Mutual funds are the primary vehicle used by individuals to invest in the stock and bond markets, and they are the overwhelming choice in retirement plans. Thus, the effectiveness of 401(k), individual retirement account (IRA), and other savings plans depends upon the efficiency and the competitiveness of the mutual fund industry. If individuals are disadvantaged by anticompetitive practices in the industry and by excessive fees, the quality of life for millions of retirees will be compromised. Small wonder that the fees charged by the industry have come under close scrutiny, and the industry has attracted more than its share of critics.

Perhaps the most vocal critic has come from the industry itself—John C. Bogle, the founder and former Chief Executive Officer of the Vanguard Group of investment companies. Bogle has developed what he calls the “cost matters hypothesis.” He believes that explicit and implicit costs from portfolio turnover are the prime determinants of fund returns. He is an evangelist for low costs, telling investors that with respect to mutual funds, “You get what you don’t pay for.”

We can certainly agree with critics such as Bogle that the fees charged by the providers of mutual fund services are a crucial determinant of the net returns earned by investors. Indeed, in my own research, I have found that total expenses, including both management expenses and the implicit costs of portfolio turnover, are the most important determinants of investor returns.

After accounting for differences in services across mutual fund providers, it is clear that investors are disadvantaged by high fees. But investors do have choices. In 2009, there were more individual mutual funds in the United
States than there were individual stocks traded on the New York Stock Exchange and NASDAQ. Consumers clearly have the ability to choose among competing fund offerings. Nevertheless, for competition to be effective, consumers must be sensitive to relative fees and services provided.

The Securities and Exchange Commission (SEC) concluded in the mid-1960s that mutual funds did not compete on price, and hence individual investors were put at a disadvantage. This conclusion, however, was based on studies of data from the 1950s and early 1960s, when there were barely more than 100 mutual funds from which investors could choose. The finding that competitive conditions did not exist a half century ago cannot be extrapolated to the far different industry that exists today. Similarly, the leading legal decision—the Gartenberg case—which concluded that effective price competition did not exist, was based on a mutual fund industry environment that was very different from conditions today. Indeed, in 2008 the Seventh Circuit Court of Appeals came to a diametrically opposite conclusion. In Jones v. Harris Associates, the court concluded that competitive conditions did, in fact, exist in the mutual fund industry. These competing decisions underscore the importance of careful modern analyses of the structure of competition at present in the industry.

This book provides that analysis. It presents an economic model of the mutual fund industry. The model examines the demand for equity mutual funds between fund companies and within fund complexes. The study allows for investor choices among funds, complexes, and channels of distribution. It presents precisely the empirical studies we need to understand the actual competitive conditions that exist in the industry today.

Estimates are provided of the price elasticity of demand for mutual funds (i.e., consumer sensitivity to the fees charged by different mutual funds). The careful empirical work presented shows that investors are very sensitive to the fees they face. Investors move their assets from fund to fund based on price differences, adjusted for product quality and fund performance. The very clear and robust conclusion is that effective competition among mutual funds does exist today.

The authors find that (1) price increases above competitive levels lead investors to switch to lower priced funds; (2) the vast majority of mutual fund assets are invested in the lowest priced funds; and (3) expense ratios (including the amortized value of sales loads) were declining at least through 2007. New products, such as exchange traded funds (ETFs), have also enhanced competition. Thus, the authors conclude that there is “no justification for . . . laws . . . to control monopoly pricing” in the mutual fund industry.
This is an important book. There has been considerable controversy, through the present time, about the competitiveness of the mutual fund industry and much recent criticism of what are called excessive fees. This careful study finds abundant evidence of price competition. The authors both enhance our understanding of the performance of the mutual fund industry and have produced useful findings for policy makers and for the legal profession. They present convincing evidence that there is no need to enact laws designed to prevent monopoly pricing in the mutual fund industry.

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