# Mutual Fund Performance:
# The Effects of Liquidity Service Provision and Active Portfolio Management

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# Mutual Fund Performance and Flows:
# The Effects of Liquidity Service Provision and Active Management


### Abstract

To disentangle the effects of liquidity service provision and active management on mutual fund performance and flows, we benchmark passive funds against ETFs and further benchmark active funds against passive funds. We show that about 75% of passive fund underperformance relative to ETFs is due to higher expense ratios and an additional 14% is due to other costs directly associated with liquidity service provision. Old funds and funds with large family size are more cost-effective in providing liquidity service to investors. While only 23% of active funds deliver higher returns to investors than passive funds, this number increases to 75% after adjusting for expense ratios and other costs associated with liquidity service provision by active funds. Again, old funds and funds with large family size exhibit better active management ability. Examining fund flows, we find that investors of passive funds chase style and investors of active funds chase individual funds based on past performance. Nevertheless, in both cases investors put more money into young funds despite higher cost of liquidity service provision and lower ability of active management. We find that marketing expenses only partially explain the decision of passive fund investors but not the decision of active fund investors.



*Key words*: Open-End Mutual Funds; Liquidity Service Provision; Active Management; Fund Performance; Fund Flows.

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