

Introduction

Book Forum:

Competitive Equity: A Better Way to Organize Mutual Funds

By Peter J. Wallison and Robert E. Litan

When Bob Litan and I began the study of mutual funds in September 2005, we were drawn to the subject by the size of the industry and the fact that it seemed to be under such sustained attack by critics in the media, and even at the SEC. It seemed to us that an industry with such opponents—as W.C. Fields would say—couldn't be all bad.

And in fact it isn't. The mutual fund industry, with \$10 trillion under management, has become the largest repository of the savings of Americans, far surpassing the banking industry. One of the reasons for this is that it provides diversification, the most important readily available protection against loss in the securities markets, and allows over 90 million American investors and savers to participate in the growth of the amazing U.S. economy.

But despite this important service, it did seem to us that reform was necessary—not so much in the fundamentals of the industry as in its pricing. We were puzzled, as Bob will describe, about why there was such a large difference between the expense ratios of very similar funds. In most competitive industries, prices converge, but that has not happened in the mutual fund industry—although, with a multitude of competing fund families and thousands of mutual funds, the industry looks as though it should be highly competitive. As some academic commentators have noted, the industry violates what economists call “the law of one price.” The effect of this, in our view, is that many mutual fund investors may be paying more for collective investment services than they would if competitive pricing prevailed.

One of the most arresting elements of the mutual fund landscape was the fact that the SEC was trying to make mutual fund boards of directors more independent, in order to drive down the cost of advisory services. We kept wondering why this was necessary. If advisers were competing to attract more investors—and certainly they were—why did boards have to struggle to reduce their prices? Why didn't this happen naturally because of the price competition that occurs in every other competitive industry?

The result of our effort to find an answer to this question is the book we will talk about today—entitled *Competitive Equity: A Better Way to Organize Mutual Funds*.

The book is founded on a theory of how mutual fund pricing works. From our perspective, it explains why there is such a disparity in the pricing of advisory and management services in the industry, and why the SEC's 40 year effort to make fund boards more independent has failed to produce the kind of efficient, low cost service that competition provides in almost every other sector of the economy.

Nevertheless, we advance the ideas in the book as a theory, and acknowledge that, like all theories, it is proposed for the purpose of debate and challenge. If it survives this process, it will be a real contribution to public policy in this area.

We look forward to your comments and questions.