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Mode of entry mode into a foreign market: the case of U.S. mutual funds in Canada

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Abstract

U.S. mutual fund companies offer funds in Canada through two channels: foreign direct investment or trade in advisement services. The total value of U.S.-controlled funds amounts to 18% of the Canadian equity fund market. This paper investigates how the fund-level and firm-level characteristics affect the channel used to enter the Canadian market. Empirical results indicate that the funds offered through FDI are not especially successful in the U.S. market but are associated with dominant companies, whereas the funds offered through trade in advisement services are highly successful in the U.S. market and are from companies with relatively few successful funds.

Keywords: Entry mode; Foreign direct investment; Trade; Service industry; Mutual funds

JEL classification: F23 (Multinational Firms, International Business); G15 (International Financial Markets)

1. Introduction

The Canadian and U.S. mutual fund industries operate as segmented markets due to regulations that restrict the ability of Canadians to buy U.S.-owned mutual funds and Americans to buy Canadian-owned mutual funds. There is, however, an increasing level of U.S. control over funds offered in Canada. There are two methods through which a U.S. mutual fund firm can control a fund in Canada. The firm can incorporate in Canada and offer the fund through its Canadian subsidiary (foreign direct investment or 'FDI') or offer it through a Canadian host company by exporting its advisement services (advisement).

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There are 174 equity funds in Canada controlled by U.S. companies with a total value of \$37.3 US billion or 18.2% of Canadian equity market[1].

This paper investigates the characteristics of U.S. mutual funds offered in Canada, the characteristics of the companies that offer them and how these characteristics affect the method chosen to enter Canada. Markusen (1995) asserts a number of characteristics of firms that perform FDI as stylized facts from a compilation of different studies. These characteristics are incorporated into the model in this paper and the estimation determines their individual contribution to the probability of a company performing FDI or choosing to export. The significance of certain fund and company characteristics suggests the motivation for the move into the Canadian market. The results indicate that if a small firm is attempting to expand upon the success of one fund, the firm will offer just that one fund through advisement. If a large firm is attempting access to a larger market, the firm will enter through FDI and offer a number of average performing funds. This information affords Canadian policy makers and, indeed, policy makers from any small country, a better understanding of the consequence of an increase or decrease of restrictions to foreign entrants on the predominance of certain funds in the home market. Furthermore, it provides deeper insight into the issues pertaining to a joint North American financial market.

The model assumes that a firm chooses to enter the foreign market based on its potential profitability reflected by firm-level characteristics in its home market. The firm-level characteristics, in this case, are the asset-weighted average characteristics of the family of funds. In the case of mutual funds, a family of funds is the term used to describe a group of funds offered by the same mutual fund firm. The channel chosen to enter the Canadian market is, in part, solved by a bargaining game with a Canadian host for an advisement fund. The bargaining section predicts that firms that choose the advisement route (advisement families) tend to have only a few outstanding funds in their family. Firms that choose FDI ('FDI families') tend to be larger and have a more equal family performance composition.

A multinomial logit regression is used to estimate the probability of a U.S. fund being offered in Canada using characteristics of the fund itself and its associated family as regressors. The empirical results indicate that FDI families have a larger market share in the U.S. market than do advisement families and that the funds offered by advisement families are highly successful in the U.S. market in terms of individual fund market share and past returns. Interestingly, funds offered in Canada by FDI families are not particularly successful in the U.S. market in terms of past returns or market share. This suggests that advisement families are not large enough to cover the cost of incorporation but are attempting to expand on the success of individual funds, while FDI families are large enough to cover the costs of incorporation and are attempting to gain access to a larger market. This also suggests that Canadian mutual fund investors gain more from access to funds offered through advisement than through FDI in terms of being able to choose high-performing funds for their investment portfolios.

[1] All data is as of January 31st, 1999. U.S. data is from Morningstar, Inc. and Canadian data is from Portfolio Analytics Ltd.