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Contracting in the investment management industry: evidence from mutual funds[☆]

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Abstract

We investigate the option to invest in derivative securities using a large sample of mutual funds. We find that those funds with the greatest transaction-cost benefit tend to permit investment in derivatives, and that funds tend to permit investment only in those derivatives that offer transaction-cost benefits. Our results indicate that a fund's decision to permit investment in derivatives is driven by increased efficiency rather than advisor opportunism. © 2002 Published by Elsevier Science S.A.

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1. Introduction

The ability of mutual fund advisors to invest in derivatives is potentially costly for fund investors. Advisors could use derivatives to achieve a level of risk different from investor preferences (Brown et al., 1996; Chevalier and Ellison, 1997). Absent any benefits, the costs of allowing investment in derivatives suggest that mutual funds should systematically prohibit their use. We find, however, that nearly

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two-thirds of funds allow investment in at least one type of derivative. Why do such a large number of funds permit investment in derivatives? We argue that derivatives offer transaction-cost benefits, such as economies with respect to trading costs, the cost of liquidity-motivated trading, and the opportunity cost of holding cash. We predict that the choice to permit investment in derivatives is driven by the transaction-cost benefits weighed against the potential agency costs.

Our empirical results support this prediction. We find that the funds that would benefit the most from the relatively low transaction costs of derivatives are the most likely to permit derivative investments, and that funds tend to permit only those derivatives that offer transaction-cost benefits. Specifically, we find that: (1) equity funds permit investment in equity derivatives, but not in debt derivatives, (2) debt funds permit investment in debt derivatives, but not in equity derivatives, (3) foreign funds are more likely than domestic funds to permit investment in derivatives, and (4) funds with high levels of portfolio turnover are more likely than funds with low turnover to permit investment in derivatives. Additionally, we find that equity funds are more likely than debt funds to permit investment in at least one type of derivative.

We also find evidence that transaction-cost benefits drive the derivative investment choice when we examine equity funds and debt funds separately. In particular, we find that equity funds that invest in less liquid equities are more likely to permit investments in equity derivatives. Among debt funds, those that invest in less liquid debt are more likely to permit investment in debt derivatives. The relations we find are economically meaningful as well as statistically significant. In the univariate analysis, for example, we find that 79.8% of equity funds permit investment in at least one type of derivative, while the same is true for only 50.5% of debt funds. In sum, our results are consistent with cross-sectional variation in the authority to invest in derivatives being driven by cross-sectional variation in the transaction-cost benefits of such investments.

Our research offers important insights on the use of derivatives by mutual funds. Financial economists have noted an inherent conflict between investors and fund advisors with respect to fund risk. They argue that derivatives offer an easy avenue for fund advisors to opportunistically manipulate fund risk (e.g., Brown et al., 1996). Koski and Pontiff (1999), however, examine the use of derivatives and conclude that those funds that actually use derivatives do so to reduce the cost of maintaining a certain risk exposure, rather than to manipulate fund risk opportunistically. Our research compliments Koski and Pontiff (1999) by showing that the option to invest in derivatives is only retained by those funds where the potential gains from reduced transaction costs are large.

The rest of the paper proceeds as follows. In Section 2 we discuss the link between portfolio type and the transaction-cost benefits of permitting investment in derivatives, and describe our hypotheses. In Section 3 we describe the data and perform univariate analyses. In Section 4 we test our hypotheses in a multivariate framework. We provide additional analysis in Section 5. In section 6 we conclude, and suggest possible directions for future research.

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