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Towards the Giant Three: The Rise and Rise of the Big Three Index Funds

Posted on July 16, 2019 by Lucian Bebchuk and Scott Hirst

The Big Three index fund managers—BlackRock, Vanguard, and State Street Global Advisors—hold a significant proportion of the stock of US public companies, and they continue to grow steadily. There is a real prospect that index funds will continue to grow, and that voting in most significant public companies will come to be dominated by the future "Giant Three," write Lucian Bebchuk and Scott Hirst.

We recently posted our study "The Specter of the Giant Three" on SSRN. It was prepared for publication as part of the 2019 *Boston University Law Review* symposium issue on institutional investors.

Our study examines the substantial and continuing growth of the so-called Big Three index fund managers—BlackRock, Vanguard, and State Street Global Advisors. We show that there is a real prospect that the Big Three will grow into the "Giant Three," and that they will come to dominate shareholder voting in most significant public companies.

Our new study is part of a larger, ongoing project on stewardship by index funds and other institutional investors in which we have been engaged. This study complements our earlier study of index fund stewardship, "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy," forthcoming in the December 2019 issue of the *Columbia Law Review.* That study of index fund stewardship builds, in turn, on the analytical framework put forward in our 2017 article with Alma Cohen, "The Agency Problems of Institutional Investors."

We begin by analyzing the drivers behind the rise of the Big Three, including the structural factors that are leading to the heavy concentration of the index fund sector. We then provide empirical evidence about the past growth and current status of the Big Three, and their likely growth into the Giant Three. We extrapolate from past trends to estimate the future growth of the Big Three. We estimate that the Big Three could well cast as much as 40 percent of the votes in S&P 500 companies within two decades. We argue that policymakers and others must recognize—and must take seriously—the prospect of a Giant Three scenario. The plausibility of this scenario exacerbates concerns about the problems with index fund incentives that we identified and documented in our earlier work.

In the first part of our study, we analyze three key drivers that underlie the steady and persistent growth of the Big Three. The nature of these drivers means that the Big Three are likely to continue to grow. First, we discuss the factors that have led to the tenfold growth of institutional investor ownership over the past six decades. Second, we document the steady increase in the proportion of the assets managed by investment managers that are allocated to index funds. Third, we analyze three factors that lead to the heavy concentration of the index fund sector: scale economies, the liquidity benefits offered by exchange-traded funds ("ETFs") with large assets, and the ability of dominant index fund managers to compete quickly with new products introduced by rivals. These factors are likely to facilitate the continued dominance of the Big Three.

In Part 2, we present our empirical analysis of the Big Three's past growth, their current status as major shareholders of US companies, and their likely future growth. Our empirical analysis focuses on the companies in the S&P 500 and Russell 3000 indices, which represent 73 percent and 91 percent (respectively) of the total market capitalization of listed US companies as of December 31, 2017.

We start with the past growth and current status of the Big Three. Among other things, we document that:

- *Over the last decade, more than 80 percent of all assets flowing into investment funds have gone to the Big Three, and the proportion of total funds flowing to the Big Three has been rising through the second half of the decade;*
- *The average combined stake in S&P 500 companies held by the Big Three essentially quadrupled over the past two decades, from 5.2 percent in 1998 to 20.5 percent in 2017;*
- *Over the past decade, the number of positions in S&P 500 companies in which the Big Three hold 5 percent or more of the company's equity has increased more than five-fold, with each of BlackRock and Vanguard now holding positions of 5 percent or more of the shares of almost all of the companies in the S&P 500;*
- *Following two decades of growth, the Big Three now collectively hold an average stake of more than 20 percent of S&P 500 companies; and*
- *Because the Big Three generally vote all of their shares, whereas many of the non-Big-Three shareholders of those companies do not, shares held by the Big Three represented an average of about 25 percent of the shares voted in director elections at S&P 500 companies in 2018.*

Building on this analysis of past growth, we then proceed to extrapolate from past trends to predict the likely growth of the Big Three in the next two decades. Assuming that past trends continue, we estimate that the share of votes that the Big Three would cast at S&P 500 companies could well reach about 34 percent of votes in the next decade, and about 41 percent of votes in two decades. Thus, if recent trends continue, the Big Three could be expected to become the Giant Three. In this scenario, three investment managers would largely dominate shareholder voting in practically all significant US companies that do not have a controlling shareholder.

> ***"If recent trends continue, the Big Three could be expected to become the Giant Three. In this scenario, three investment managers would largely dominate shareholder voting in practically all significant US companies that do not have a controlling shareholder."***

We conclude by observing the substantial policy implications of the specter of the Giant Three. Here we build on our large-scale study of index fund stewardship, which analyzes the incentives of index fund managers and provides comprehensive empirical evidence on their stewardship activities. That study analyzes and documents the incentives of index fund managers, and especially major fund managers such as the Big Three, to be excessively deferential toward corporate managers. We argue that recognition of the Giant Three scenario increases the importance of the agency problems afflicting Big Three incentives that we have identified. Recognizing the specter of the Giant Three reinforces the importance of serious consideration of these problems.

In addition to our own prior work, the work that is most closely related to this article is an elegant essay by Professor John Coates, "The Future of Corporate Governance Part I: The Problem of Twelve." Although we and Coates both focus on issues arising from the growing concentration of ownership in the hands of a relatively small number of institutional investors, our works and views differ in key respects. Coates's essay focuses on what he labels "the problem of twelve"—that is, the possibility that twelve management teams will gain "practical power over the majority of US public companies."

By contrast, we focus on, and investigate empirically, the possibility that a much smaller number of management teams—the Big Three—will come to dominate ownership in most public companies. Furthermore, our view on the problems with the growing concentration of ownership substantially differs from that of Coates. Whereas Coates seems to be concerned that investment managers will excessively use the power that comes from their large ownership stakes, we have a very different concern—that the Giant Three will have incentives to be excessively deferential to corporate managers. Our concern is therefore that the substantial proportion of equity ownership with incentives towards deference will depress shareholder intervention overall, and will result in insufficient checks on corporate managers.

Whatever one's view of the nature of the Giant Three problem and the concerns that it raises, the specter of the Giant Three that we document and analyze represents a major challenge. We hope that our work will highlight for researchers, market participants, and policymakers the importance of the Giant Three scenario. The specter of the Giant Three deserves close attention, and our empirical evidence and framework of analysis could inform any future consideration of this subject.

Our study is available here, and comments would be most welcome.

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This post is based on their recent study, available here.

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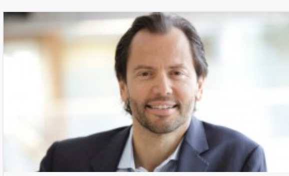

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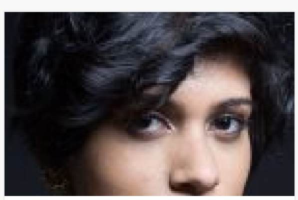

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