

Calm Down about Common Ownership

The evidence of anticompetitive harm from institutional investing is weak and the proposed policy solutions would be more harmful than the supposed problem.

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Prominent antitrust scholars have recently sounded alarm bells about large institutional investors' "common ownership" of competing businesses. Writing in the *Harvard Law Review*, Harvard Law School's Einer Elhauge proclaimed that "an economic blockbuster has recently been exposed"—namely, a "small group of institutions has acquired large shareholdings in horizontal competitors throughout our economy, causing them to compete less vigorously with each other." In the *Antitrust Law Journal*, Eric Posner of the University of Chicago and Fiona Scott Morton and Glen Weyl of Yale University contended that "the concentration of markets through large institutional investors is the major new antitrust challenge of our time." Those same authors took to the pages of the *New York Times* to argue that "the great, but mostly unknown, antitrust story of our time is the astonishing rise of the institutional investor ... and the challenge that it poses to market competition."

Not surprisingly, these scholars have offered solutions to the alleged problem. Elhauge has called for using the Clayton Act's Section 7, which precludes anticompetitive mergers, to police common ownership of minority stakes in competing firms. Posner et al. have proposed a government enforcement policy that would encourage institutional investors either to avoid holding stock of multiple firms in concentrated industries or to limit their influence over such firms by not voting their shares.

These scholars are getting ahead of themselves. There are serious difficulties with both the claim that small-stakes common ownership poses a significant competitive problem and the solutions the scholars have offered for that purported problem. We

show below that the problem's existence has not been adequately established and that, even if it does exist, the proposed policy cures would be worse than the disease. First, though, we describe the alleged problem.

THE PURPORTED PROBLEM

Given the recent explosion in index investing, institutional investors that sponsor index funds—Vanguard, BlackRock, Fidelity, etc.—are now among the largest shareholders of most publicly traded companies. They frequently hold significant stakes in all the firms in an industry. Proponents of restrictions on common ownership theorize that this pattern of institutional investment could reduce market competition and they point to empirical evidence purporting to show that such theoretical harm is, in fact, occurring.

Theory of harm / An investor in a single firm within a market—say, American Airlines—would prefer that the company try to win business from its rivals. By contrast, an investor holding stakes in all the firms in a market—American, Delta, Southwest, and United, if those were the only airlines servicing a particular route—would not want the firms to compete vigorously. After all, any gains to one competitor would come at the expense of other firms in the investor's portfolio.

An investor that is "intra-industry diversified" in this fashion would prefer maximization of *industry* profits, whereas a single-firm investor would prefer that its company maximize *own-firm* (i.e., just its own) profits. Corporate managers typically maximize own-firm profits by growing market share, and they do that by expanding output, enhancing quality, and discounting prices. Industry profits, by contrast, are maximized when corporate managers collectively act like a monopolist by reducing output,



expenditures on product improvements, and discounts from the levels that would attain in vigorous competition. Because institutional investors tend to be intra-industry diversified, they prefer maximization of industry profits and therefore want their portfolio companies to pull their competitive punches.

But why would corporate managers defer to the interests of institutional investors when most of their companies' shareholders are not intra-industry diversified? The theory is that institutional investors are better positioned to influence management decision-making. Relative to individual shareholders, institutional investors possess more extensive monitoring resources and greater expertise on matters of business strategy and firm policy. They also hold larger stakes in the corporations in which they are invested, and they therefore have greater incentive to become informed before voting their shares in director elections and on shareholder proposals, executive compensation packages ("say-on-pay"), etc. What's more, the votes of institutional investors often attract media attention, amplifying such investors' power over management. Given their greater clout, institutional investors are in a better position to engage corporate managers, and anecdotal evidence suggests they regularly do so. For all these reasons, corporate managers often honor the preferences of institutional investors over those of individual, uncoordinated stockholders, even when the latter collectively own a greater proportion of company stock.

Putting all this together generates the two main premises of the theoretical argument that common ownership by institutional investors softens competition in concentrated industries. Those premises are:

- Intra-industry diversified institutional investors have an *interest* in maximizing industry profits and would prefer that corporate managers not engage in business-usurping competition that would enhance own-firm profits but reduce overall profits within the industry.
- Institutional investors have sufficient *influence* over corporate managers to induce them to refrain from own-firm profit maximization in favor of greater industry profits.

Both of these premises ultimately prove to be flawed. However, before we explain those flaws, we first present the evidence often cited in support of the claim that institutional investing harms competition.

Evidence of harm / Two recent studies—one involving the U.S. airline industry, the other involving commercial banks—purport to demonstrate that institutional investors' common ownership of competing firms has reduced competition and injured consumers in concentrated industries.

In "Anti-Competitive Effects of Common Ownership" (the

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airline study), co-authors José Azar, Martin Schmalz, and Isabel Tecu tested whether institutional investors' common ownership of interests in domestic airlines raised airfares higher than they otherwise would be. To assess common ownership and the degree to which it changed over time, the authors employed a measure known as "MHHI delta" (MHHIΔ).

MHHIΔ is a component of the "modified Herfindahl-Hirschman Index" (MHHI), which, as the name suggests, is a modification of the Herfindahl-Hirschman Index (HHI), a well-known measure used in evaluating the legality of business mergers. HHI, which ranges from near zero to 10,000 and is calculated by summing the squares of the market shares of the firms competing in a market, assesses the degree to which a market is concentrated and thus susceptible to collusion or oligopolistic coordination. MHHI endeavors to account for both market concentration (HHI) and the reduced competition incentives occasioned by common ownership of the firms within a market. MHHIΔ is the part of MHHI that accounts for common ownership incentives, so $MHHI = HHI + MHHI\Delta$.

Calculating MHHIΔ for a particular market is a bit complicated. (For an explanation, see Appendix A of our working paper listed in the Readings.) For present purposes, it will suffice to understand what MHHIΔ purports to measure and which variables determine its magnitude. MHHIΔ aims to assess the degree to which the managers of firms within an industry, on the assumption that they seek to maximize their shareholders' portfolio returns, would cause their firms to avoid vigorous competition in an effort to maximize industry rather than own-firm profits. The primary variables that determine MHHIΔ are:

- the degree of control intra-industry diversified investors exercise over the managers of their portfolio firms (the greater such control, the higher the MHHIΔ)
- the size of the financial stakes intra-industry diversified investors hold in the firms within the industry, and the degree to which, for each such investor, those stakes are equal across firms (the greater the stakes of intra-industry diversified shareholders and the more equal those stakes across firms, the higher the MHHIΔ)
- the degree to which the firms within the industry have non-diversified shareholders with control over firm management (the greater the financial stakes and control of investors who are not intra-industry diversified, the lower the MHHIΔ)
- the market shares of firms that share common ownership (the greater their market shares, the greater the market effect of firm managers' decisions concerning competitive behavior, and the higher the MHHIΔ)

In their airline study, Azar et al. first calculated the MHHIΔ on each domestic airline route from 2001 to 2014. The authors then examined, for each route, how changes in the MHHIΔ over time correlated with changes in airfares on that route. To

control for route-specific factors that might influence both fares and the MHHIΔ, the authors ran a number of regressions. They concluded that common ownership of air carriers resulted in a 3%–7% increase in fares.

In "Ultimate Ownership and Bank Competition" (the banking study), Azar, Sahil Raina, and Schmalz attempted to assess how common ownership has affected service fees and interest rates in local markets for bank deposits. The authors correlated account fees, the minimum account sizes required to avoid fees (fee thresholds), and interest rates paid on deposits with the "generalized HHI" (GHHI), a metric similar to MHHI. They concluded that for interest-bearing checking accounts, a one-standard-deviation increase in GHHI increased fees by about 11% and fee thresholds by around 17%. For money market accounts, a similar increase in GHHI resulted in a 3% increase in fees and a 17% increase in fee thresholds. The authors also found that increases in GHHI reduced the interest rates paid to depositors.

PROBLEMS WITH THE PROBLEM

There are significant problems with both the theory that small-stakes common ownership causes competitive harm and the empirical studies purporting to support that theory.

Carefully parsed, common ownership critics' theoretical argument proceeds as follows:

- Premise 1:** Because institutional investors are intra-industry diversified, they benefit if their portfolio firms seek to maximize industry, rather than own-firm, profits.
- Premise 2:** Corporate managers seek to maximize the returns of their corporations' largest shareholders—intra-industry diversified institutional investors—and will thus pursue maximization of industry profits.
- Premise 3:** Industry profits, unlike own-firm profits, are maximized when producers refrain from underpricing their rivals to win business.
- Conclusion:** Intra-industry diversification by institutional investors reduces price competition and should be restricted.

The first two premises of this argument are, at best, questionable.

Inter-industry diversification / With respect to Premise 1, it is unlikely that intra-industry diversified institutional investors benefit from, and thus prefer, maximization of industry rather than own-firm profits. That is because intra-industry diversified mutual funds tend also to be inter-industry diversified, and maximizing one industry's profits requires supracompetitive pricing that tends to reduce the profits of firms in complementary industries. Vanguard's Value Index Fund, for example, holds around 2% of each major airline (1.85% of United, 2.07% of American, 2.15% of Southwest, and 1.99% of Delta), but also holds:

- 1.88% of Expedia Inc. (a major retailer of airline tickets)
- 2.20% of Boeing Co. (a manufacturer of commercial jets)
- 2.02% of United Technologies Corp. (a jet engine producer)
- 3.14% of AAR Corp. (the largest domestic provider of commercial aircraft maintenance and repair)
- 1.43% of Hertz Global Holdings Inc. (a major automobile rental company)
- 2.17% of Accenture (a consulting firm for which air travel is a significant cost component)

Each of those companies—and many others—perform worse when airlines engage in the sort of supracompetitive pricing (and corresponding reduction in output) that maximizes profits in the airline industry. The very logic suggesting that intra-industry diversification causes investors to prefer less competition necessarily suggests that inter-industry diversification would counteract that incentive.

Manager incentives/ Premise 2, the claim that corporate managers will pursue industry rather than own-firm profits when their largest shareholders prefer that outcome, is similarly dubious. For nearly all companies in which intra-industry diversified institutional investors collectively hold a significant proportion of outstanding shares, a majority of the stock is still held by shareholders who are not intra-industry diversified. There are several reasons to doubt that corporate managers would routinely disregard the interests of shareholders owning the bulk of the company's stock and pursue industry rather than own-firm profits.

For one thing, favoring intra-industry diversified investors holding a minority interest could subject managers to legal liability. The fiduciary duties of corporate managers require that they attempt to maximize firm profits for the benefit of shareholders as a whole; favoring even a controlling shareholder (much less a minority shareholder) at the expense of other shareholders can result in liability.

More importantly, managers' personal interests usually align with those of the majority when it comes to the question of whether to maximize own-firm or industry profits. As sellers in the market for managerial talent, corporate managers benefit from reputations for business success, and they can best burnish such reputations by beating—winning business from—their industry rivals. In addition, many corporate managers are compensated in stock of the companies they manage. They maximize the value of that stock by maximizing own-firm, not industry, profits. It thus seems unlikely that corporate managers would ignore the interests of stockholders owning a majority of shares and cause their corporations to refrain from business-usurping competition.

Confusing institutions with fund holders/ When confronted with criticisms of their theory of anticompetitive harm, proponents of

common ownership restrictions generally point to the empirical evidence in the two studies described above. The authors of the airline study, for example, greeted a criticism of their theory with the retort, “This argument falls short of explaining why, empirically, taking into account shareholders' economic interests does help to explain firms' product market behavior.”

Of course, to demonstrate “empirically” that institutional investors' “economic interests” influence their portfolio companies' “product market behavior” (i.e., cause the companies to charge higher prices, etc.), researchers would need to correctly identify institutional investors' economic interests with respect to their portfolio firms' product market behavior and establish that those interests cause firms to act as they do. On those crucial tasks, the airline and banking studies fall short.

In assessing institutional investors' economic interests, the studies have assumed that if an institutional investor reports holding a similar percentage of each firm in a market—say, 5% of the stock of each major airline—then it must have an “economic interest” in maximizing industry rather than own-firm profits. Such an assumption is unwarranted. That is because each institutional investor's reported holdings, set forth on forms it must submit under Section 13(f) of the Securities Exchange Act, *aggregate* its holdings across all its funds. Such aggregation paints a misleading picture of the institutional investor's actual economic interest.

For example, while Vanguard's Section 13(f) filing reports ownership of a similar percentage of American, Delta, Southwest, and United Airlines—suggesting an economic interest in industry profit maximization—the picture looks very different at the individual fund level:

- Vanguard's Value Index Fund (VIVAX) holds significant stakes in American, Delta, and United (0.46%, 0.45%, and 0.42%, respectively), but holds no Southwest stock. VIVAX does best if United, American, and Delta usurp business from Southwest.
- Vanguard's Growth Index Fund (VIGRX) holds a significant stake in Southwest (0.59%), but holds no stake in American, Delta, or United. Investors in VIGRX would prefer that Southwest win business from American, Delta, and United.
- Vanguard's Mid-Cap Index Fund (VIMSX) and Mid-Cap Value Index Fund (VMVIX) hold significant stakes in United (1.00% and 0.321%, respectively), but hold no stock in American, Delta, or Southwest. Investors in VIMSX and VMVIX would prefer that United win business from American, Delta, and Southwest.
- Vanguard's PRIMECAP Core Fund (VPCCX) holds stakes in all four major airlines, but its share of Southwest (1.49%) is twice its share of American (0.72%), nearly four times its share of United (0.38%), and seven-and-a-half times its share of Delta (0.198%). Investors in VPCCX would prefer that Southwest grow at the expense of American, United, and Delta.

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They would also prefer that American win business from United and Delta, and that United win business from Delta.

We could go on, but the point should be clear: because returns to retail investors in the funds of Vanguard and similar institutions turn on fund performance, the competitive outcome that maximizes retail investors' profits will differ among funds.

Mistaking institutional investors' incentives / Proponents of restrictions on common ownership might respond that even if an institutional investor's individual funds have conflicting preferences, the institutional investor as an entity must have *some* preference about whether to maximize industry profits or the profits of a particular company. Because it cannot honor all its individual funds' conflicting preferences with respect to competitive outcomes, the institutional investor will settle on the compromise strategy that maximizes its individual funds' *aggregate* returns: industry profit maximization. Such a strategy would be the first choice of the institution's funds holding relatively equal shares of all firms within a market. And, while the first choice of the institution's funds that are disproportionately invested in one firm would be to maximize that firm's profits, those funds would do better with industry profit maximization than with the first-choice strategy of other of the institution's funds, i.e., those that are disproportionately invested in a different firm.

But even if maximization of industry profits leads to the greatest aggregate returns for an institutional investor's funds, such a strategy may not be the best outcome for the institutional investor itself. An institutional investor typically wants to maximize its profits, which will grow as it attracts retail investors into its funds versus those of its competitors and steers those investors toward the funds that earn it the greatest profits (fees less costs). To assess an institutional investor's preferences with regard to the returns of its different funds, then, one must know the degree to which each fund's attractiveness vis-à-vis rivals' similar funds turns on portfolio returns, and the profit margin each fund delivers to the institutional investor.

For funds tracking popular stock indices, portfolio returns play little role in winning business from rival fund sponsors. (For example, higher returns on the stocks in the S&P 500 are unlikely to attract investors to BlackRock's S&P 500 index fund over Fidelity's or Vanguard's.) Moreover, the fees charged on such funds, and thus the institutional investor's potential profit margins, are extraordinarily low. For actively managed funds, portfolio returns are far more significant in attracting investors, and management fees are higher. The upshot is that an institutional investor, in determining what competitive outcome it prefers, will attach little weight to the competitive preferences of passive index funds and more weight to the preferences of actively managed funds, with that weight growing as the funds provide the institutional investor with higher profit margins.

It is quite possible, then, for an intra-industry diversified

institutional investor to prefer a competitive outcome other than the maximization of industry profits, even if industry profit maximization would maximize the aggregate returns of its individual funds. Consider, for example, an institutional investor that offers funds similar to the following Vanguard funds:

- Vanguard's 500 Index Fund (VFIAX) holds near equivalent interests in American, Delta, Southwest, and United and would thus do best with a strategy of industry profit maximization. Its expense ratio (annual fees divided by total fund amount) is 0.04 percent.
- Vanguard's Value Index Fund (VIVAX) holds similar stakes in American, Delta, and United but does not hold Southwest stock. Its expense ratio is 0.18 percent.
- Vanguard's PRIMECAP Core Fund (VPCCX) holds a much higher stake in Southwest than in the other airlines and has an expense ratio of 0.46 percent, 2.5 times as great as the no-Southwest VIVAX fund and 11.5 times as high as the fully diversified VFIAX fund.
- Vanguard's Capital Opportunity Fund (VHCAX) holds significantly higher shares of Southwest and United (1.74% and 1.55%, respectively) than of Delta and American (0.65% and 1.16%, respectively). Its expense ratio is 0.38, more than twice as great as the no-Southwest VIVAX fund and 9.5 times the fully diversified VFIAX fund.

This institutional investor's Southwest-heavy funds (those resembling Vanguard's VPCCX and VHCAX funds) charge much higher fees than its fully diversified index fund (the one resembling VFIAX, for which fund returns are unimportant) and significantly higher fees than its funds that are more heavily invested in airlines besides Southwest (those resembling VIVAX). Despite being intra-industry diversified at the institutional level, this institutional investor may do best if Southwest maximizes own-firm profits.

The point here is that discerning an institutional investor's actual economic interest requires drilling down to the level of its individual funds, something the common ownership studies have not done. 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 to explain firms' product market behavior." Simply put, they have never established what those economic interests are.

Endogenous measure / Even if institutional investors' aggregated holdings accurately revealed their economic interests with respect to competitive outcomes, the common ownership studies would still be deficient because they fail to show that those economic interests *caused* portfolio firms' "product market behavior." As explained above, the common ownership studies employ MHHIA (or a similar measure) to assess institutional investors' interests in competition-softening. They then correlate changes

in that metric with changes in portfolio firms' pricing behavior. The problem is that MHHIΔ is itself affected by factors that independently influence market prices. It is thus improper to infer that changes in MHHIΔ caused changes in portfolio firms' pricing practices; the pricing changes could have resulted from the very factors that changed MHHIΔ. In other words, MHHIΔ is an endogenous measure.

To see why this is so, consider the three-step process involved in calculating MHHIΔ. The first step is to assess, for every coupling of competing firms in the market (e.g., Southwest/Delta, United/American, Southwest/United, etc.), the degree to which the controlling investors in each of the firms would prefer that it avoid competing with the other. The second step considers the market shares of the two firms in the coupling to determine the competitive significance of their incentives not to compete with each other. (The idea is that reduced head-to-head competition

the other airlines. The market shares of the airlines in the high season are equal: 25% each.

On these facts, the increase in demand causes MHHIΔ to rise from 7,200 to 7,500. But the increase in demand is also likely to raise ticket prices. We thus see an increase in MHHIΔ that correlates with an increase in ticket prices, but the price change is not caused by the change in MHHIΔ. Instead, the two changes have a common independent cause.

Endogeneity also creeps in during the third step in calculating MHHIΔ. In that step, the "cross MHHIΔs" of all the couplings in the market—the metrics assessing for each coupling the extent to which common ownership will cause the two firms to compete less vigorously—are summed. As the number of firms participating in the market—and thus the number of couplings—increases, the MHHIΔ will tend to rise. While HHI (the market concentration measure) will decrease as the number of competing firms

rises, MHHIΔ (the measure of common ownership pricing incentives) will increase.

For example, suppose again that five institutional investors hold equal stakes (say, 3%) of each airline servicing a market and that the airlines have no other significant shareholders. If there are two airlines servicing the market and their market shares are equivalent, HHI will be 5,000, MHHIΔ will be 5,000, and MHHI (HHI + MHHIΔ) will be 10,000. If a third airline enters and grows so that the three airlines

have equal market shares, HHI will drop to 3,333, MHHIΔ will rise to 6,667, and MHHI will remain constant at 10,000. If a fourth airline enters and the airlines split the market evenly, HHI will fall to 2,500, MHHIΔ will rise further to 7,500, and MHHI will again total 10,000.

This is problematic because the number of participants in the market is affected by consumer demand, which also affects market prices. In the market described above, for example, the third or fourth airline might enter the market in response to an increase in demand, and that increase might simultaneously cause market price to rise. We would see, then, a price increase that is correlated with, but not caused by, an increase in MHHIΔ; increased demand would be the cause of both the higher prices and the increase in MHHIΔ.

In the end, then, the empirical evidence of competition-softening from common ownership is not the smoking gun proponents of common ownership restrictions proclaim it to be.

PROBLEMS WITH THE PROPOSED SOLUTIONS

Even if common ownership by institutional investors did cause some degree of competition-softening in oligopolistic industries, the solutions that have been proposed for the problem would not be justified.

Under Elhauge's proposal to police common ownership

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by bit players matters less for overall market competition than does reduced competition by major players.) The final step is to aggregate the effect of common ownership-induced competition-softening throughout the overall market by summing the softened competition metrics for each coupling of competitors within the market.

Given this process for calculating MHHIΔ, there are at least two sources of endogeneity in the metric. One arises because of the second step. To assess the significance to market competition of any two firms' incentives to reduce competition between themselves, the market shares of those two firms must be incorporated into the metric. But factors that influence market shares may also influence market prices apart from any common ownership effect.

Suppose, for example, that five institutional investors hold significant and equal stakes (say, 3%) in each of the four airlines servicing a particular air route and that none of the airlines has another significant shareholder. The air route at issue is subject to seasonal demand fluctuations. In the low season, the market is divided among the four airlines so that one has 40% of the business and the other three have 20% each. The MHHIΔ for this market would be 7,200. When the high season rolls around, demand for flights along the route increases, but the leading airline is capacity constrained, so additional ticket sales go to

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using the Clayton Act's Section 7 (which, by its literal terms, precludes stock acquisitions that tend to lessen market competition), liability would result from "any horizontal stock acquisitions that have created, or would create, a MHHIA of over 200 in a market with an MHHI over 2500" if "those horizontal stock acquisitions raised prices or are likely to do so." Posner et al. advocate a more determinate, rule-based approach. They would have the federal antitrust enforcement agencies compile annual lists of oligopolistic industries and then threaten enforcement action against any institutional investor holding more than 1% of the stock in such an industry if the investor held stock in more than one firm within the industry and either voted its shares or engaged firm managers.

The administrative costs of these proposed solutions, coupled with the losses they would create by eliminating welfare-enhancing arrangements, would swamp any welfare benefits they secured.

Administrative costs / Both of the proposed approaches would impose tremendous decision costs on business planners and adjudicators. Because institutional investors cannot prevent market prices from rising, institutional investors seeking to avoid liability under Elhauge's approach would have to monitor MHHI and MHHIA in the markets in which they were invested to ensure that the relevant thresholds were not exceeded. The monitoring would have to continue perpetually, for MHHI and MHHIA change constantly based on factors beyond an institutional investor's control (e.g., the market shares of the competing firms, stock ownership percentages of other investors). If the MHHI and MHHIA thresholds were crossed and a lawsuit filed, adjudicators would have to weigh complex evidence like that presented in the airline study to determine whether common ownership had caused or was threatening an adverse price effect. Evaluating complicated econometric studies is beyond the competence of most judges and virtually all juries.

Posner et al.'s bright line approach might initially seem to reduce the decision costs for business planners, but because the approach says only when *government* enforcement actions will be brought, it would hardly reduce business planners' burdens; they would still have to monitor MHHI and MHHIA to avoid liability in private antitrust lawsuits. Moreover, the Posner et al. approach would saddle enforcers with the herculean task of compiling, and annually updating, lists of oligopolies. Given that the antitrust agencies frequently struggle with the far more modest task of defining markets in the small number of merger challenges they file each year, there is little reason to believe enforcers could perform their oligopoly-designating duties at a reasonable cost.

Error costs / Even greater than the proposed solutions' administrative costs are their likely "error costs"—i.e., the welfare losses that would stem from wrongly deterring welfare-enhancing arrangements. Such costs would result if, as is likely, institutional investors were to respond to the policy solutions by making one

of the two changes proponents of the solutions appear to prefer: either refraining from intra-industry diversification or remaining fully passive in the industries in which they hold stock of multiple competitors.

If institutional investors were to seek to avoid liability by investing in only one firm per concentrated industry, retail investors would lose access to a number of attractive investment opportunities. Passive index funds, which offer retail investors instant diversification with extremely low fees (because of the lack of active management), would virtually disappear, as most major stock indices include multiple firms per industry.

Moreover, because critics of common ownership maintain that intra-industry diversification *at the institutional investor level* is sufficient to induce competition-softening in concentrated markets, each institutional investor would have to settle on one firm per concentrated industry *for all its funds*. That requirement would impede institutional investors' ability to offer a variety of actively managed funds organized around distinct investment strategies—e.g., growth, value, income etc. If, for example, Southwest Airlines were a growth stock and United Airlines a value stock, an institutional investor could not offer both a growth fund including Southwest and a value fund including United.

Finally, institutional investors could not offer funds designed to bet on an industry while limiting exposure to company-specific risks within that industry. Suppose, for example, that a financial crisis led to a precipitous drop in the stock prices of all commercial banks. A retail investor might reasonably conclude that the market had overreacted with respect to the industry as a whole, that the industry would likely rebound, but that some commercial banks would probably fail. Such an investor would wish to invest in the commercial banking sector but hold a diversified portfolio within that sector. A legal regime that drove fund families to avoid intra-industry diversification would prevent them from offering the sort of fund this investor would prefer.

Of course, if institutional investors were to continue intra-industry diversification and seek to avoid liability by remaining passive in industries in which they were diversified, the funds described above could still be offered to investors. In that case, though, another set of significant error costs would arise: increased agency costs in the form of managerial misfeasance.

Unlike most individual shareholders, institutional investors often hold significant stakes in public companies and have the resources to become informed on corporate matters. They have a stronger motive and greater opportunity to monitor firm managers and are thus particularly well-poised to keep managers on their toes. Institutional investors with long-term investor horizons—including all index funds, which cannot divest from their portfolio companies if firm performance suffers—have proven particularly beneficial to firm performance. Indeed, a recent study by Jarrad Harford, Ambrus Kecskés, and Sattar Mansi found that investment by long-term institutional investors enhanced the quality of corporate managers, reduced measurable instances

of managerial misbehavior, boosted innovation, decreased debt maturity (causing firms to become more exposed to financial market discipline), and increased shareholder returns. It strains credulity to suppose that this laundry list of benefits could similarly be achieved by long-term institutional investors that had no ability to influence managerial decision-making by voting their shares or engaging managers. Opting for passivity to avoid antitrust risk, then, would prevent institutional investors from achieving their agency cost-reducing potential.

CONCLUSION

Proponents of additional antitrust intervention to police common ownership simply have not made their case. Their theory as to why current levels of intra-industry diversification would cause consumer harm is implausible and the empirical evidence they say demonstrates such harm is both scant and methodologically suspect. The policy solutions they have proposed for dealing with the purported problem would radically rework an industry that has provided substantial benefits to investors, raising the costs of portfolio diversification and enhancing agency costs at public companies. Courts and antitrust enforcers should reject their calls for additional antitrust intervention to police common ownership. R

READINGS

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