. Ultimately, all of these firms seek the same goal: to capture consumers' dollars. To meet their need to pay bills, reduce risk, and save for retirement or for college, consumers are forced to choose from among thousands of different mutual funds, 401(k) investments, variable rate annuities, insurance products, certificates of deposit, stocks, bonds, limited partnerships, and exotic financial instruments. In this market it is no surprise that even sophisticated consumers have surrendered, letting professionals make and execute their investment choices.[33]

A marketer advising anyone who hopes to sell to these already overloaded consumers would tell them, "Listen to the customer." Merton and Bodie might phrase it differently, but they would convey a similar message. Whereas mutual fund firms think of themselves as

33. See Jay O. Light and André Perold, "The Institutionalization of Wealth: Changing Patterns of Investment Decision Making," in *Wall Street and Regulation*, edited by Samuel L. Hayes, III (Boston: Harvard Business School Press, 1987), pp. 97–126.

competing *against* one another, the most successful rivals will remember that they are competing *for* consumers. This suggests that both managers of financial services firms and academics studying these firms would be well advised to spend more time thinking not about exotic solutions but about fundamental consumer needs.