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How do mutual funds transfer scale economies to investors? Evidence from France

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ABSTRACT

Previous studies on the U.S. mutual fund market show that funds transfer large economies of scale to investors only if these economies come from outside service providers. Unlike the US market, in the French market, most of the fund services are provided by the fund company itself or by the companies belonging to the same group. Because scale economies exhibited during the fund operation stay in the fund company or the parent group, funds might not be willing to transfer scale economies to investors. In this article, using a large sample containing 3125 equity funds and 1296 bond funds in the French market, I examine whether and in which services funds transfer scale economies to investors. The results show that at the fund and the family level, only slight economies of scale are passed on to investors through the reduction of total fees as the fund assets increase. Funds seem to transfer large economies of scale in portfolio management and distribution services but slight economies of scale in administration services. Bond funds, which have in general lower fees than equity funds, do not pass economies of scale on to investors.

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1. Introduction

Previous studies on the determinants of the total expenses of mutual funds observe a negative relation between fund size and fund fees.[1] Thus, they conclude that there are economies of scale in the mutual fund industry. However, the economies of scale observed in these studies are only those passed on to investors, not the entirely economies of scale exhibited in mutual funds. Indeed, a fund can enjoy large economies of scale but transfer only a small amount of these economies to investors or even maintain the same level of fees charged to investors as the fund assets increase. Bogle (2001) estimates that only 60% of the total expenses paid by investors are used for the management and operating of the fund. The remaining 40% is the pre-tax profit earned by the fund management company. In this paper, I consider that a decrease in fund fees (as fund assets increase) only reflects a transfer of scale economies of the fund company to investors.

Using a sample of 4421 funds, containing bond and equity funds sold in the French market, for the period from 1993 to 2007, I examine whether and how economies of scale are passed on to investors. I try to respond to two questions. Do funds really pass economies of scale on to investors? In which services (portfolio management, custodian, distribution, administration or other services) do funds transfer these economies to investors? The analysis of fund fees in the French case is interesting for several reasons.

First, Gao and Livingston (2008) show that in the US market only fees that are paid to outside providers (such as custodian or administration fees) exhibit large economies of scale. It suggests that funds will pass economies of scale on to investors only if these economies are come from outside providers. In contrast to the US market, 80% of French funds are proposed by banks (COB report, 2002) and it is common that a fund's services are provided by the companies belonging to the same group (e.g., a banking group). In this context, the eventual economies of scale transferred to investors are come from the fund company itself or the parent group. As a result, the fund company should not be willing to pass scale economies on to investors. Therefore, the results in the French case can be different.

Second, in France, funds are not required to detail all their fee components in their periodical reports. They often place non-management fees (such as custodian, administration or distribution fees) into management fees. Also, funds can disclose economies of scale for some services and at the same time increase other fee components in order to maintain their benefits. Because there is no requirement in fee detailing and all fees paid by investors stay in the fund company or the parent group, it can be easy for French fund to have this practice.

Third, the French market has some characteristics that can directly affect the exploiting of scale economies. On the one hand, French funds are on average six times smaller than American funds.[2] Thus, they less enjoy economies of scale than American funds. On the other hand, as mentioned above, in the French market, 80% of funds are proposed by banking groups. It is well known that many operation services of mutual funds (e.g., custodian and distribution services) are provided by banks. Banks then have knowledge and expertise in the funds' operation services. Therefore, they can enjoy large economies of scale.

Finally, although the French market is the largest market in Europe and the second largest in the world, there has been no research on the sources of economies of scale transferred to investors in this market.

This study has several contributions to the literature. Firstly, this study is applied for one of the largest market in the world outside the US. Secondly, I use a large sample and for a recent and long period. Thirdly, I also investigate the existence and sources of economies of scale at the fund family level. Indeed, funds belonging to the same family often share services (e.g., distribution services).

[1] Chance and Ferris (1991), McLeod and Malhotra (1994), Malhotra and McLeod (1997), Dellva and Olson (1998); Malhotra et al. (2007) in the U.S market, Dermine and Röller (1992), Grillet-Aubert and Rifaldi (2009) in the French market; Martinez-Sedano and Gil-Bazo (2004) in the Spain market; Korkeamaki and Smythe (2004) in the Finland market; Gernanio and Zanotti (2005) in the Italian market and recently Khorana et al. (2009) studying fee determinants around the world.

[2] *Source*: AMF report (2009).

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