ETF Expansion and Alpha Discovery in the Mutual Fund Industry

by Oleg Shibanov

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Summary – the idea

- The author studies the reaction of the performance of mutual funds to the flow of funds into exchange-traded funds.
- The sample is the near-universe of US-based mutual funds of the CRSP database for the time period 2002-2010.
- He does it in two ways:
  1. Fama-McBeth type method: Estimating a multifactor model for time series of returns of portfolios of funds, sorted by size and/or past performance, with an additional "factor" being the aggregate flow of funds to ETFs. In a second step, risk premia are estimated in the cross section.
  2. Correlations between inflows into "similar" ETFs and four-factor alphas at the fund level.

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Summary – the results

- Exposure to flows into ETFs is not priced.
- There is a significant risk premium for some subsamples and sorting criteria for portfolios but no consistent pattern emerges.
- Inflows into a similar ETF (the one with the highest return correlation) is positively correlated with mutual fund alpha for the smallest two quintiles of mutual funds (significant at 10% level).

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Comments (1)

- Aggregate inflow into ETFs may be a crude measure of the competition that they represent for a particular mutual fund (or portfolio of funds).
- Why not combine the two exercises and take the flow into those ETFs whose returns are highly correlated with the mutual funds?
- Adding a flow variable into a factor model of returns seems odd. In addition, the flow to ETFs during the period 2002-2010 is likely to be non-stationary.
- Using the market share of ETFs in the combined market for passively and actively managed funds would be probably better.

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- For a whole picture about the causal relations an analysis of fund flows together with effects on returns (including fees) seems indicated.
- In other words, there might be quantity competition (fund flows) as well as price competition (fees).
- Do we see higher returns to some funds because they get less inflows and we have decreasing returns to scale? Or is it because the worst-performing funds do not survive? Or does the tougher competition impose stronger incentives on fund managers?
- What is the effect of fund flows to ETFs on fees?
- Disentangling these various effects would generate additional insights on the nature of competition in this market.

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- The second methodology used by the author uses the most correlated among all ETFs with any particular mutual fund, regardless whether this correlation is 0.1 or 0.9.
- A clearer measure of intensity of compensation might be the one of Wahal and Wang ("Competition among mutual funds", JFE 2011): the overlap in fund holdings between new entrants and incumbents.
- With data on fund holdings at hand also the following question might be addressed: Does the competition from passive funds lead to changes in fund strategy? Do they become more passive (co-called "closet indexing") or perhaps more active to differentiate from the index funds?
- What is the reason to exclude index funds? They are certainly the closest substitute to ETFs.

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