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Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds

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Abstract

We investigate the role that nonportfolio fund differentiation and information/search frictions play in creating two salient features of the mutual fund industry: the large number of funds and the sizable dispersion in fund fees. In a case study, we find that despite the financial homogeneity of S&P 500 index funds, this sector exhibits the fund proliferation and fee dispersion observed in the broader industry. We show how extra-portfolio mechanisms explain these features. These mechanisms also suggest an explanation for the puzzling late-1990s shift in sector assets to more expensive (and often newly entered) funds: an influx of high-information-cost novice investors.

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