Abstract

We examine the way mutual funds invest in firms involved in mergers that are advised by the funds’ affiliated investment banks. Information barriers generally prohibit communication between asset managers and investment bankers within a financial conglomerate. However, anecdotal evidence from our industry experience has shown that those barriers are sometimes crossed. Using a unique dataset that maps mutual fund companies to their investment banking affiliates, we first look for evidence of informed merger arbitrage by mutual funds. In theory, the non-public information held by an investment bank advising a firm in a merger could be abused by the bank’s affiliated mutual funds. This would manifest itself in the funds’ pattern of trading activity. Mutual funds acting on inside information from their investment banking affiliate would be more likely to buy shares of target firms advised by the affiliated bank in advance of a merger announcement. In addition, if banks have information about a merger’s likelihood of completion, these informed mutual funds would also be more likely to divest from firms in advance of merger abandonment announcements. We also test whether these informed mutual funds exhibit better risk-adjusted performance than mutual funds that do not invest in the merger clients of their investment bank affiliates. Our analysis can provide new insight into how financial services providers in both asset management and investment banking use (and possibly misuse) material non-public information.