Why the presence of common shareholders in rival companies looms as a threat

"Common ownership" is a buzzword in academic and regulatory circles these days. José Azar's paper linking common ownership to higher airline ticket prices and other negative consequences is at the center of a new debate that could profoundly affect the investment fund industry as we know it.

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Index funds offer investors a chance to diversify while keeping investment costs low. That's good for investors.

But there may be a dark side: Index funds are a key reason competitors within a market are commonly owned, i.e., have the same powerful shareholders if their shares trade publicly. Consider this: BlackRock, the largest investment company in the world, was the single largest shareholder of about 20 percent of all American publicly traded firms. Add rivals Vanguard and State Street, and the top three asset management companies were collectively the largest shareholders of at least 40 percent of all American publicly traded firms last year. And as index funds continue to gain in popularity, their reach continues to grow.

So, why does common ownership have the potential to cause harm? In short, common ownership reduces market competition, evidence shows. That can be bad for consumers and for the economy as a whole. In their widely discussed and cited paper, José Azar of IESE, Martin C. Schmalz and Isabel Tecu find that common ownership within the airline industry goes hand in hand with higher ticket prices — even when passenger numbers dwindle.

Sudden Impact

When Azar et al. shared the first draft of their working paper, it caught the attention of many economists, journalists and regulators. The U.S. Justice Department launched an investigation into the matter in 2016. *The Atlantic* magazine's provocatively titled "Are Index Funds Evil?" summarized in 2017: "Azar, Schmalz and Tecu's paper went viral among academics, launching a whole new field of inquiry and many heated debates." And from there, attention only grew, with more articles appearing in the *New York Times*, *Wall Street Journal*, *the Economist*, *Financial Times*, *New Yorker*, *Bloomberg BusinessWeek*, and other media outlets. Prominent columnists, regulators and other op-ed writers called for action. The OECD held hearings, European antitrust enforcers took note, and academic conferences dedicated special sessions to the topic.

BlackRock, for one, issued a response in a 2017 white paper, calling the mechanism by which common ownership raises prices "vague and implausible." At the same time, the research and responses, described as "third-party commentary citing concerns about the growth of index investing, as well as perceived competition issues associated with... 'common ownership'" now appears among the risks in BlackRock's most recent annual report. The concerns raised by Azar et al. are obviously on the radar of the world's largest investment company as well as regulators and writers.

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How Much Did You Pay for That Seat?

So what are the supposed mechanisms at work here?

After analyzing over 10 years of airline industry data — which included the before-and-after results of a merger between investment companies with common ownership of certain airline stocks — the co-authors conclude that the link between higher market concentration levels and higher ticket prices is statistically significantly. In the case of BlackRock's acquisition of Barclays Global Investors (BGI), increased market concentration lifted certain airline route prices by 10 to 12 percent. And the first mechanism the co-authors point to was "the indirect channel: doing nothing."

In other words, common shareholders, like BlackRock, and the management of companies in their portfolios seem to lack the impetus to start the (potentially painful) game of undercutting the competition. And so, product prices float upwards, and profits within a given market do, too. It's not that management and their most important shareholders are colluding to hurt consumers, it's more like the rising prices reflect the path of least resistance. Management doesn't have to work too hard initiating price wars, pouring money into R&D, pioneering new markets and improving operations — these are projects that take a personal toll.

Consider the fact that when all airline prices are higher, many common owners remain happy with higher stock prices. But consider the fact that the co-authors found higher prices co-existing with slightly lower passenger traffic, suggesting that common ownership translates into decreased economic efficiency, or, "deadweight loss for the macro-economy." So, both the economy as a whole and consumers pay a price here.

The authors note how unregulated increases in common ownership have had stronger effects on product prices than the mergers that have been thoroughly scrutinized by antitrust authorities. The research begs the question as to whether governments should try to restrict the holdings of diversified mutual funds. That debate is still very much open.

Methodology, Very Briefly

The researchers analyze over 10 years of market-firm-level panel data from the U.S. airline industry between 2001 and 2013. They also look at BlackRock's acquisition of Barclays Global Investors' equity portfolios in 2009 to observe a sudden change in market concentration on certain prices.

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