Common and Universal Ownership

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Personal views that do not reflect PCAOB, board, individual board members, or staff.

Plan

1. Facts about common (CO) and universal ownership (UO)
2. Governance mechanisms
   - Non-exclusive and non-exhaustive
   - Skeptical provocations about potential for beneficial effects of UO
3. Why we must rethink the framework to discuss policy

Common **and** Universal Ownership

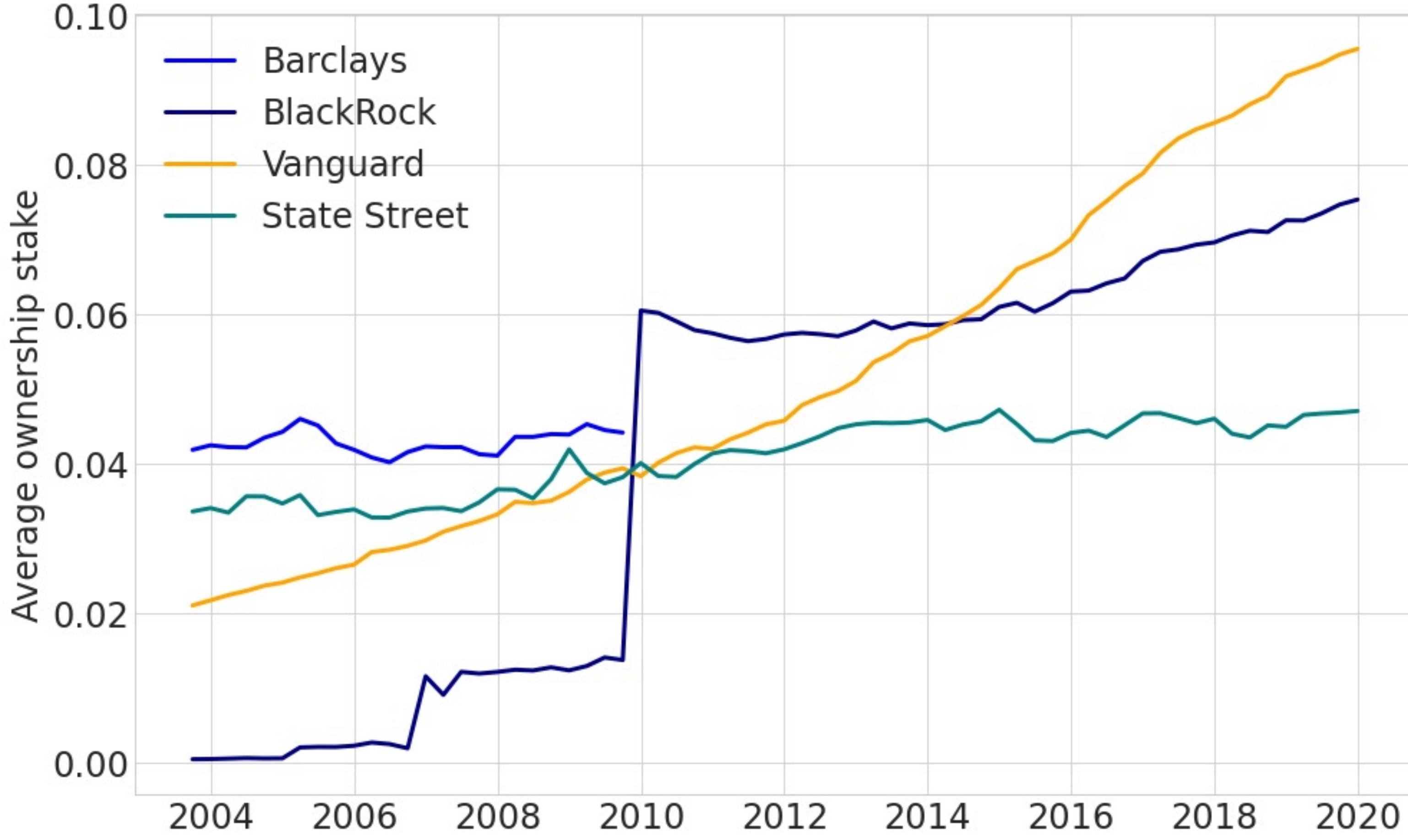
Kroger		Target		Costco	
Shareholder	**Stake (%)**	**Shareholder**	**Stake (%)**	**Shareholder**	**Stake (%)**
BlackRock	7.89	State Street	9.42	Vanguard	7.67
Vanguard	7.71	BlackRock	8.37	Capital Research	6.24
Capital Research	7.45	Vanguard	6.73	BlackRock	5.68
Fidelity	5.37	Franklin Resources	3.80	State Street	4.14
State Street	4.39	Dodge & Cox	3.63	Wellington	3.31
Janus Capital Mgt.	2.64	Capital Research	3.34	Fidelity	2.46
J.P. Morgan Asset Mgt.	2.23	BNY Mellon Asset Mgt.	1.64	Northern Trust Global Inv.	1.49

This table shows the largest institutional and noninstitutional beneficial owners and corresponding stakes for a selection of American supermarket chains as of 2017 Q2. Data from S&P Capital IQ. Schmalz (ARFE 2018)

- Big 3 ”own” not only competitors (CO), but all kinds of other public firms (UO)
  - But not private farmers in Pakistan, consumers, workers, the environment
  - Ultimate investors care about the latter, to various extent. Information problem?
- Most universal *investors* are not universal *owners*
  - Asset owners’ stake 1/10 that of asset managers (AM)

Asset manager growth, fund-family level

- Vanguard now controls more than 10% of the avg SP500 firm
- Big 3 jointly control ~25%
- Hard not to be influential when you're big
  - If just by encumbering voting rights
  - <u>Control is a scarce resource</u>



- Amel-Zadeh, Kasperk &Schmalz (2022)

Common **vs** Universal Ownership

Republic S	%	File		Waste Mgmt	%	File
Cascade Inv	34.1	13-D		Vanguard	8.3	13-F
BlackRock	6.3	13-F		BlackRock	7.2	13-F
Vanguard	5.7	13-F		State Street	4.8	13-F
State Street	3.3	13-F		Gates Found.	4.4	13-F
TRowe Price	3.2	13-F		Cascade Inv	3.9	13-G

Amel-Zadeh, Kasperk & Schmalz (2022) make data freely available at corporate ownership data.com

- Impossible to correctly calculate CO/UO from 13-Fs alone
  - **To which extent influential investors have financial stakes in rivals / other firms?**
    - Elon Musk does not file 13-Fs. Neither does Mark Zuckerberg or Sergey Brin.
    - Most papers in the CO literature use 13-Fs alone. (Others use data that doesn't exist.)
- Common ownership & universal ownership not just driven by "passive" indexing
  1. Active investors and activists contribute positively as well
     - Diversification vs monopolization (Frey, Ockenfels, and Schmalz, 2023)
  2. Centralized control across funds & consolidation of asset management

Real-world "passive" investing

There are now more than 10,000 ETFs.

Probably not to enable household portfolio diversification.

- Leveraged Equities (View Leveraged Equities ETFs)
  - Alerian MLP Index (150%)
  - Alphabet Inc. Class A (150%)
  - Amazon.com, Inc. (150%)
  - Apple Inc. (150%)
  - Coinbase Global Inc - Benchmark Price Return (150%)
  - Consumer Discretionary Select Sector (300%)
  - CSI China Overseas Internet Index (200%)
  - DJ US Select / Aerospace & Defense (300%)
  - DJ US Select / Home Construction (300%)
  - Dow Jones Industrial Average (-300%)
  - Dow Jones Industrial Average (300%)
  - Dow Jones Industrial Average Index (-200%)
  - Dow Jones Industrial Average Index (200%)
  - Dow Jones U.S. Dividend 100 (200%)
  - Dow Jones U.S. Semiconductors Index (-200%)
  - Dow Jones U.S. Semiconductors Index (200%)
  - Energy Select Sector Index (-300%)
  - Energy Select Sector Index (300%)

TL;DR --- in empirical reality

Indexing

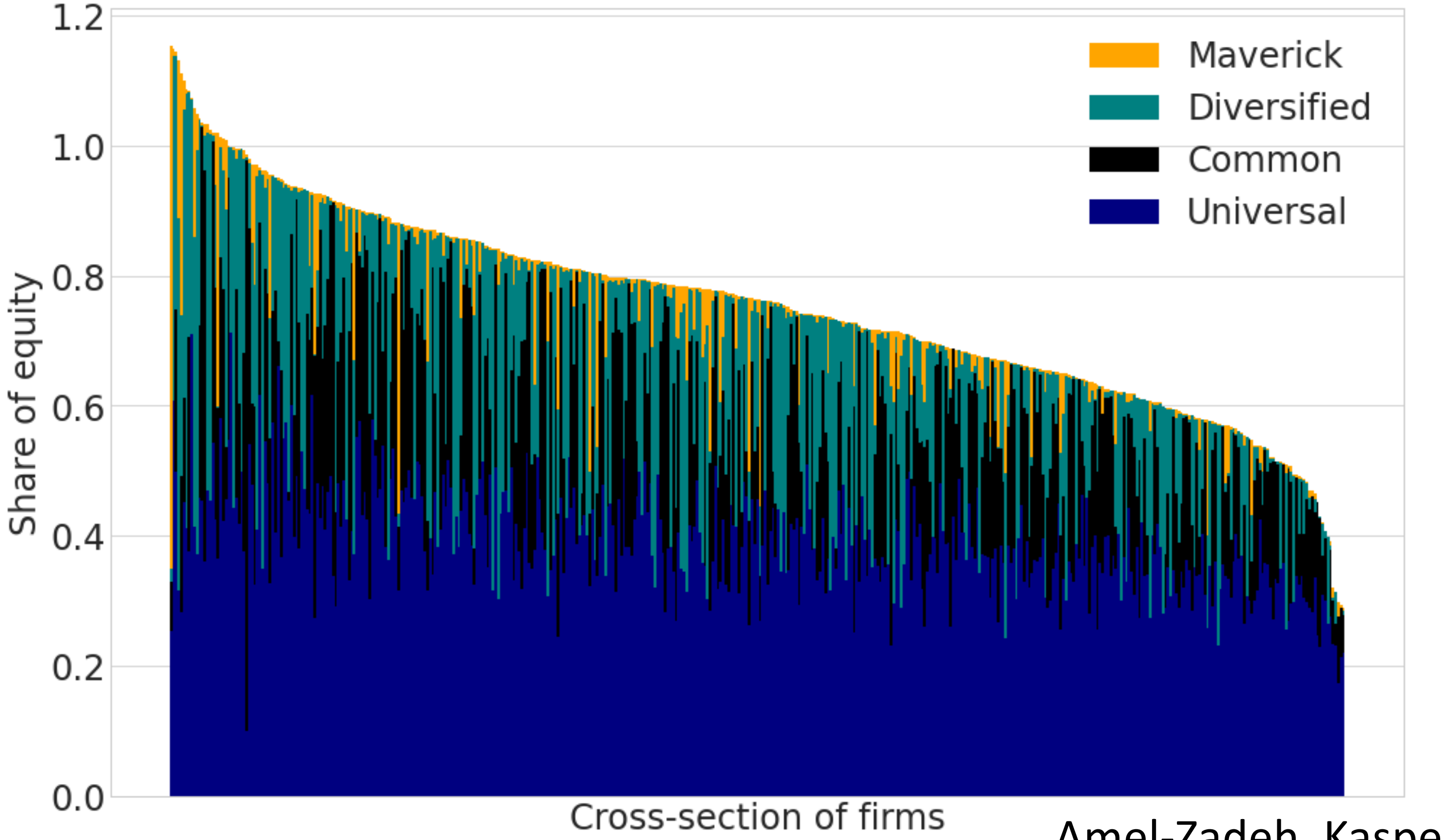
≠

common ownership

≠

universal ownership

S&P 500 ownership

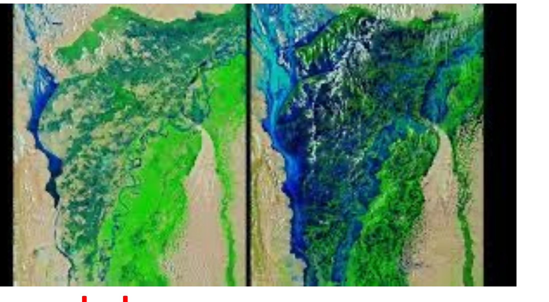


Amel-Zadeh, Kasperk & Schmalz (2022)

- **Understanding x-sectional variation requires comprehensive ownership data.**

Taxonomy of mechanisms (1): portfolio maximization

- **Firm managers act in most influential shareholders' interest**
  - Measurable interest is portfolio value. Coincides with explicit AM incentives.
  - Portfolio value higher when externalities internalized.
    - CO: Reduced incentives to compete.
    - UO: Solve climate change? Floods in Pakistan? Seems to require theory that CC will hurt ~~the overall economy~~ market cap / asset prices.



  - Either way, cannot believe in UO effects but not CO effects in this model

- *Deviation from ubiquitous profit maximization assumption!!*
  - Isn't that the only firm objective shareholders will surely agree on? No.

- Some direct evidence from Schmalz & Xin (WP 2023): "fake" generic entry by commonly owned firms to protect branded-drug profits

Taxonomy of mechanisms (2): standard agency conflicts

- **Managers maximize *firm* value, subject to costly effort**
  - But firms are NOT price takers. Product prices determined in equilibrium.
- Common owners have reduced incentives to improve governance because

  Cost-reducing ”good governance” is a negative externality on rivals

- Hence, CO, <u>if just by encumbering control</u> rights that would otherwise be used to improve corporate governance, increases costs & prices
  - Antón, Ederer, Giné, Schmalz (2023)

Empirical evidence for compensation channel

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Common Ownership, Competition, and Top Management Incentives

Miguel Antón, Florian Ederer, Mireia Giné, and Martin Schmalz

PDF | PDF PLUS | Abstract | Full Text | Supplemental Material

Abstract

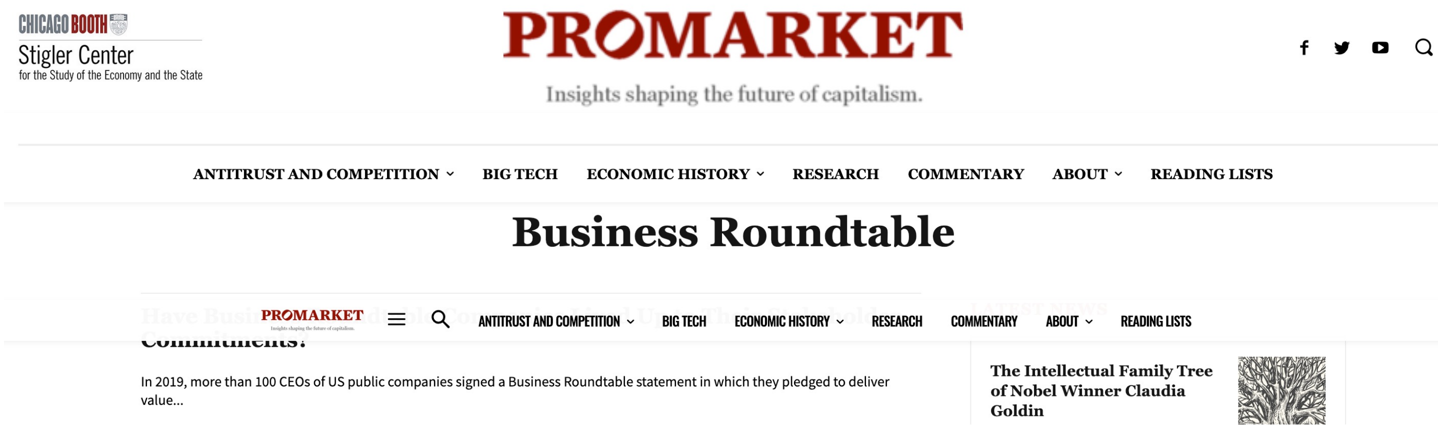
We present a mechanism based on managerial incentives through which common ownership affects product market outcomes. Firm-level variation in common ownership causes variation in managerial incentives and productivity across firms, which leads to intraindustry and intrafirm cross-market variation in prices, output, markups, and market shares that is consistent with empirical evidence. The organizational structure of multiproduct firms and the passivity of common owners determine whether higher prices under common ownership result from higher costs or from higher markups. Using panel regressions and a difference-in-differences design, we document that managerial incentives are less performance sensitive in firms with more common ownership.

Journal of Political Economy
Volume 131, Number 5
May 2023

Taxonomy of mechanisms (2): standard agency conflicts

- UO/CO have reduced incentives to engage for many other reasons
  - Probably with similar effects on product market prices
- Can “being lazy” and enabling “quiet life” also implement UO incentives?
  - Yes: Fewer emissions, by reducing output. Technology spillovers (*not* enforcing a patent).
  - No: no less hate speech on facebook?

Both mechanisms simultaneously at work?



- Asset managers (not asset owners!), who are supposed to monitor portfolio firm managers, joined managers to abandon profit-maximization as the firm objective
  - In favor of …

- Weak, diversified principals don’t enforce own-firm-value maximization?
  - Reflection of a double agency problem?

Active mechanisms are everywhere!

- @martincschmalz & Shekita (2021) list 30+ active CO interventions

Wall Street Tells Frackers to Stop Counting Barrels, Start Making Profits

The shale-oil revolution produces lots of oil but not enough upside for investors

By Bradley Olson and Lynn Cook

Updated Dec. 13, 2017 6:09 p.m. ET

Twelve major shareholders in U.S. shale-oil-and-gas producers met this September in a Midtown Manhattan high-rise with a view of Times Square to discuss a common goal, getting those frackers to make money for a change.

The September Manhattan meeting homed in on one factor in particular: the role executive pay plays in driving a growth-at-all-costs mentality.

Analysis of Over 2,200 Life Science Companie Reveals a Network of Potentially Illegal Interlocked Boards

Stanford Law and Economics Olin Working Paper No. 578

15 Pages • Posted: 21 Oct 2022 • Last revised: 12 Dec 2022

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Real-world example of active UI / CO mechanism?

Drugmakers urged to collaborate on coronavirus vaccine

Investors say competition needs to be put aside for the greater good

BlackRock has held talks with pharma companies about ways of developing medicines, including working with competitors © REUTERS

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"Big Pharma fights patent disclosure demand from investors"

… meanwhile …

- When TX governors ask about climate-change
  - BlackRock says they do "not pressure the companies it backs to lower their emissions"

- I am confused and look forward to learning from Becht, Franks, Miyajima, Suzuki *on ESG*
  - Overlap btw ESG and universally recognized social problems?

BlackRock is under fire again for its E.S.G. stance

BlackRock is getting the squeeze once again from two sides of the culture war.

Earlier this month, the world's biggest money manager defended its environmental, social and governance-based investment practices to 19 Republican state attorneys who accused it of colluding with climate activists. Now that defense has raised eyebrows with those on the left-hand side of the E.S.G. debate — in particular, the New York City comptroller, Brad Lander, who sent BlackRock's C.E.O., Larry Fink, a letter yesterday arguing that some of the firm's recent actions contradicted its previous climate commitments.

BlackRock wrote in its public response to the state A.G.s that it does not pressure the companies it backs to lower their emissions ~~and that it continues to invest in the fossil~~ fuel industry. Lander called these statements "alarming" and asked Fink to explain how BlackRock would create a portfolio that overall generates zero new greenhouse emissions. (It's not the first time the New York City ~~comptroller has made~~ this sort of

Why it might be harmful to believe UO will solve social problems (in quantitatively important ways)

1. Distracts from real solutions and allows societal harm to continue
    - E.g. politicians get a free pass
        - But: complements or substitutes?

2. If so, harms [utilitarian] investors
    - E.g. redistribution (fees) from households/investors to asset managers

3. Harms institutions, e.g.
    - Regulators that are supposed to regulate but don't
    - Central banks (CB) that aren't supposed to regulate but do
        - Consume resources at populace's expense, financed by inflation or reduced gvt budget

The Solution (This is a provocation to start a lively discussion.)

- Strengthen self-interest and high-quality government regulation
  - **We need more corporate profit maximization, not less**
  - Individual self-interest, incentives to compete, Wealth of Nations etc.

- Strengthen civic engagement rather than outsource to AM and CBs

- Unfortunately, that's hard, and a constant struggle
  - And hence an unpopular message
  - And I guess slightly political?

An objective reason to re-think policy debate

- Diversification benefits individual investors because it reduces risk
- **Reduced cost of diversification** causes greater of allocation to equity,
  - … which increases the price of equity
  - … which reduces expected returns
  - … which reduces expected wealth
  - … which **harms investors** as a group (no surprise)
    - … across the entire wealth distribution. (But may benefit firms *and consumers*.)
- Hence, the common-ownership policy tradeoff cannot possibly be
  - Benefits of investor diversification vs. costs of reduced competition
  - Partial equilibrium view gets the policy tradeoff *qualitatively wrong*

→ Need to take into account eqm asset prices in serious policy discourse

- Suspect this is true also for universal ownership

Schmalz & Zame, Index Funds, Asset Prices, and the Welfare of Investors, 2023

Summary

1. Much of the debate thus far lacked a factual basis
   - In particular on levels and drivers of common and universal ownership
     - No evidence either is primarily or only driven by textbook indexing
   - **Indexing ≠ common ownership ≠ universal ownership**

2. “Mechanism” discussion would benefit from more work
   - Lazy owners / quiet life can explain higher costs and prices prices
     - Does that mechanism also allow for beneficial effects of universal ownership?

3. The intuition on policy tradeoff flips in an equilibrium model
   - Equilibrium thinking seems necessary to get this one right