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Market structure and diversification of mutual funds ☆

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Abstract

This study characterizes a systematic relationship between the diversification incentives and the market structure of the mutual funds industry with investors differentiated by their attitude towards risk. With sufficiently low competition the subgame perfect portfolio equilibrium exhibits maximal risk differentiation. With intensified competition intermediate funds, i.e., those attracting investors with intermediate attitudes towards risk, select diversified portfolios. Finally, we offer a general characterization of how imperfect competition between risk-differentiated funds will generate an equilibrium relationship between risk and expected returns. © 2002 Elsevier B.V. All rights reserved.

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1. Introduction

To an increasing extent investors do not invest in individual securities one at a time. Instead investors want to combine many assets into well-diversified portfolios in order to reduce the risk of their overall investment. Institutions

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like mutual funds offer such services. By the end of 1999 mutual funds were estimated to manage assets in excess of those at commercial banks in the U.S. Overall equity mutual funds represented 18 per cent of all U.S. equity, by value. However, mutual funds are differentiated along several dimensions as they offer portfolios which are diversified according to different characteristics, thereby forming different market categories. In fact, the number of mutual funds in the U.S. exceeds the number of stocks traded on both the NYSE and the AMEX added together, reaching far beyond 6000 funds. Similarly, in this industry the degree of segmentation has increased, reportedly reaching around 41 different categories (see, Massa, 2000). Parallel to the expansion of the mutual fund industry the financial markets have been transformed by a frantic pace of financial innovation directed towards security design (see, for example, Allen and Gale, 1994). In light of this evidence we can conclude that diversification and differentiation represent crucial strategic instruments whereby fund managers compete for investors.

In this paper we design a stylized formal model of the mutual funds industry in order to investigate the structural relationship between market structure and the incentives of mutual funds to diversify their asset portfolios. In general, the way managers of mutual funds construct their asset portfolios will affect the risk inferences drawn by investors and thereby the expected portfolio return required by these investors. In fact, the choice of riskiness incorporated in the portfolio selection might constitute an important strategic instrument with respect to the competition taking place among mutual funds. In this respect each fund manager faces a number of central strategic decisions: Should the fund concentrate on a few industries or a few geographical regions (countries) so as to exploit gains from specialization based on economics of scale with respect to, for example, monitoring as a way to create a competitive advantage for itself? Or, should the fund invest in a portfolio with maximal diversification so as to minimize the risk of its asset portfolio thereby attracting risk averse or liquidity-oriented investors who will accept a lower expected rate of return?

In the present paper we build a formal model of strategic competition between mutual funds in order to analyze this tradeoff between specialization and diversification. In particular, our model makes it possible to provide answers for the following questions: How will competition between mutual funds impact on their diversification decisions? Is there a systematic relationship between the diversification incentives and market structure in the mutual funds industry?

The research literature devoted to the mutual funds industry has so far presented no formal models of competition between funds with diversification as the strategic instrument in an oligopolistic sense. Nanda et al. (2000) focus on a perfectly competitive mutual fund industry with risk-neutral investors and heterogeneous managerial ability. Within such a context they demonstrate how funds differentiated by load types can separate investors with different liquidity

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