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Brothers from different mothers how distribution fees change investment behavior

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ABSTRACT

We ask whether loads affect investment flows in the US mutual fund industry. We argue that sales fees make the investment decision partially irreversible. Under these circumstances investors await for a stronger signal of managerial ability before committing to a new fund. This stronger signal can take the form of a particularly strong performance or a particularly long series of positive performance realizations. Looking at pairs of fund shares with the same portfolio but different sales fee arrangements we show that investment flows in share classes with front loads react disproportionally to good performances (higher convexity in the flow-performance relationship) and react to performance realizations further back in time (longer memory). A counterfactual example of fund shares with back-end loads allows us to rule out the hypothesis that this behavior is due to the incentive structure of brokers. Finally we show that these behavioral modifications induced by front loads have a negative and significant effect on investors' timing ability.

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1. Introduction

Investors pay for asset management services via annual management and performance fees. When investment flows are intermediated by a third party fund management companies can charge a one-off sales fee to be paid at the subscription or at the redemption of the fund shares.

While the relevance of sales fee has steadily decreased in the last ten years it still remains substantial[1] and a significant number of contributions have addressed the effect of loads on investment decisions.

The effect of sales fees can be analyzed at two different levels: on the one side they usually indicate the presence of a broker within the investment decision process[2] and many authors have argued that broker incentives may pay a key role in the choice of investment product (see for example O'Neal, 1999; Zhao, 2008; Del Guercio et al., 2010; Lemeunier, 2011).

On the other side investment cost is one of the key determinants, together with past performance, of investment decisions. While some authors have argued that investors only care about a comprehensive "total investment cost" measure where all the cost components are lumped together (see for example Sirri and Tufano, 1998; Khorana et al., 2009) other authors have demonstrated that the "form" of the charge (one-off vs. recurring annual fee) is relevant as it may affect investors' behavior (see for example Barber et al., 2005).

Overall, our understanding of the investment effect of distribution fees is so far limited. A major problem in the previous literature is that load and no-load funds investment policies may differ significantly. If for example, as postulated by Houge and Wellman (2007), load funds cater to less sophisticated investors, then we should expect them to invest more conservatively. Under these conditions is very hard to disentangle the effect of the load from the effect of the different investment policy when looking at investors' behavior: failure to properly control for portfolio differences between load and no load fund could lead to erroneously attribute to loads what is in reality caused by differences in investment strategies.

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[1] The 2013 *Investment Company Fact Book* reports a weight of load fund shares in terms of asset under management declining from 36.5% in 2003 to 25.4% in 2012.

[2] See Pozen and Hamacher (2011) for examples of revenues sharing agreements between brokers and investment companies.

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In this paper we address this issue looking at mutual funds with multiple share classes and considering couples of fund shares (with and without loads) with the same portfolio. This allows us to isolate the effect of the load on investors' behavior. We call these pairs "brothers from different mothers" because we document striking dissimilarities in investors' behavior in spite of the identical portfolio composition.

In this paper we hypothesize that when investors infer managerial ability from funds' past performance, their investment behavior will be affected by the presence of loads. Specifically we will argue that investors become "more cautious" and wait for a stronger signal of managerial ability before committing to a new fund. This effect derives from the fact that while dissatisfied investors in no-load funds can easily switch to another product, the front load acts as a non-recoverable upfront cost and makes the investment decision partially irreversible.[3]

A "stronger" signal of managerial ability can derive from a particularly good past performance or from a long series of positive performances. We empirically show that investment flows in fund shares with front load are characterized by: (a) a more convex relationship with past performance, they react disproportionally to strong returns; (b) a longer memory, they react to performance realizations further back in time.

A counterfactual example looking at fund shares with back-end loads confirms that these effects are generated by the salience and the upfront nature of front loads rather than by the involvement of a broker in the investment decision process.

Finally we look at how these behavioral modifications induced by front loads affect investors' timing ability measured as the difference between dollar-weighted and time-weighted rates of returns of investment flows (as in Friesen and Sapp, 2007). We show that investment flows into share classes with front loads show worse timing ability than flows into the no-load class of the same fund with the difference both statistically and economically significant.

The rest of the paper is organized as follows: in Section 2 we summarize the relevant literature and develop our hypotheses;

This paper is divided into four sections. Section 2 covers the relevant literature and develops the main hypotheses; Section 3 describes the data, Section 4 analyses the effect of loads on investment decisions; Section 5 analyses the effect of loads on timing ability; Section 6 summarizes and concludes.

2. Relevant literature and hypotheses

In this paper we address three strands of financial literature: (a) The effect of sales fees on investment flows in the mutual fund industry; (b) The role of brokers as advisors for mutual fund investors; (c) The role of (partial) irreversibility on investment decisions.

2.1. Loads and investment flows

The effect of loads on investment flows has been the object of a number of relevant contributions. Sirri and Tufano (1998) and, more recently, Khorana et al. (2009) show that investment flows respond negatively to a total investment cost measure built as the expense ratio plus the amortized value of loads. Barber et al. (2005) separate the expense ratio from loads and show that the latters are more salient for investors and have a stronger (negative) impact on flows than the former. This result has been later contradicted by Zhao (2008) and Bergstresser et al. (2009) who, looking at a sample of funds distributed through the broker channel, find a positive relationship between investment flows and loads. More recently Christoffersen et al., 2013 find a positive relationship between investment flows and the portion of loads paid to brokers. Different hypothesis have been advanced to justify this positive effect: Nanda et al. (2009) argue that offering multiple share classes mutual funds are able to attract investors with a range of different preferences.[4] Iannotta and Navone (2012) argue that loads increase fund visibility and lower search costs through the fund selection activity of the broker.

A common characteristic of these papers is that they do not account for portfolio differences between load and no-load funds. While every analysis includes some controls such as portfolio performance, size, turnover, volatility etc. it is impossible to completely rule out the possibility that the samples of load and no-load funds differ along some unobserved dimension.

2.2. Brokers and investment decisions

Investors can buy mutual fund shares through a variety of channels. Brokers can offer both transactional and advisory services. In the latter case they may advise the client in asset allocation and or fund selection. While the obvious rationale for this service is that brokers should have better knowledge and higher skill Bergstresser et al. (2009), and Friesen and Sapp (2007) show that investment flows intermediate through the broker channel either do not earn any extra performance or they outright underperform. While Bergstresser et al. (2009) suggest that investors may derive some unobserved non-portfolio benefit from their relationship with brokers, other authors have pointed out that brokers advice may be affected by conflict of interest. O'Neal (1999) shows that brokers have the incentive to steer clients towards fund shares with load structure that is not optimal for their planned investment horizon. Houge and Wellman (2007) and Zhao (2008) argue that brokers target clients with lower sophistication and empirically show that brokers distribute funds with higher fees. Since these studies do not properly account for portfolio differences between fund sold through direct and brokered channel is not possible to attribute the lack of performance of brokered flows to bad timing of investment decisions or bad fund selection.

2.3. Irreversibility and investment decisions

The effect of sunk costs and irreversibility on investment decisions has been thoroughly investigated both in economics and corporate finance literature. While basing investment decisions on past financial outlays is considered irrational (the so-called sunk cost fallacy documented, among many others, by Kahneman and Tversky, 1979 and Thaler, 1980) firms rationally anticipate the unrecoverable nature of their future investments when they evaluate prospective projects. Pindyck (1991) summarizes the main findings of economic literature on irreversible investment decisions under uncertainty. These contributions mainly deal with investments in physical assets with limited secondary market value such as industrial plants or infrastructures such as pipelines and oil wells. On the other side financial assets are inherently more liquid and thus portfolio investments are eminently reversible, with transaction costs being the only unrecoverable component. When transaction costs are low irreversibility should not play a

[3] The reader should note that investment in a portfolio of liquid financial asset is totally reversible in absence of transaction costs. The load here acts as a form of transaction cost that is paid at the moment of the purchase (front load) or at moment of the sale (back-end load).

[4] An exploratory analysis of our database suggests that out of 7636 unique funds with a single share class active between 1999 and 2011 5570 where no-load. The predominance of no-load share classes among single-class mutual fund could account for the positive effect between loads and flows under the Nanda et al. (2009) argument that the introduction of multiple share classes increases the total flows to the fund.

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