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INDEX INVESTING

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By Aron Szapiro

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A small but growing body of provocative literature has argued that when institutional investors own large shares of competing companies, it results in higher prices for consumers. If an institutional investor owns a large share of each of the four major airlines, for example, the concern is that the investor may try to discourage the airlines from lowering prices and being competitive. This literature could have profound implications for policymakers looking to promote competitive markets if they accept the central arguments.

For example, Azar et al. (2018) conclude that the government should restrict institutional investors from owning competing firms if the anticompetitive effects of common ownership are not outweighed by the efficiency-enhancing effects of diversification. Others already have suggested policy proposals to address problems with concentrated ownership in a given industry. Most notably, Posner et al. (2017) proposed restricting asset managers from owning more than 1 percent of all firms in certain industries; they argue that common ownership leads to anticompetitive behavior—behavior that ultimately hurts consumers.

This debate may seem academic, but it has found a receptive audience among politicians, at least among Democrats. With the release of their Better Deal policy document,[1] Democratic politicians signaled they plan on running for election in 2018 on a campaign of breaking up unpopular monopolies (albeit without yet naming large asset managers as a target). The Organization for Economic Co-operation and Development also has examined these issues.

As these ideas jump from economic and legal literature to policymaking, policymakers will need a framework for evaluating whether the potential costs of concentrated ownership are, in fact, greater than the benefits. As Azar et al. (2018) conclude, "Which effect prevails is an empirical question that goes beyond the scope of our paper, which merely intends to start the debate." This article also will not answer the question of which effect prevails; its goal is to ascertain the key questions that policymakers need to ask to develop a framework.

THE BENEFITS OF INDEX FUNDS

Dramatic changes could be required to eliminate any anticompetitive effects of common ownership of competing companies. For example, Posner et al. (2017) explore a few solutions before concluding that an institutional investor should own no more than one company in a potentially noncompetitive industry unless the investor owns less than 1 percent of the market share. Further, the paper argues that no institutional investor should communicate with top managers or directors of a firm.

According to Posner et al. (2017), a potentially uncompetitive industry is one where a few large companies do not compete for market share. They call this an oligopoly and define it using a mathematical formula for competition, although they envision regulators would have discretion to designate oligopolies.

This novel approach has the potential to change the operations of index funds dramatically; it could fundamentally turn them into active stock-pickers. After all, active funds constrained from owning, say, multiple airlines could continue to use the tools of active ownership to determine in which airline to invest. So the rule, although a constraint, does not alter the value proposition of an active fund the way it does a passive fund.

To quantify the costs of such a change, policymakers first need to understand how many people benefit from index funds. More than 50 percent of Americans have retirement savings accounts. Changing one of the key innovations in retirement investing over the past 30 years directly affects 57 million households, according to our analysis of the Survey of Consumer Finances.[2] In short, such a shift would affect a small number of institutional investors profiting from concentrated holdings in leading companies—and many Americans saving for retirement.

Another critical question is the importance to investors of the diversification that common ownership provides. Common ownership is a necessary byproduct of diversifying in a single fund. If a fund has the goal of providing broad ownership of the stock market to achieve diversification, it will necessarily hold shares in competing companies. Posner et al. (2017) cite Campbell et al. (2001), which argues that the volatility of diversifying across companies can be mitigated by diversifying across industries. But how robust is this finding over time? Presumably, some investors will end up investing in the airline, bank, or technology company that doesn't perform well or is driven out of business by competition. Will this create a "longer tail" of failed retirement accounts by increasing the idiosyncratic risk that retirement savers and other investors take on in their investments? Indeed, Morningstar has found that most returns earned by investors can be attributed to the growth of the upper 20 percent of successful companies—growth many investors would miss if they were in funds forced to choose among leading companies rather than owning several leaders in a broadly diversified fund.

Posner et al. (2017) argue that passive funds could randomly select companies within an industry and that investors could hold multiple funds with overlapping strategies to mitigate this problem. But this would have large ramifications for the retirement-plan market. Employers who offer 401(k) plans would have to offer new plans and explain to employees how to use them. There also likely would be risks that such a novel approach would violate fiduciary principles. Further, asset managers would lose the economies of scale that have led to steadily decreasing costs for investors.

Which leads to another question: How broad are the benefits of index funds beyond their reduced costs for people who invest in them? Index funds have forced active funds to justify their higher fees and explain their strategies. They have put plan sponsors and individual retirement account advisors under pressure to ensure they recommend active funds with fees they can justify to their clients. Indeed, the asset-weighted average expense ratio for all funds (including exchange-traded funds) fell to 0.52 percent in 2017, down from 0.56 percent in 2016 and 0.63 percent in 2015, according to Morningstar's latest fees study (Oey 2018). If index funds could no longer operate as they have, but had to pick which companies to invest in, what would the ripple effects be for investors? Keep in mind that the low costs of index funds are related directly to their simplicity. Add another layer of stock selection to the process of indexing, and investors can expect fees to go up. The asset-weighted average fees for passive funds and active funds are 0.17 percent and 0.72 percent, respectively (Oey 2018).

OTHER EXPLANATIONS FOR ABNORMAL PROFITABILITY

As for the anticompetitive effects of common ownership, how strong is the available evidence, and where can we look for other proof? What other explanations might there be for the abnormal profitability of publicly traded companies we have seen? And how can we drill down to the total costs of these anticompetitive effects, if there indeed are any?

Morningstar's analysts have found evidence for two other explanations for why companies have become abnormally profitable recently. First, there are more wide-moat companies today than we have seen in the past. There firms operate in industries with a high barrier to entry and thus can charge higher prices. Second, U.S. industries have become less competitive as fewer publicly traded companies compete against each other. (Such a problem suggests more traditional antitrust solutions.)

In other words, there is not conclusive evidence that asset managers with too much concentrated ownership are the problem—yet. That does not mean this could not become a problem in the future. This merely means that we don't have enough evidence to link the cause of higher-than-normal profitability to the anticompetitive effects of asset managers owning large shares of competing companies rather than to other trends.

Finally, to properly perform a cost-benefit analysis on restricting mutual funds from common ownership of competing firms, we would need a clear empirical estimate of the costs to consumers. Azar et al. (2018) estimate that common ownership within the airline industry costs consumers an extra 3 percent to 7 percent in ticket prices. But what about other industries? Note that this estimate for airlines is a wide range. The two ends of the range (3 percent and 7 percent) might yield different answers to a cost-benefit analysis, given the importance of index funds to a broad range of ordinary retirement savers.

BREAKING UP INDEX FUNDS?

It seems unlikely that U.S. policymakers will act on any of these ideas now, but that might change the next time Democrats are ascendant. A key centerpiece of the Democrats' plan is the "Better Deal on Competition and Costs," which promises to "crack down on corporate monopolies."[3] Further, several bills in Congress explicitly call for studying common ownership among mutual funds and other institutional investors, which could provide additional momentum for bills addressing common ownership concerns.

There are two big reasons this line of argument will make for appealing rhetoric in the midterm elections and beyond. First, as income and wealth inequality has grown, there is a growing sense that the system is rigged, so running against monopolies is a good way to align that feeling with concrete policies.

Second, antitrust action allows politicians to talk about increasing equality without arguing for massive new bureaucracies, raising taxes, or redistributing resources in obvious ways.

The political messages we have seen do not mention asset managers but focus instead on the usual suspects: airlines and cable and telecom companies, along with less-frequently talked about industries such as breweries and commercial agricultural seed companies—examples that seem crafted to appeal to Americans living in the heartland. However, most legislation tends to give broad statutory authority to regulators, who can fill in the details later.

In this case, should the "Better Deal" plan turn into legislation and eventually law, it would create a new consumer competition advocate, with broad authority to keep "markets fair and open."[4] Given the academic literature on common ownership among asset managers of competing companies, this could pave the way to new, novel forms of antitrust action, effectively ending broad index funds, thus raising costs (and lowering returns) for ordinary investors.

EVIDENCE NEEDED BEFORE ACTION

None of this is to say we should not treat arguments about concentrated ownership seriously. As the great political theorist Albert O. Hirschman argued in *The Rhetoric of Reaction* (1991), for centuries reform opponents have argued that reforms perversely result in effects that are opposite to the reformers' wishes or that jeopardize a positive status quo. The questions raised in this article may be viewed as an endorsement of the status quo. Without more evidence to resolve the key questions regarding the costs and benefits of a policy response, we prefer to err on the side of the known advantages of index funds as opposed to the putative gains from their disruption.

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ENDNOTES

1. See https://www.democrats.senate.gov/abetterdeal/.
2. See https://www.federalreserve.gov/econres/aboutscf.htm.
3. "A Better Deal: Cracking Down on Corporate Monopolies," https://www.democrats.senate.gov/imo/media/doc/2017/07/A-Better-Deal-on-Competition-and-Costs-1.pdf.
4. Ibid.

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