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Common Ownership: Faulty Assumptions on Investors' 'Economic Interests'

By Mike McNamee

The claim that competition in a concentrated industry suffers when institutional investors hold shares in firms across that industry continues to garner attention, as advocates pen op-eds and seek press attention. But as more and more experts examine what one official calls "the common ownership story," critical commentary is tearing large holes in this claim. Both the theoretical and empirical bases for this "story" are looking increasingly threadbare.

In "The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms," two scholars from the University of Missouri conduct a thorough review of the common ownership hypothesis and conclude that "the purported competitive problem is overblown and the proposed solutions would reduce overall social welfare." Thomas A. Lambert and Michael E. Sykuta reach their conclusion from several different angles. But one seems particularly relevant to mutual funds: they find that proponents for the hypothesis don't understand—or even attempt to consider—the actual economic interests and incentives of asset managers and their fund clients.

Proponents for the hypothesis argue that "empirically, taking into account shareholders' economic interests does help explain firms' product market behavior"—e.g., airlines' pricing decisions. But what are "shareholders' economic interests"? As Lambert and Sykuta point out, the proponents assume that institutional investors that are "intra-industry diversified"—that is, those who, on behalf of their clients, hold shares in firms across a concentrated industry—will reap better returns when company managers act to improve profits across the entire industry rather than focusing on their own firms' profits. Hence, those proponents argue, such investors will want company managers to dial back competition and raise prices.

But those proponents need to dig deeper, Lambert and Sykuta say. The proponents base their research on the aggregated stock holdings of all the funds or other clients of an asset manager. Those holdings are owned by many individual clients, including mutual funds—and "investors in those individual funds would have divergent preferences as to whether the airlines should maximize industry or own-firm profits….The competitive outcome [among airlines] that maximizes retail [fund] investors' profits will differ among funds," they note. Those differing preferences undermine any notion that the asset manager would have a collective "interest" in maximizing industry profits.

Lambert and Sykuta conduct a detailed examination of the holdings in four airlines by 11 funds managed by one large fund sponsor. They find:

- Two funds held only Southwest Airlines, and so would get their best performance when Southwest maximizes its own profits at the expense of competitors.
- Two funds held only United Airlines, and would benefit most when United out-flies the other three.
- One fund held Delta Airlines and United, and two funds held American, Delta, and United—so those three funds would benefit from airline managers who took business away from Southwest.
- Two funds held all four airlines, but had disproportionately larger stakes in Southwest—so they would get their best performance if Southwest thrived.
- Two funds held all four airlines in roughly equal shares. Only these two funds, Lambert and Sykuta note, would fit the

hypothesis's model—and even these funds might do better if all four airlines compete vigorously. As these and other authors note, "intra-industry diversified mutual funds tend also to be *inter*-industry diversified," investing in companies who would lose revenues (hotels, travel agents, car rental agencies) or face higher costs (nearly every company) if airlines raise prices.

(Lambert and Sykuta don't mention it, but ICI would be remiss if we didn't point out that each mutual fund in a fund family is a separate legal entity, with a responsibility to follow its stated investment objectives and strategies—not to uphold some sort of family-wide strategy.)

Lambert and Sykuta point out some features of competition in the fund industry that raise further doubt about hypothesis proponents' claim to understand investors' "economic interests":

- "For funds tracking popular stock indices, portfolio returns play little role in winning business from rival fund sponsors." In other words, S&P 500 funds generally deliver the performance of the S&P 500 (minus fees), and so different families' S&P 500 funds compete with one another along other dimensions (tracking error, fees, etc.).
- "For actively managed funds, portfolio returns are far more significant in attracting investors, and management fees are higher," than for index funds.

These vastly differing interests among funds and clients don't support the facile assumption that proponents of the common ownership hypothesis can readily discern a manager's "economic interests." As Lambert and Sykuta point out, discerning the adviser's actual economic interest requires drilling down to the level of the individual clients—and the common ownership studies have not done that.

"Thus, contrary to the assertion of the airline study's authors, the common ownership studies have not shown 'empirically' that 'taking into account shareholders' economic interests does help explain firms' product market behavior,'" they conclude. "Indeed, *they have never established what those economic interests are*" (emphasis added).

Lambert and Sykuta's paper deserves attention, because it knocks several other holes in the claim that common ownership is anticompetitive. But this hole is one of the largest.

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