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Are ETFs Replacing Index Mutual Funds?

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Abstract

We develop an equilibrium model to investigate whether an Exchange-Traded Fund (ETF) is a more efficient indexing vehicle than an Open-Ended Mutual Fund (OEF). We find that while flow-induced trading is costly to OEF investors, it is also beneficial to those investors who cause the flow -- it is simply a zero-sum game. Indeed, the OEF structure can be viewed as providing insurance for investors with liquidity shocks, and hence is beneficial for risk averse investors. However, this liquidity insurance is not without cost -- it can cause moral hazard %that induce excessive trading and reduce the OEF performance. Moreover, we find that investors with higher individual liquidity needs prefer to invest via the OEF since they benefit more from the liquidity insurance. Surprisingly, the OEF structure is still viable despite the concentration of higher-liquidity-need investors in the OEF. The reason is that flow-induced trading costs depend only on the aggregate liquidity need, not on individual liquidity needs, which cancel out at the fund level. As a result, OEFs and ETFs coexist in equilibrium with different liquidity clienteles. Finally, we derive empirical predictions that ETFs are better suited for narrower and less liquid underlying indexes, and for investors with longer investment horizons.

Keywords: ETF, Index Mutual Fund, Transaction Costs

JEL Classification: G23

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