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Are Vanguard's ETFs Cannibalizing the Firm's Index Funds?

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Abstract:

Existing literature on exchange traded funds ("ETFs") and conventional index mutual funds suggests that the two fund types are substitutes for each other in terms of attracting investors' money. Vanguard is an industry-leading index fund provider that offers both conventional index mutual funds and ETFs. The question is whether Vanguard experiences a substitution effect between their index funds and ETFs to the same degree as it is observed in the industry in general. The examination of the substitutability of the two fund types can help explain Vanguard's decision to offer ETFs that could cannibalize the firm's existing products. Results of the paper show that contrary to the initial expectations, Vanguard's ETFs and corresponding index funds are not substitutes, but are instead complements. The flows of ETFs and index funds positively affect each other. Positive spillover effects, such as ETF tax efficiency, may help explain the synergy between Vanguard index products. The results can help fund families take advantage of similar efficiency spillover effects when structuring new products.

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