Outsourcing vs. Integration in the Mutual Fund Industry: An Incomplete Contracting Perspective

joint paper with
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Abstract

With detailed product- and firm-level data for mutual funds, we study why mutual fund families relinquish control of fund management (advising) and outsource to non-affiliated entities and why those entities agree to manage for the fund family. Fund families and fund advisors cannot write enforceable contracts over the return earned by the fund (task of the advisor) and the size of the fund to be raised (task of the fund family). Our empirics confirm key tenets of the incomplete contracting view of the firm’s boundaries. Expertise drives the fund family’s decision to manage funds internally or not. The closer the fund is to its core expertise, the more critical the fund family is for the operation of the fund, and the more likely the fund is managed internally. Access to investors drives the advisor’s decision to manage assets for an unaffiliated fund family. Consistent with sharing marginal revenue under outsourcing, outsourced funds on average are smaller and also have lower returns than internally managed funds. At the same time, from the perspective of the fund family and the advisor, once the selection bias of the family of fund’s decision to outsource and the advisor’s decision to agree to that outsourced arrangement are controlled for, the difference in size and returns between internally and externally managed funds disappear. In other words, because of their lack of expertise, the fund family would not be able to earn a higher return by managing the outsourced funds internally and because of their lack of access to investors, the advisor could not raise a larger fund.