Problems of Index Fund Capitalism

If the trend of the last two decades continues, index funds could control 40 percent of the voting rights in the largest corporations by 2040.The share is already up to 25 percent in the US. There a two perspectives on this. Some scholars say it threatens shareholder value, others fear it will lead to too much of it. I side with the latter. ...

Law-and-economics professors Lucian Bebchuk and Scott Hirst from the Universities of Harvard and Boston make the extrapolation of the index funds share in votes in their paper "The Specter of the Giant Three".

The concentration of shares in an ever smaller number of fund companies is a trend that has started roughly 70 years ago. In 1960 only about six percent of US shares were held by capital management companies. This share has increased tenfold to 65 percent by 2017, according to Bebchuk and Hirst.

Index funds don't select shares, actively, but instead replicate passively the composition of a stock market index with their assets, such as the DAX or the Standard & Poor's 500 (S & P 500). The advantage for investors is that they do not have to pay fund managers and analysts to work on stock selection. Experience has shown that the majority of actively managed funds do not outperform index funds even before fees.

The Giant Three

The two law scholars show how much influence the three largest index fund companies, BlackRock, Vanguard, and State Street Global Advisors, are already having or could be having – depending on your perspective - in the largest companies. In the past ten years, the three giants have drawn the lion's share of the inflows into the fund industry. Each of them holds five percent or more of the shares in almost all of the largest 500 US companies. Together they account for 20 percent of the shares in the corporations that make up the S & P 500. Their share in the executed voting rights at general meetings is even around 25 percent because some of the other shareholders do not take part in votes. BlackRock also holds over or close to five percent of the shares in most of the 30 largest German stock corporations in the Dax stock index, with BlackRock being the largest single shareholder in a number of them.

The increasing concentration of investment capital in a few large fund companies is due to the fact that large funds have considerable advantages over small ones: They can distribute the fixed costs of fund management to more customers and thus offer them at lower annual fees. They can also offer purchases and sales of fund units at lower margins due to their greater liquidity. In addition, it is very easy to take the wind out of the sails of smaller competitors by imitating them, if these should launch a successful fund that is based on a new index.

A Shareholder-Value Perspective

Bebchuk and Hirst assess this development from the perspective of shareholder value and the principal-agent problem. The shareholder value theory postulates that stock corporations should be managed in such a way that they generate the maximum return for shareholders. The problem is that the managers, i.e. the agents, might pursue other, selfish goals besides or instead of the the interests of the shareholders (principals).

The scholars suspect that this principal-agent problem will be exacerbated by the concentration of voting rights in passive investment funds. The managers of these funds would have an underdeveloped incentive to ensure that a company is optimally managed in the interests of its shareholders. The manager of an active fund could tell management that he will hold their companies' shares if and only if they pursue shareholder interests. A passive fund has to hold all companies' shares in pre-specified quantities anyway. As a further reason for index fund managers to be overly lenient to company management they hypothesize, that fund managers might want

to secure lucrative orders from management, for example to manage company pension funds.

Bebchuk and Hirst see these theses confirmed by the fact that the proportion of institutional votes which are cast in favor of management proposals keeps increasing.

A Stakeholder-Value Perspective

Bebchuk's Harvard colleague John Coates sees things quite differently. He is also diagnosing a problematic concentration of power in the hands of only a few index fund managers, who can increasingly dominate strategic decisions of almost all large corporations. In the essay "The Problem of Twelve" he contradicts the thesis that index fund managers do not interfere enough. He describes how the index fund managers influence corporate governance in a subtle but powerful way. For example, the funds have formulated corporate governance guidelines that managers of all companies in which they hold investments are expected to comply with. They coordinate these guidelines with each other.

> 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.

As Coates reports, such coordination-meetings also take place at Harvard University, where he teaches. The guidelines include questions such as whether the CEO should receive mostly a fixed salary or, predominantly stock options, how high an appropriate salary would be, what structure the management bodies should have, or whether a company should focus on one branch of business or diversify. Given the large proportion of voting rights in the funds' hands, company heads do well to take into account the fun' stated preferences, which are also brought to their attention in personal meetings with the fund managers. If they don't, they risk not getting the funds' support in critical situations Coates argues.

Submissive CEOs

This support is especially important for CEOs when shareholders vote on hostile takeovers, campaigns by activist investors or mergers. The index funds often hold a decisive block of votes and thus their support is crucial, Coates sees the balance of power tilted in exactly the opposite way from Bebchuk and Hirst, as far as side deals between companies and funds are concerned. Coates presumes that company management will try to grace key fund managers by giving them additional business.

From this point of view, the high degree of agreement between the fund company and the management when it comes to voting is a result of the subservience of company management towards the preferences of the funds.

> The mere threat of an activist supported by index funds can reduce investment,

Coates does not follow the narrow shareholder value approach. "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," he criticizes. Ultimately, the funds would have the decisive voice in important decisions that affect the company, its owners and society as a whole, from cost reductions and layoffs, investments in new technologies, acquisitions to internal control systems (compliance). "The mere threat of an activist supported by index funds can reduce investment," says Coates, [February 9, 2020]

See also: "Breakfast With BlackRock & Co"