The Hidden Dangers of the Great Index Fund Takeover

The Big Three—BlackRock, Vanguard, and State Street—are the most important players in corporate America. Whether they like it or not.

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If you hold a stock market index fund, congratulations. The S&P 500's total return was a thumping 31.5% in 2019, and a fund that passively tracks that benchmark delivered almost all those gains, minus a tiny fee—perhaps just 0.04% of assets. Now here's something you probably weren't thinking about when you clicked on the box to choose an index fund in your 401(k) or IRA: You were also part of one of the biggest shifts in corporate power in a generation.

The index fund is one of a handful of unambiguously beneficial financial innovations. Before it caught on, investors routinely paid sky-high fees to active stockpickers who often delivered subpar returns. The near-universal popularity of index funds puts them up there with Social Security, Stevie Wonder, and streaming TV.

Indexing also has been a runaway success for some fund companies. The largest asset manager in the world, BlackRock Inc., best known for its iShares brand of exchange-traded index funds, has $7 trillion under management. Index pioneer Vanguard Group Inc. has $5.6 trillion. The No. 3 indexer, State Street Corp., manages $2.9 trillion. These companies also run active funds, but together they hold about 80% of all indexed money. They've come to be known as the Big Three.

Their success has had a weird and unintended consequence. As millions of investors have done the most sensible thing financially, they've also concentrated shareholder power in the Big Three. Some 22% of the shares of the typical S&P 500 company sits in their portfolios, up from 13.5% in 2008. Their power is probably greater, given that many stockholders don't bother to vote their shares.

BlackRock, Vanguard, and State Street combined own 18% of Apple Inc.'s shares, up from 7% at the end of 2009. Of the four largest U.S. banks, the fund companies together own 20% of Citigroup, 18% of Bank of America, 19% of JPMorgan Chase, and 19% of Wells Fargo. The phenomenon can be even more pronounced for smaller companies. The Big Three own 28% of Cabot Microelectronics Corp., an Aurora, Ill., seller of materials to semiconductor manufacturers that has a market value of $4 billion.

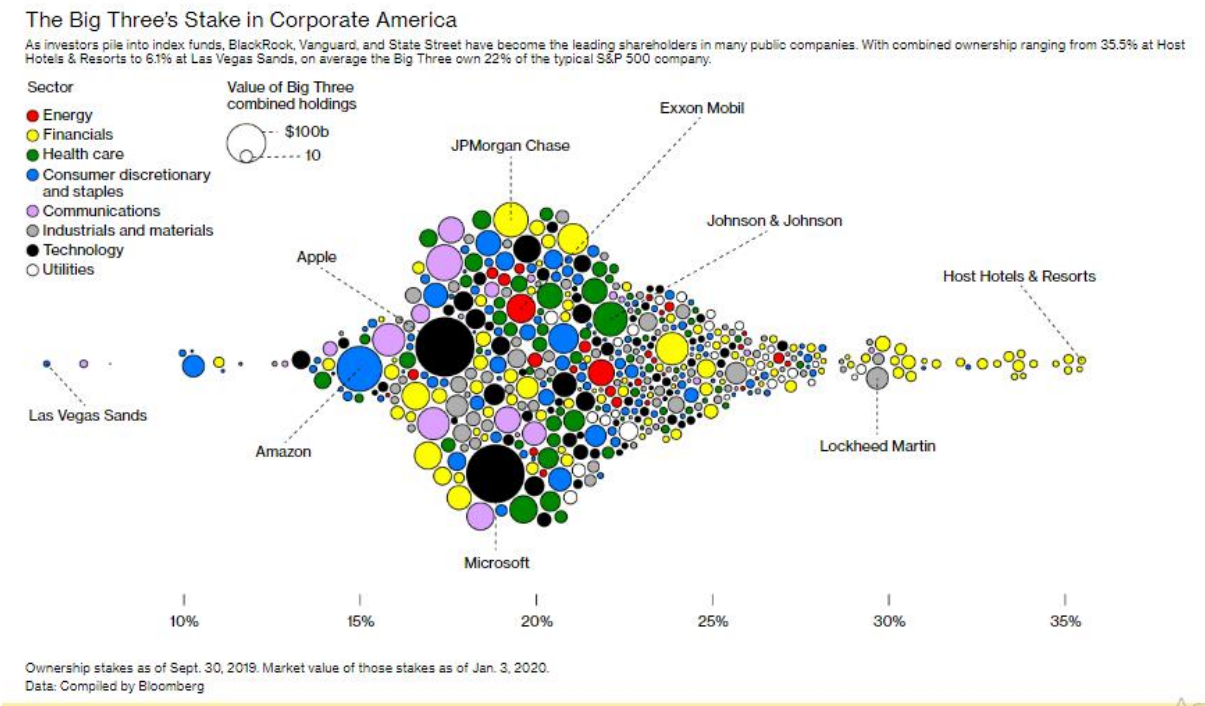
The fund companies say there's nothing to worry about because they don't vote as a bloc. And index funds don't buy shares to pursue any special agenda—they just buy whatever's in the index, usually in proportion to its market value. If passive managers weren't grabbing up all these shares, similar power would likely be in the hands of active funds, which haven't served investors nearly as well. Index fund managers are more technocrat than robber baron.

And yet voting power is voting power. The fund companies' combined votes and back-channel jawboning, in which they make their views known to directors and chief executive officers, could swing the outcome of important matters such as mergers, major investment decisions, CEO succession, and director elections—even if no fund house has the ability to decide the outcome of such matters alone. They're potentially the most powerful force over a huge swath of America Inc. Alarm bells have begun to go off with some regulators, as well as with an ideologically diverse array of academics and activists.

Environmental and consumer groups, for example, accuse index managers of shirking their broader social responsibilities, such as by not divesting the shares of fossil fuel companies or by not blocking lavish CEO pay. BlackRock CEO Larry Fink was met by protesters at an October black-tie gala at the Museum of Modern Art, where he sits on the board. (The fund companies say the passive investment model means they can't divest from companies listed on indexes.) Other detractors say companies may not be competing aggressively because their common owners—the funds that hold them all—don't want or need them to.

Where the critics agree is that index funds, as good as they are for investors, may be also indirectly harming consumers and workers. And, of course, many of us are all three. "When you see a small handful of players with ever-growing share and ever-growing clout affecting the trajectory of the largest public companies in the world, that's going to raise a lot of eyebrows," says Ben Johnson, a Morningstar Inc. analyst. "The question is whether their influence will be wielded for better or worse."

Even Vanguard founder Jack Bogle—a tireless advocate for indexing—warned just before his death in January 2019 that there may be too many shares in too few hands. Index funds are so successful, he wrote in the Wall Street Journal, that they could one day effectively control the U.S. stock market. "I do not believe that such concentration would serve the national interest," he said.



The debate threatens to put the giants of passively managed money under the same harsh light as Big Tech, where rising market concentration is blamed for the disappearance of small businesses, fewer startups, lower wages, and the loss of privacy.

The antitrust worries about index funds involve common ownership, when the same large investors own a big chunk of the shares in the major corporations in the same industry. Academics have long theorized that common ownership might encourage coordinated behavior among companies linked by the same set of owners. And recently researchers have made some surprising findings, including that high levels of common ownership can lead to higher prices and lower levels of investment, innovation, and output. Harvard Law School professor Einer Elhauge calls common ownership the greatest anti-competitive threat in the economy today. Index funds "are great for investors," says Elhauge, "but part of the reason they're great for investors is exactly because of the anti-competitive effects." Elhauge says the trusts of the late 19th century that gave rise to today's antitrust laws also involved a form of common shareholding.

Index fund managers aren't meeting with companies to secretly carve up markets in smoke-filled rooms. The process critics imagine is more subtle. It starts with the idea that passive funds seek only to match an index's return and not outperform it. Thus the fund managers lack financial incentives to ensure the companies in their portfolios are competing fiercely with one another. Compare this to an active manager who holds, say, shares of Coca-Cola Co. but not PepsiCo Inc. She might want Coca-Cola to take big risks to crush Pepsi, and invest capital in new products and markets to do so. An investor who holds both, on the other hand, would prefer that Coke and Pepsi avoid price wars.

Such going along to get along may not always be benign. A 2018 study found that, when the same institutional investors are the largest shareholders in branded drug companies and generic drugmakers, the generic companies are less likely to offer cheaper versions of the brand-name drugs. Consumers could be paying higher drug prices as a result. “The potential effects on anti-competitive conduct are really serious,” says Melissa Newham, a Ph.D. candidate at KU Leuven in Belgium and a co-author of the study. It isn’t clear whether funds are somehow pressuring management or management just knows that competing hard isn’t in the interest of their key shareholders.

This line of research began with a 2014 paper about competition among U.S. airlines that quietly shook the fund industry and the antitrust world. José Azar, an economist at the University of Navarra in Barcelona, along with Martin Schmalz and Isabel Tecu, showed that airline ticket prices were 3% to 7% higher because big funds owned stakes in so many airlines.

Azar says he first became interested in common ownership in late 2010 as a Princeton graduate student. It led to his dissertation on the issue, but it wasn’t until he was working at economic consulting firm Charles River Associates that he and Tecu decided over lunch to look at airlines, partly because the industry produces reams of data on fares.

The research prompted BlackRock to hire an economic consulting firm to do its own study. It concluded that Azar and his co-authors had overestimated the effects of common ownership on ticket prices by not accounting for periods when the major airlines were in bankruptcy. (When a company is bankrupt, its shares are removed from indexes, and the index funds usually sell.) Azar says that he did account for bankruptcies in the paper and hasn’t seen any research that invalidates his key findings.

The fund management companies reject any notion that their ownership is anti-competitive. They point to studies that back them up, and say that higher air fares, for example, would hurt the hotel stocks they also own. Besides, they say their sway over companies is vastly overstated. Being the largest shareholder of a company is not the same thing as holding voting control over it. “For the overwhelming majority of proxy votes, the data shows that index managers’ votes do not determine the outcome,” says BlackRock spokeswoman Tara McDonnell. “Any assertion otherwise is not based in fact.”

The Big Three are paying close attention to this research because it’s beginning to have an impact beyond the ivory towers. On Nov. 15, Rohit Chopra, a Democratic member of the Federal Trade Commission, cited overlapping ownership in Bristol-Myers Squibb Co. and Celgene Corp. as one reason to vote against the pharmaceutical giants’ $74 billion merger. His point was that incentives for the merger might be distorted since many of the same investors owned both the buyer and the seller.

While Chopra lost the vote, FTC Chairman Joe Simons said at an antitrust conference three days later that his agency is considering conducting an in-depth study of common ownership. “Serious people have raised these issues, and there’s empirical work, and it’s definitely worth looking into,” he says. The Justice Department’s antitrust chief, Makan Delrahim, in May said the department was closely following common-ownership research.

The European Union has gone further. When competition officials reviewed the proposed merger of DuPont Co. and Dow Chemical Co., they looked into the high levels of common ownership, including by index funds, already in place across the agricultural chemical industry (not only in Dow and DuPont). The EU found it potentially threatened innovation. In part to allay these concerns, the EU in 2017 forced DuPont to offload large parts of its global pesticide business to win approval for the deal.

The Investment Company Institute, the fund industry trade group, has arranged for members to meet with lawmakers to reassure them that common ownership isn’t a problem. Separately, BlackRock Vice Chairman Barbara Novick began a flurry of emails and phone calls with the FTC in October 2018, according to documents obtained through the Freedom of Information Act. Some of the outreach was triggered by FionaScott Morton, an economics professor at the Yale School of Management, who voiced concerns about common ownership. In December 2018 the FTC devoted a hearing to the issue.

The potential impact of common ownership reaches beyond antitrust matters to questions about how companies are run. Index fund managers may follow passive investment strategies, but they don’t blindly choose stocks and sit back, says John Coates, a Harvard law professor. Fund companies have multiple tools to influence corporate behavior, such as developing preferred policies on executive compensation, carbon footprints, gender diversity, and other governance matters. They often do this in coordination with other industry leaders, Coates says. “A small number of unelected agents, operating largely behind closed doors, are increasingly important to the lives of millions who barely know of the existence much less the identity or inclinations of those agents,” Coates wrote in a widely cited 2018 paper. The agents, in this case, are the managers of fund companies—and the most important of those are the index giants.

Assets in U.S. equity index funds as of August 2019: $4.3 trillion

The surprising thing about all this is that index funds began so modestly. They were a niche product aimed at investors who took the then-radical position that paying close attention to individual companies wasn’t worth the effort and expense. In the decades after Bogle launched the first retail index fund in 1976, that idea would be proven right again and again. For example, only 10% of actively managed U.S. large-cap funds outperformed the market in the 15 years through June 2019, according to S&P Dow Jones Indices data.

Investors caught on, and money piled in. Vanguard, now led by CEO Mortimer “Tim” Buckley, boasts more than 30 million investors globally. The original Vanguard 500 Index fund now has about $405 billion in assets; there are about 380 U.S. mutual funds that follow indexes. Add to this list exchange-traded funds that track indexes and can be bought and sold instantly just like stocks. In 1993, State Street’s investment management arm, State Street Global Advisors, launched the first of these in the U.S., the SPDR S&P 500 ETF Trust, or SPY for short. BlackRock got into the business when it acquired iShares in 2009 from Barclays Plc. The U.S. now has more than 1,400 equity index ETFs. In August 2019 the industry reached a milestone when the $4.27 trillion in passively managed U.S. stock funds outflanked the $4.25 trillion run by stockpickers. According to the ICI and Morningstar, last year assets in index funds globally climbed above $11 trillion.

The Big Three represent the key votes on matters such as mergers and shareholder activist campaigns. The fund companies also hold what they call “engagements” with companies through meetings and phone calls. But perhaps unsurprisingly, because the rise of index funds is relatively new, academics who study common ownership have different ideas about how the fund managers’ influence might be felt. Some, such as Coates, think they could emerge as key power players, perhaps joining their votes with hedge funds that push for deals or corporate restructurings. Such deals can boost share prices but may also lead to layoffs.

Others worry that index funds, mainly by keeping quiet, will simply enhance the power of CEOs. In a 2018 paper, New York University professors Ryan Bubb and Emiliano Catan found that the Big Three were unlikely to oppose management on hot-button issues such as executive pay and likely to support management proposals to merge or make large acquisitions. BlackRock supported such M&A proposals 79% of the time and Vanguard, 85%. BlackRock and Vanguard overwhelmingly favored election of incumbent company directors, according to another analysis of proxy voting records at 25 global asset managers.

Lucian Bebchuk, a Harvard law professor, says index fund managers don’t have incentives to invest the time into actively supervising companies. That’s because any effort to increase the value of a company would also increase the value of the index, which in turn benefits every fund that tracks the index. As a result, the fund that pushes management can’t stand out from its peers and attract more money—yet it incurs higher stewardship costs. The concern is that such deference will “result in insufficient checks on corporate managers,” Bebchuk says.

In a 2019 paper, he writes that the Big Three spent minuscule amounts on stewardship. According to Morningstar, Vanguard employed 21 people to do the work of corporate oversight at a cost, by Bebchuk's estimate, of about $6.3 million—a drop in the bucket considering Vanguard's trillions of dollars under management.

The Big Three all claim to be good stewards of the companies whose shares they own. Vanguard, for example, said it engaged with 868 companies in the 2019 proxy year and voted on more than 169,000 proposals. BlackRock reported more than 2,000 engagements with 1,458 companies in its 2019 global investment stewardship report. BlackRock's McDonnell says the fund company takes its role "as a shareholder seriously" and that it dedicates more people to overseeing the companies whose shares it owns "than any other investment management firm in the world." BlackRock employs about 45 full-time people globally to work on stewardship issues. State Street spokesman Marc Hazelton says the company uses its "voice and vote to influence companies on long-term governance and sustainability issues." He says State Street has seen "companies respond to our calls to action across a range of important topics."

Novick, the BlackRock executive, has called the competing theories over how fund companies wield their power the Goldilocks dilemma: "Do asset managers do enough? Do they do too much? Or are they doing just the right amount?" she said at a Harvard roundtable on corporate governance.

The power of the index funds is also becoming a concern of social activists. One study found that BlackRock and Vanguard voted against at least 16 climate-related shareholder proposals in which their support would have given the measures a majority of votes. The study, conducted by the nonprofit Majority Action, looked at 41 climate change-related proposals ranging from setting greenhouse gas emission targets to disclosing environmental lobbying activity. BlackRock and Vanguard were less likely than their fund company peers to back the resolutions, supporting them less than 15% of the time. State Street voted in favor of climate-related resolutions more often—about 27% of the time—but still less often than its peers did. "I think the large passive managers have a real difficult decision to make," former Vice President Al Gore told the Financial Times in December. "Do they want to continue to finance the destruction of human civilization, or not?"

Leo Strine Jr., an influential corporate law jurist who recently retired as chief justice of the Delaware Supreme Court, thinks index funds ought to be doing more to check the political influence of the companies they own. In a paper, he castigates BlackRock and Vanguard for failing to curb campaign contributions, lobbying expenses, and other political spending by their portfolio companies. He calls this "a huge fiduciary blind spot." Although the companies' political spending might be good for each individual business, Strine argues that asset managers should bear in mind the broader interests of their own fund shareholders, who are often workers investing in 401(k) retirement plans. Political spending to elect lawmakers who favor giving companies more leverage over pay and benefits, for example, can result in lower wages.

The role of fund companies in Americans' retirements may pose another conflict. The corporations in their portfolios may be clients, too. Vanguard, for example, administers

1,900 retirement plans with about $1.4 trillion in assets under management. The worry is that fund houses might cast votes as shareholders that appease executives "even when voting with management—the client—is not in its investors' best interests," wrote Sean Griffith, a Fordham School of Lawprofessor, and Dorothy Lund, a law professor at the University of Southern California, in a recent article. Carolyn Wegemann, a Vanguard spokeswoman, says Vanguard keeps a clear separation between its stewardship efforts and its retirement plan business.

"The potential effects on anti-competitive conduct are really serious"

Is there any way to limit the potential downsides of the Big Three's dominance? It's possible that competition from other fund managers could chip away at it. Fidelity Investments, known for its stable of actively managed funds, intensified a price war among indexers when it introduced four no-fee index mutual funds in 2018. But such competition may only change things marginally. Cost-cutting tends to entrench big players. Tiny management fees add up when they're spread over trillions of dollars, and larger companies can more easily offset any loss of fee revenue with advisory and other services.

State Street CEO Ron O'Hanley has suggested having individual fund managers vote the shares in their portfolios, rather than the parent fund company voting all the aggregated shares. "My view is we should be open to change on this," he told the Wall Street Journal in December.

In his op-ed, Bogle discussed other remedies floated by experts and rejected most of them. Barring index funds from owning the shares of more than one company in an industry, he said, would destroy the index fund model—breaking one of the best investment tools ordinary people have. Only one suggestion—more transparency—won the endorsement of Bogle and BlackRock. BlackRock already discloses its engagement priorities, voting guidelines, actual votes cast annually, and other summary statistics. Bogle wanted to take the idea further by requiring index funds to publicly disclose each engagement with corporate managers.

If the problem is that companies' key shareholders have a tangle of conflicting interests, a more radical fix could be to get new voices into the room. Companies could add employee representatives to boards. Politicians from the Left (Democratic presidential candidate Elizabeth Warren) and the Right (former U.K. Prime Minister Theresa May) have proposed as much. German companies already include workers on their supervisory boards.

Perhaps the most immediate solution comes from Anat Admati, a Stanford finance and economics professor. Fund companies, she says, should use their leverage to make sure corporations are managed in the true interests of a fund's clients. "Start with the basics, such as ensuring better controls to prevent fraud, deception, reckless practices, and political activities against the public interest," Admati says, "and it's just possible that competition will improve and costly scandals, such as the opioid

epidemic, Boeing Co.'s 737 Max failure, Wells Fargo & Co.'s fraudulent checking accounts, and Facebook Inc.'s repeated privacy breaches, might have been avoided."
—With Aoife White, Mark Glassman, and Bloomberg Global Data's Denise Cochran and Bruce Johnson

(Updates the 25th paragraph with data on worldwide index fund assets)