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Asset sales in the mutual fund industry: Who gains?

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ABSTRACT

We analyze gains from intercorporate sales of mutual fund subsidiaries, using mandated SEC disclosures to assess the performance of mutual funds transferred by these transactions. Sellers are financial conglomerates (banks) using equity-based deals to transfer poorly performing funds to highly focused asset management companies. The transferred funds experience significant improvements in risk-adjusted returns, efficiency, and asset growth. These improvements are closely correlated with the gains in wealth to buyers and sellers at deal announcements, indicating the market efficiently capitalizes expected performance improvements. Our results provide evidence that these transactions transfer assets to acquirers better able to manage them, generating gains for fund holders and buyer and seller shareholders.

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1. Introduction

In this paper we contribute to an understanding of intercorporate asset sales by analyzing sell-offs of mutual fund subsidiaries and evaluating whether these transactions lead to enhanced fund performance. Prior studies of corporate asset sales (Jain, 1985; Hite et al., 1987; John and Ofek, 1995; Sicherman and Pettway, 1992) encompass broad ranges of divested assets, but the research generally focuses on an analysis of announcement effects on seller share prices. In most settings the absence of consistent data about the performance of wholly owned assets before or after an asset sale limits the scope of the analysis of the gains from asset sales. We circumvent this difficulty by analyzing divestitures of a specific class of corporate assets, mutual funds that are subject to uniform SEC standards for reporting fund performance, irrespective of the nature of the parent entity. Thus, we obtain direct evidence about changes in asset productivity around transfers of control and relate these changes to the share price effects for sellers and buyers observed at sale announcements.

We analyze the results of 21 sale transactions involving 429 mutual funds over the period 1990–2007. This set of transactions, although modest in number, is exhaustive over the sample period and encompasses a substantial number of separate funds. Additionally, the mutual funds in our sample are larger than the industry average and the gains in shareholder wealth and in subsequent fund performance that we observe are statistically significant and economically important. Our results entail several major findings. First, sellers of mutual fund entities are mainly financial (e.g., bank) conglomerates and the funds divested generally have sustained poor prior performance for a substantial period. Second, acquirers are typically highly focused, free-standing asset management companies with considerable ownership concentration. Third, after transfer to acquirers, mutual funds experience significant improvements in operational efficiency, performance, and asset growth. Similar gains are not observed for benchmark mutual funds matched by style and prior performance, indicating that the performance gains generated after asset sales are not due to reversion to the mean. Fourth, mutual fund holders benefit from significant reductions in expense ratios and increased alphas following asset sales. Fifth, asset sales involving mutual fund entities are disproportionately equity-based deals, eliciting significant announcement gains in shareholder wealth for both sellers and buyers, indicating a sharing of the gains from trade. These large gains are consistent with theory that predicts that the use of buyer equity as a means of payment in an asset sale signals favorable informa-

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tion about expected future productivity gains.[1] Sixth, cross-sectional changes in buyer and seller shareholder wealth at sale announcements are closely linked to ex post changes in mutual fund performance. This correlation suggests that buyers bid aggressively and generate large gains to sellers when acquirers expect to be able to significantly improve the performance of the asset management entities sellers are divesting. The pattern of our results suggests a well-functioning asset sales market, a competitive mutual funds environment, and a capital market that is efficient at capitalizing the value of subsequent improvements in performance. Thus, the asset sales we study are a mechanism to transfer underperforming funds at broad financial institutions to more highly focused asset management firms that are better at managing these assets, to the benefit of fund holders and both seller and buyer shareholders.

Prior finance literature distinguishes several motives for asset sales: (1) as a means to reallocate resources to a buyer with higher-valued uses or better managerial skills (Hite et al., 1987; Maksimovic and Phillips, 2001), the efficiency hypothesis; (2) as an exit strategy that divests unprofitable units (Alexander et al., 1984; Jain, 1985; Brown et al., 1994; Ofek, 1993), the liquidation hypothesis; and (3) as a means of restructuring a diversified parent into a more focused entity (John and Ofek, 1995), the focus hypothesis.[2] Numerous studies document that asset sales enhance seller value, with few gains to buyers, suggesting that the asset sale market is competitive and that the overall gains generated by asset sales are modest.[3] Since assets to be divested are generally not public entities and their performance is typically subsumed within a much larger parent organization, analyses of share price effects cannot separate these alternative hypotheses given that news of a sale simultaneously conveys information about an asset's expected profitability (value), changes in the value of the seller's remaining assets, and expected synergies of the acquirer. However, by analyzing the performance of mutual funds transferred through sales of asset management entities, we finesse these difficulties because each fund's performance must be consistently reported to the SEC. Moreover, there is little ambiguity about the boundaries of this industry given the specificity of federal regulation. Thus, we examine changes in performance of divested funds (i.e., returns on mutual funds), evaluate changes in productivity around transfers of control, and analyze whether buyers, sellers, and/or mutual fund holders obtain significant gains from these corporate control transactions.[4] Our evidence provides direct support for the efficiency hypothesis of asset sales, but it does not exclude the liquidation or focus hypotheses as additional avenues through which value may be generated by these transactions.

The management of financial assets differs in some ways from the management of tangible outputs and inputs. For example, the relatively long investment periods for many nonfinancial firms imply that current performance is largely a function of earlier investment decisions. In contrast, mutual fund performance after a transfer of control is not tightly constrained by prior decisions since portfolio adjustments can be readily accomplished without undue costs. Thus, we believe our results contribute to a more precise understanding of the operating performance effects of market-based transfers of control and their relation to share price reactions to news of these announcements.

Our work also has implications for both the banking and mutual funds industries. Amidst a continuing debate about bank deregulation and whether there should be barriers to universal banks, the evolution of banking has involved a succession of transactions involving asset management entities.[5] Massa and Rehman (2008) argue that bank affiliated funds exploit private information about a bank's customers that can bolster mutual fund returns, supporting the view that full-service, conglomerate financial firms generate superior fund performance. However, Golez and Marin (2012) find that managers of bank-owned funds act to support the parent company's shares in response to sharp declines in the bank's share price, to the detriment of fund holders, leading to the conclusion that a severe agency problem is intrinsic to bank-affiliated mutual funds. We find that sellers of mutual fund subsidiaries are predominantly financial conglomerates. These sales typically transfer poorly performing mutual fund subsidiaries to more highly focused asset management companies with more concentrated ownership structures that are able to generate a significant improvement in fund performance. This systematic pattern for sellers and acquirers provides some indirect support for the views of researchers who cast doubt as to whether a conglomerate model enhances efficiency in the provision of financial services.[6]

Our work also contributes to the continuing controversy about competition in the mutual fund industry. Critics have filed numerous lawsuits against the industry, contending that fees are excessive due to a lack of competition that reflects close relations between mutual funds and their advisors.[7] Industry defenders argue that mutual fund services are priced competitively, reflecting the absence of barriers to entry in the mutual fund industry. We find that after asset sales involving asset management entities, there are significant gains in fund performance and improved efficiency, suggesting that there is sufficient competition in the industry to insure that some of the gains from trade benefit fund holders in the form of higher risk-adjusted returns.

Auction theory implies that the price paid to a seller of an asset conveys information held by the buyer about the value that it can derive from the asset and reflects a buyer's ability to seize economies of scale, generate synergies, or obtain other productivity improvements from the asset. Consistent with this view, we find significant post-transaction improvements in performance for divested mutual funds, and we show these gains are not due to reversion to the mean. Moreover, the changes in performance are closely correlated with the changes in shareholder wealth ob-

[1] Slovin et al. (2005) and Hege et al. (2009) show that there are large gains in wealth for both buyers and sellers in equity-based asset sales, while cash asset sales generate small gains in wealth that accrue only to sellers. On this basis there should be greater gains in efficiency and wealth when mutual fund entities are sold in equity-based asset sales rather than cash deals.

[2] Among the other studies that argue there is a positive relationship between focus and shareholder wealth are Lang and Stulz (1994), Berger and Ofek (1995), Comment and Jarrell (1995), Servaes (1996), and Lamont and Polk (2002). In contrast to the focus hypothesis, Stein (1997) and Desai et al. (2004) argue that internal capital markets can allocate capital more efficiently than external capital markets when private information is important.

[3] Previous research reports that event study gains to sellers typically average about 1%, with little gain to buyers, and that the typical asset sale transaction generates only a small gain in combined value. See for example, Rosenfeld (1984), Alexander et al. (1984), Klein (1986), and Hite et al. (1987), and the summary of this research found in Eckbo and Thoburn (2008).

[4] Although subsequent changes in mutual fund performance and the wealth gains to the seller and acquirer firms should be linked, we note that there need not necessarily be a positive relation between wealth gains to buyers and returns to mutual fund holders, since some factors that harm fund holders, such as the buyer's ability to increase fees, could generate significant benefits for acquirer shareholders.

[5] Among the major transactions were Citigroup's sale of its mutual fund unit to Legg Mason in 2005, and Merrill Lynch's sale of its mutual fund business to Blackrock in 2006.

[6] More broadly, Allen and Santomero (2001) and Berger and Mester (2003) argue that there are benefits to banking (i.e., financial supermarkets) from such fee-based lines of business due to informational efficiencies and cross-selling, which can be viewed as a form of bundling opportunities in the standard industrial organization literature (Adams and Yellen (1976)). In contrast, Stiroh and Rumble (2006) and Golez and Marin (2012) argue that there is no evidence for such gains in banking.

[7] Among the more prominent academic studies to argue that there is insufficient competition to constrain mutual fund fees are Freeman and Brown (2003) and Freeman et al. (2008), while the case for the presence of effective competition can be found in Coates and Hubbard (2007). This controversy has spawned considerable litigation in the form of class action suits against mutual fund advisors, the history of which is detailed in these academic studies.

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