Abstract:

This paper examines the effect of incentive fees on the behavior of mutual fund managers. Funds with incentive fees exhibit positive stock selection ability, but a beta less than one results in funds not earning positive fees. From an investor's perspective, positive alphas plus lower expense ratios make incentive-fee funds attractive. However, incentive-fee funds take on more risk than non-incentive-fee funds, and they increase risk after a period of poor performance. Incentive fees are useful marketing tools, since more new cash flows go into incentive-fee funds than into non-incentive-fee funds, ceteris paribus.