

Introduction

Competition for Mutual Funds from New Investment Vehicles

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This is the eighth conference in a series Bob Litan and I have organized under the general question “Is there a better way to regulate mutual funds?”

One of the most important benefits offered to investors by mutual funds is the opportunity at limited cost to achieve diversification, and thus limit investment risk. One of the lessons of Enron and WorldCom is that investors can protect themselves against fraud and business collapse through diversification.

In this conference, we want to look at competition for conventional mutual funds from other kinds of investment vehicles that also offer diversification, and sometimes more.

It may at first seem anomalous to be considering whether there is serious competition for an industry that has almost \$9 trillion dollars in assets and over 90 million customers. There is no doubt that mutual funds are today the dominant form of equity and fixed income investment for Americans. It may also seem anomalous to consider whether changes in regulation are necessary for such an industry, since regulation cannot be much of a problem for an industry that has grown so large.

But regulation has a way of stifling innovation and change in a regulated industry, leaving the field open to competition from less regulated or unregulated alternatives. This is especially true when the market undergoes a profound change, but regulation does not keep pace.

Indeed, alternatives often develop because the regulated industry cannot serve a demonstrated need or adapt to a new technology. What this often means is that the talented people in the industry go elsewhere, and the industry stops growing and improving. The people who are hurt in this process are the customers who don't have the knowledge to get out as the industry provides less and less value.

What we should want are industries that are free to change in response to consumer demands, to offer their products in new ways in order to avoid the danger of obsolescence in a constantly evolving market.

Accordingly, any study of regulation must also consider whether the regulated industry has the flexibility under its regulatory framework to change and innovate in order to meet new competition.

In today's conference, we'll look at some of the new competitors for the conventional mutual fund. Exchange traded funds, or ETFs, are a relatively recent innovation, and are regulated under the Investment Company Act of 1940. They offer the diversification advantage of mutual funds and also address some of the tax and other deficiencies that some investors find in mutual funds. ETFs are currently based on indexes, but could be managed like conventional mutual funds if the SEC approves various exemptions from the Investment Company Act. Separately managed accounts and Folio fn are both ways for investors to achieve diversification through customized portfolios that meet their specific investment objectives.

What we are likely to see today is that while mutual funds are currently the dominant form of investment for the retail investor who is looking for diversification, ETFs and customized portfolios of various kinds are growing faster than conventional mutual funds. If we subtract out of the mutual funds' market share the investments made by pension plans and similar collective retirement vehicles, we will probably see that these customized competitors are capturing now, and will capture in the future, a much larger portion of the retail investor market than the gross numbers suggest.

This should be a warning signal for those concerned about excessive, or excessively rigid, regulation. If mutual funds are not meeting the needs of a substantial body of retail investors, something significant is going on.

It seems clear that retail investors are increasingly willing to pay for individualized advice in the management of their assets. This is a major change in the market and has profound implications. For years, mutual fund groups have been proliferating various kinds of funds—balanced funds, bond funds, index funds, income funds, small cap, large cap, growth funds, aggressive funds, maybe even passive-aggressive funds—but it appears that all of these specialized funds are not sufficiently personalized to meet the needs of today's sophisticated investors, who seem to want something even more tailored and customized.

Perhaps this is a passing phase, or maybe there is only a relatively small group of investors who want and are willing to pay for this kind of service. Maybe the growth of alternative investment vehicles will stop as they mine the opportunities in this limited group. But as Americans become more affluent and sophisticated about what the financial world offers, it may well be they will not be satisfied with the fund categories that the mutual fund industry is economically capable of offering in its current structure.

It is important to keep in mind that it is expensive to create a mutual fund. A mutual fund is a corporation which must comply with the full panoply of costs that are borne by all corporations that offer their shares to the public—even Sarbanes-Oxley. It's hard to imagine that it could be profitable for the mutual fund industry to continue to set up more and more corporations to meet the demands of investors for more and more individualized or specialized portfolios.

At some point, it may be necessary to authorize a less expensive alternative to the corporate form, which is the only form currently recognized by the Investment Company Act. That's why an important component of any study of mutual fund regulation has to consider the competitive position of the industry and what is happening in its market.