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The scope of international mutual fund outsourcing: Fees, performance and risks☆

Douglas Cumming[a,∗,1], Armin Schwienbacher[b,2], Feng Zhan[c,3]

[a] York University—Schulich School of Business, 4700 Keele Street, Toronto, ON, Canada M3J 1P3
[b] Université de Lille—SKEMA Business School, Université de Lille 2, Faculté de Finance, Banque, Comptabilité, Rue de Mulhouse 2—BP 381, F-59020 Lille Cédex, France
[c] Boler School of Business, John Carroll University, University Heights, OH 44118-4581, United States

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ABSTRACT

This paper examines the causes and consequences of mutual fund outsourcing to different types of service providers: advisors, custodians, administrators, and transfer agents. The data indicate outsourcing is less common among bank-managed funds, funds of leading groups, but more common among funds that are distributed through third parties. Moreover, initial subscription fees are lower among funds that outsource non-advisory services, while annual management fees are not different among funds that outsource. The effect of service outsourcing on subscription fees occurs only for funds targeting institutional investors; retail investors enjoy no fee gains. The outsourcing of advisor services is associated with greater fund risk, but also with higher risk-adjusted performance (Sharpe ratio). However, the positive link with performance disappears when controlling for endogeneity, suggesting that fund managers optimally outsource advisory services in response to expected performance gains. Consistent with our predictions, outsourcing of other services does not impact portfolio decisions. Their impact is through lower subscription fees.

> "Investors simply don't believe that advisory firms can do it anymore, especially your $150 million [AUM] firms and smaller. They just don't believe that you have the resources, the research, the ability to do globally diversified portfolios.
>
> Every advisor should ask themselves, can I do it best? . . . And if not, how do you fire yourself?
>
> . . . Outsourcing does not lead to fee changes."
> Northern Trust Asset Management, Webinar Summary, October 3, 2014

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∗ Corresponding author. Tel.: +1 647 280 3410.
E-mail addresses: dcumming@schulich.yorku.ca (D. Cumming), armin.schwienbacher@skema.edu (A. Schwienbacher), fzhan@jcu.edu (F. Zhan).

[1] http://ssrn.com/author=75390.
[2] http://ssrn.com/author=301672.
[3] http://ssrn.com/author=1570631.

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1. Introduction

Mutual fund management involves a variety of functions, and some of these functions may be outsourced to external service providers. For example, strategy formation, portfolio management and stock picking may be outsourced to advisory service providers. Administrators are another service provider that issue and redeem interests and shares, and calculate the net asset value of the fund; these tasks can be done internally or outsourced to an external service provider. Similarly, some funds act as their own transfer agents which involves maintaining their own records, account balances and transactions, and handle the issuance of certificates and process of investor mailings; other funds chose a third party service provider to carry out these tasks on behalf of the fund. Custodians provide safe keeping of a fund's assets, and some funds elect to have this task carried out internally. Trustees and auditors, by contrast, are generally required to be external to a fund for legal reasons to guarantee the neutrality of such functions.

There is a small but growing literature on mutual fund outsourcing, mainly with samples of U.S. mutual funds. This literature to date has focused mainly on the outsourcing of advisory services, which relates to the front office. To the best of our knowledge, no prior paper has examined the full scope of services that are outsourced: administrator, transfer agent, custodian, advisory, trustee, and auditor. Our paper adds to the literature by examining the full scope of outsourcing, and by examining international evidence. Further, unlike prior work, in this paper we examine for the first time the effect of outsourcing on fund fees.

We believe it is important to study the causes and consequences of mutual fund outsourcing, as evidenced by the frequency of outsourcing. Based on the LIPPER database from over 13,000 mutual funds domiciled in Europe, we show outsourcing is very common: 12% of funds use external advisors, 41% use external administrators, 45% use external transfer agents, 58% use external custodians, and all funds outsource to external trustees and auditors[4].

An important question for practitioners and academics alike is whether outsourcing affects portfolio selection and thus ultimately operating risk and performance of funds. While operating risk cannot be measured directly, an indirect way is to examine the impact on the risk–return profile of funds; i.e., do funds with more outsourced services have a different risk–return profile and efficiency level from funds with internal services? Principal–agent theory may predict that the effect may go either way: (1) external services may oversee investment decisions more thoroughly as there are no conflicts of interests with management, leading to more oversight and thus a less risky (or better performing) portfolio; (2) external services may oversee fund management less effectively as access to "soft" information (i.e., not directly quantifiable) is more difficult than for internal services, leading to less efficient monitoring and ultimately more risk-taking behavior of investment fund managers. The UK (Financial Conduct Authority (FCA), 2013) has expressed such a concern with "oversight risk" in the fund management industry. Eventually this may impact the level of fees as more players get involved along the chain of operations, as well as potentially generating performance inefficiencies. Whether customers of funds are better served when some of the services are outsourced is an open issue worth investigating.

Our examination of the LIPPER database indicates the following main findings. Outsourcing is less common among funds managed through banks, UCITS funds, and institutional funds. Outsourcing is more common among funds that use third party distributors, retail client funds, and equity funds. Next, we find that funds relying on outsourcing have different fee structures. Initial subscription fees are lower among funds that outsource a greater number of types of services, while annual management fees are not different.

Further, the data indicate performance implications with outsourcing. While outsourcing of administrator, transfer agent, and custodian services is unrelated to risk in terms of the standard deviation of fund returns, outsourcing advisor services is associated with greater fund risk. Moreover, outsourcing advisor services is associated with higher risk-adjusted performance (gross of fees), measured by Sharpe ratios. The association between outsourcing of advisory services and performance is more pronounced for funds belonging to bank-managed groups than funds of asset management firms. However, we find the performance results are sensitive to controlling for endogeneity. In other words, if funds that outsourced did not in fact do so then they would underperform. We further examine the impact of outsourcing when we would not have expected a fund to do so (based on our statistical model), and find a positive performance impact from the outsourcing decision. The finding is consistent with the view that fund managers have private information that leads them to make better decisions about whether or not to outsource.

Our paper is related to a small number of recent papers on outsourcing in the mutual fund literature that falls into at least four streams. One stream of literature shows outsourcing advisory services is negatively associated with performance. Duong (2010) and Chen et al. (2013) find that outsourced mutual funds underperform internally managed mutual funds. Chen et al. argue that the contractual externalities due to firm boundaries imply that it is more difficult for a fund to extract performance from an outsourced relationship, and as such outsourced funds are less likely to take excessive risk and are more likely to be closed in the event of poor performance. Chen et al.'s results are consistent regardless of whether or not they control for endogeneity of the outsourcing decision. More specifically on endogeneity, Cashman and Deli (2009) find that outsourced mutual funds perform better when they are both predicted to be sub-advised and are in fact sub-advised relative to those that are predicted to be sub-advised but are not sub-advised.

[4] In rare circumstances (4% of our sample), trustees are used internally when there is a Chinese wall in the organization. In view of this very small proportion of internal trustees, we do not examine this component of outsourcing in our analysis.