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Is "voting with your feet" an effective mutual fund governance mechanism?

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ABSTRACT

Investors in open-end mutual funds can vote with their feet by withdrawing assets from or adding assets to these funds. This paper assesses the effectiveness of this market discipline mechanism by investigating whether voting with the feet prevents the abusive practices that led to the 2003–2004 trading scandals. The research results indicate that funds with higher flow sensitivity—that is, a higher density of vigilant clients—have lower arbitrage potential and fewer abnormal flows, which in turn implies less opportunistic trading. As a result, these funds have a lower probability of being implicated in scandals. These findings suggest that investor ability to withdraw assets from or add assets to the funds is an effective mutual fund governance mechanism. In funds with less sophisticated investors who cannot use this option, other means of governance are especially important.

1. Introduction

In mutual funds, shareholders are also fund clients, a special organizational structure to which conventional results from corporate governance studies may not apply. Indeed, Fama and Jensen (1983) argue that boards of mutual funds are less important in the management control process than those of nonfinancial corporations because shareholder ability to withdraw resources directly from the fund serves as a form of liquidation. However, individual investors may lack the combination of knowledge and information to monitor funds or the monitoring cost may be too high relative to the benefit. Although the empirical evidence on the effectiveness of this voting with the feet mechanism is scarce and inconclusive,[1] Gruber (1996) and Zheng (1999) show that investors vary in their responses to changes in fund prospects: some monies flow from worse to better prospects; others do not. These findings imply that fund clients are heterogeneous in their monitoring vigilance. This paper therefore investigates investor vigilance in terms of voting with their feet and its influence on fund behavior.

The term "voting with your feet" in the mutual fund setting means that investors reward good performance by allocating more money flow into the fund and punish bad performance by allocating less money flow or withdrawing existing shares. Such reward and punishment in each individual fund naturally manifests in the fund's own flow-performance relation. That is, funds with a high density of vigilant investors have strong positive flow sensitivity, whereas funds with a low density of vigilant investors have weak flow sensitivity. In fact, funds with a large portion of investors who tend to withdraw shares after returns run up may even have negative flow sensitivity.

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[1] The flow performance literature suggests that although flows go to funds with high performance, they do not necessarily leave funds with low performance. However, because this evidence is based on a cross-sectional relation between fund flows and performance, it implies incomplete competition among funds for new money flows rather than the monitoring in each individual fund.

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Such differences in flow sensitivity may influence fund behaviors. On the one hand, in funds with a strong positive flow-performance relation, increased returns lead to a large inflow of money, implying a high opportunity cost for deliberate dilution of given returns. On the other, in funds with weak flow sensitivity, decreased returns result in only a small loss of money flow. Therefore, ceteris paribus, these latter are more likely to engage in shareholder value-destroying behaviors that dilute fund returns.

The shareholder value-destroying behavior focused on here is the timing and late trading activities revealed in litigations following the September 2003 mutual fund scandal. Specifically, a number of fund management companies sold the rights to engage in timing and late trading to increase the assets managed, an abusive practice that diluted fund returns to existing shareholders.[2]

In a special issue of the *Journal of Corporate Finance*, Ferris and Yan (2007) show that the internal governance structures of mutual funds, especially measures like board and chairman independence that have attracted the most public and regulatory attention, are unimportant in explaining the incidence of these fund scandals. In the same special issue on SEC regulation and corporate finance, Mulherin (2007) reviews the economic theories of regulation and their empirical applications to SEC regulation of financial securities. Although the multiple possible motives for regulation and the endogeneity involved make it challenging to determine the effectiveness of these regulations, aggregate evidence in the literature suggests that, in many cases, regulation can serve special rather than public interests. Thus, in the overview of this special issue, Smith (2007) calls for consideration of the boundaries of SEC regulation, which together with lack of evidence on an effective internal governance structure and regulation ambiguity in protecting public interests, motivates ongoing studies of external market discipline mechanisms. One of the most important of these latter is "voting with your feet."

Accordingly, based on the argument of an investor vigilance effect, I anticipate that fund fraud is less likely to occur in funds with stronger positive flow sensitivity. The empirical tests of the hypothesis thus follow two steps. The first documents investor vigilance by estimating the flow sensitivity of individual funds and examining its cross sectional and time series properties. The results indicate that more than half of the funds have a high density of vigilant investors and their flow sensitivity is positive and significant at the 1% critical level. Ten to twenty percent of the funds, however, have weak flow sensitivity, meaning lax fund monitoring. The remaining funds have a high density of investors who tend to withdraw shares when returns run up, thereby creating negative flow sensitivity. Both flow sensitivity and its statistical significance are persistent over time, which validates its usage as a measure of investor vigilance.

The second step assesses whether investor vigilance influences funds' subsequent involvement in timing and late trading activities. The results indicate that funds' flow sensitivity is negatively associated with their arbitrage potential, abnormal fund flows, and the likelihood of scandal. Not only are these results robust to a subsample of funds containing Global Equity funds, Municipal Bond funds, and other illiquidity funds that are most susceptible to abusive practices, they are also robust to a subsample of funds matched by size, age, and style. Most particularly, the coefficients on scandal exposure (−0.29 in the full sample, −0.51 in the subsample, and −0.49 in the matched-funds sample) indicate that funds with significant positive flow sensitivity are 13%, 20%, and 19% less likely, respectively, to be involved in scandal than funds with significant negative flow sensitivity.

The empirical tests also control for the impact of other governance mechanisms in this event, including the characteristics of management and the board of directors. The results indicate that the likelihood of scandal is negatively associated with unitary board structure and board member participation in a deferred payment program but positively associated with excess compensation to independent board directors. Management companies that are subsidiaries of a large financial service group are also less likely to be involved in abusive practices.

Understanding this mechanism of investors' voting with their feet makes important contributions to both academic research and industry practices. First, whereas extant studies on mutual fund governance focus on the monitoring mechanism by the board of directors (Dann et al., 2003; Ferris and Yan, 2007; Khorana et al., 2007; Tufano and Sevick, 1997), this paper investigates the exit mechanism of voting with the feet. In doing so, it provides a comprehensive estimation of investors' use of this exit strategy in the fund industry and examines its influence on fund actions.

In addition, the event studied in this paper is arguably more unambiguously harmful to investors than the issues studied in the extant fund governance literature, such as fund expenses and M&As. Despite a strong and persistent negative relation between expense ratio and fund performance, a lower expense ratio does not guarantee higher performance because of the heterogeneous returns and risks in portfolios. Rather, the major conflict between investors and management companies is performance versus sales. Whereas investors desire high risk-adjusted performance after expenses and trading costs; management companies, whose fees are calculated as a percentage of total assets, want to increase asset size. Hence, even though good performance is one of many ways to attract money flows, sound fund governance should ensure that no practice is implemented that increases sales at the cost of performance. The violations triggering the scandals in 2003 are breaches of this fiduciary duty.

[2] This practice is exemplified by the following case, reported in SEC litigation release 8288, 2003 (Complaint, State of New York v. Canary Capital Partners, LLC et al., N.Y., Sup. Ct., September 3, 2003. http://www. Oag.state.ny.us/press/2003/sep/canary_complaint.pdf). In this instance, Bank of America owned a mutual fund management subsidiary (Nations Fund) and a broker–dealer subsidiary with which Canary Capital Partners LLC, a hedge fund in New Jersey, may place an order after 4:00 pm. After forwarding the order to the fund and executing it at the net asset value (NAV) of that day, the dealer created a false audit record showing that Canary's order had been received before 4:00 pm. The following day, Canary reversed the transaction, thereby profiting from the price change. In exchange for this favor, Canary agreed to long-term investment in Bank of America-sponsored securities with an annual "wrap fee" of 0.5%–1%. Funds affiliated with Bank of America and Bank One allowed Canary such in-and-out trades up to a certain amount, typically 1% of the funds' assets. Canary also timed mutual funds by entering into an arrangement with the Security Trust Company (STC), an electronic trading service provider to institutional clients, which hid Canary's orders in large flows so that it could evade fund limits and avoid the fees on short-term transactions.