THE SPECTER OF THE GIANT THREE

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ABSTRACT

This Article examines the large, steady, and continuing growth of the Big Three index fund managers—BlackRock, Vanguard, and State Street Global Advisors. We show that 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."

We begin by analyzing the drivers of the rise of the Big Three, including the structural factors that are leading to the heavy concentration of the index funds 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. Among other things, we document that the Big Three have almost quadrupled their collective ownership stake in S&P 500 companies over the past two decades; that they have captured the overwhelming majority of the inflows into the asset management industry over the past decade, that each of them now manages 5% or more of the shares in a vast number of public companies; and that they collectively cast an average of about 25% of the votes at S&P 500 companies.

We then 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% of the votes in S&P 500 companies within two decades. 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 identify and document in other work.

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This Article is part of a larger, ongoing project on stewardship by index funds and other institutional investors. This Article complements our earlier study of index fund stewardship, Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794, which in turn builds on the analytical framework put forward in our article with Alma Cohen, Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 95 (2017).

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INTRODUCTION

This Article analyzes the steady rise of the "Big Three" index fund managers—Blackrock, Vanguard, and State Street Global Advisors ("SSGA"). Based our analysis of recent trends, we conclude that the Big Three will likely continue to grow into a "Giant Three," and that the Giant Three will likely come to dominate voting in public companies. This Giant Three scenario raises the importance of the problems with index fund incentives in general, and the Big Three in particular, that we analyze and document in other work.[1]

Our analysis is divided into three parts. In Part I, we analyze three key drivers that underlie the steady and persistent growth of the Big Three, and which mean that this growth is likely to continue. First, we discuss the factors that have led to the tenfold increase in institutional investor ownership over the past six decades. Second, we document the steady growth of 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 II, we present our empirical analysis of the past growth of the Big Three, their current status as major shareholders of U.S. 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% and 91% (respectively) of the total market capitalization of listed U.S. companies as of December 31, 2017.[2]

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% of all assets flowing into investment funds has 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;

[1] *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 95 (2017); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, COLUM. L. REV. (forthcoming 2019) (manuscript at 1), http://ssrn.com/abstract_id=3282794.

[2] Calculated based on market capitalization data from the Center for Research in Securities Prices. Market capitalization data is based on those types of shares included in the Russell 3000 and S&P 500, including common shares of U.S. companies, non-U.S. companies, real estate investment trusts, shares of beneficial interest, and units of companies incorporated outside the United States.

- The average combined stake in S&P 500 companies held by the Big Three essentially quadrupled over the past two decades, from 5.2% in 1998 to 20.5% in 2017;[3]
- Over the past decade, the number of positions in S&P 500 companies in which the Big Three hold 5% or more of the company's equity has increased more than five-fold, with each of BlackRock and Vanguard now holding positions of 5% 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% of S&P 500 companies;[4] and
- Because the Big Three generally vote all of their shares, whereas not all of the non-Big Three shareholders of those companies do so, shares held by the Big Three represent an average of about 25% 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% of votes in the next decade, and about 41% of votes in two decades. Thus, if recent trends continue, the Big Three could be expected to become the "Giant Three." In this Giant Three scenario, three investment managers would largely dominate shareholder voting in practically all significant U.S. 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.[5] 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 a 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.[6] Although we and Coates both focus on issues arising from the growing concentration of ownership in the

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[3] *See infra* Figure 1, Panel 1 and accompanying text.

[4] *See infra* Table 5 and accompanying text.

[5] *See generally* Bebchuk & Hirst, *supra* note 1.

[6] *See generally* John C. Coates IV, *The Future of Corporate Governance Part I: The Problem of Twelve* (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 1001, 2019), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Coates_1001.pdf.

hands of a relatively small number of institutional investors, our works and views differ in key respects. To begin, 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 U.S. public companies."[7] By contrast, we focus on the possibility that a much smaller number of management teams—the Big Three—will come to dominate ownership in most public companies. In addition, this Article differs from Coates's work in that our empirical analysis focuses on documenting the growth of the Big Three and estimating its future trajectory.

Finally, 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 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.

I. THE RISE OF THE GIANT THREE: DRIVERS

This Part analyzes three key drivers that underlie the consistent growth of the Big Three and make it likely that this growth and the related dominance of the Big Three will continue. First, the proportion of shares held by institutional investors has grown considerably and can be expected to continue to grow. Second, of the shares held by institutional investors, the proportion invested in index funds has also grown steadily, and can also be expected to continue to grow. Third, structural factors have led to heavy concentration in the index funds sector and suggest that the Big Three will only increase their dominance. Sections I.A through I.C examine in turn each of these three drivers.

A. *The Rise of Institutional Investors*

Over the last fifty years, institutional investors have come to hold a majority of the equity of U.S. public companies.[8] From 1950 to 2017, the institutional

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[7] Coates IV, *supra* note 6, at 1.

[8] For early works on the rise of institutional investors, see, for example, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567 (1990); Robert Charles Clark,