A Fundamental Approach to Estimating Economies of Scale and Scope of Financial Products: The Case of Mutual Funds

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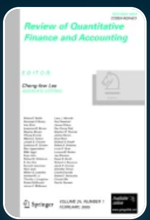

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Abstract

We propose a ‘Fundamental’ approach to estimate the economies of scale and scope for financial institutions offering multi-product lines. We first estimate pure economies of scale from its fundamental definition, which is the marginal cost reduction that is to be achieved by single product firms of increasing size that offer the same product. Similarly, we estimate the economies of scope from its fundamental definition, as the marginal cost reduction achieved by the addition of a new product line. Operationally, we compare the cost of operating a say, 3 product-line financial institution with the cost of operating a portfolios of companies that are synthetically created from a control sample of financial institutions offering fewer, such as 2 and 1 similar product lines. When this approach is applied to mutual funds data, we find economies of scale for some fund type. The evidence on marginal cost economies due to increasing scope is rather weak. The results have practical implications for potential organizers and current management of investment companies.

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