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Daily mutual fund flows and redemption policies ☆

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Abstract

We examine how redemption policies affect daily fund flows in open-end mutual funds. Since short-term trading of fund shares, as manifested in daily fund flows, can have an adverse impact on returns to the fund's shareholders, mutual funds might find it desirable to discourage short-term trading through the use of redemption fees. However, if daily fund flows are due to fund shareholders' legitimate liquidity demands, the redemption fee would have little effect on daily fund flows and possibly adversely affect fund shareholders by imposing a liquidity cost on them. We find that the likelihood of a fund charging a redemption fee is largely a function of its overall fee structure. We also use a sample of funds that imposed redemption fees to examine whether the distribution of daily fund flows changes after the initiation of the redemption fee. We find that the redemption fee is an effective tool in controlling the volatility of fund flows.
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1. Introduction

In addition to the potential benefits of professional investment management and diversification, open-end mutual funds offer the privilege of nearly free and unlimited liquidity. Most funds grant shareholders the right to exchange fund shares for cash at its end-of-day per share net asset value (NAV). Shareholders typically pay no direct costs when exercising this right to exchange shares, despite the possibility that these exchanges impose costs on the fund's remaining shareholders through increased expenses and lowered realized returns. While numerous studies explore the performance of funds' portfolio managers, more recent scrutiny focuses on how the liquidity feature of mutual funds affects performance.[2] This paper examines mutual funds' attempts to restrict the sale of fund shares through fund policies such as redemption fees.

Mutual fund shareholders redeem their shares for several reasons. Typically, redemptions are considered to be motivated by infrequent liquidity shocks or regular asset allocation decisions. These liquidity motives are similar to those of the uninformed liquidity traders in the models of Glosten and Milgrom (1985), Kyle (1985), and Admati and Pfleiderer (1988). Liquidity-motivated and infrequent redemptions that are uncorrelated over time should not impact the fund manager's portfolio selection strategy and should not result in significant costs to the fund. However, Edelen (1999) suggests that excessive fund flows can have detrimental effects on mutual fund performance, and attributes the effect on performance to transaction costs arising from the adjustment of the underlying portfolio holdings and the need to carry cash to fund liquidations.

Some shareholders might trade fund shares in order to engage in market-timing or short-term speculative trading. Among these traders, some might redeem shares in order to exploit a possible mis-pricing in the fund's per share NAV. Bhargava and Dubofsky (1998), Zitzewitz (2003), Goetzmann et al. (2001), and Chalmers et al. (2001) show that funds' NAV's can be mis-priced on average due to the stale prices of the fund's underlying assets. Greene and Hodges (2002) show that traders have exploited stale-priced trading opportunities in international funds, significantly diluting fund returns. In addition to the adverse impact of strategically timed fund flows, the shifting of capital-gains tax liabilities to passive investors can lead to even greater dilution of after-tax fund returns, as suggested by Dickson et al. (2000).

Fund managers might attempt to limit the effects of these fund exchanges. Chordia (1996) presents a model in which fund managers choose policies (an exchange fee in the model) to entice investors to self-select into funds based on their liquidity needs. Nanda et al. (2000) construct a model in which the heterogeneity of managerial ability and the differences in investors' liquidity needs determine the fees charged by a fund. Managers who can earn higher returns may be able to charge higher fees to deter liquidity traders. Similarly, Nanda and Singh (1998) construct a model in which the endogenous liquidity needs of investors lead them to form a mutual fund, while also determining the fee structure and size of the fund. In their model, funds that are more efficient in managing transaction costs (including the costs arising from fund redemptions and taxes) will have lower

[2] Studies of overall fund performance include Carhart (1997), Grinblatt and Titman (1994), Gruber (1996), Hendricks et al. (1993), Ippolito (1989, 1992), and Jensen (1968). Studies that consider the liquidity of fund shares and its impact on performance include Alexander et al. (2007), Bergstresser and Poterba (2002), Dickson et al. (2000), and Edelen (1999).

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