3 Takeaways Podcast Transcript

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Ep. 180: An Eye-Opening, Cautionary Look At The Problematic Clout Of A Few Giant Index Funds

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INTRO male voice: Welcome to the 3 Takeaways podcast, which features short, memorable conversations with the world's best thinkers, business leaders, writers, politicians, scientists, and other newsmakers. Each episode ends with the three key takeaways that person has learned over their lives and their careers. And now your host and board member of schools at Harvard, Princeton and Columbia, Lynn Thoman.

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Lynn Thoman: Hi everyone. It's Lynn Thoman. Welcome to another 3 Takeaways episode. Democracy in the US, starting from the founding fathers, has been wary of any kind of concentrated power. The founding fathers imposed checks and balances on government and then government, through antitrust law, imposed limits on businesses. But there's a new kind of control by a few of the big financial firms, which has happened completely under the radar. Today I'm excited to be joined by Harvard Law School professor John Coates. John argues that three companies effectively control most of America's largest companies, and that one company is the largest single shareholder in the vast majority of America's largest public companies including Apple, Microsoft and Exxon. I'm excited to find out how that can be possible. John is also the author of the new book, "The Problem of Twelve." Welcome, John, and thanks so much for joining 3 Takeaways today.

John Coates: Thanks, Lynn. Happy to be here.

LT: It is my pleasure. Let's jump right in. How big are Vanguard and BlackRock today?

JC: Well, if I used absolute dollars, they would be so large as to not really make a lot of intuitive sense. So, I'm just going to tell you what they own because I think that's an easier way to answer your question. The two of them alone control somewhere between 10-15%, sometimes as high as 20%, of all of the stock of all of the companies that are listed on all of the US stock exchanges. So, they own roughly 15-20% of the part of the economy that's run through public companies, which is the biggest part of the economy. We're talking trillions of dollars in aggregate.

LT: And Vanguard is larger than BlackRock and Vanguard owns what? About 8 or 9% or so of some of the largest companies in the US? Can you give some examples?

JC: BlackRock is slightly larger in terms of total assets. As an index fund provider, Vanguard is a little bigger, but the percentages vary a little bit and sometimes it's Vanguard that's the leading owner and sometimes it's BlackRock. But just to take some examples, Exxon, which everybody's heard of, it's a big company, Vanguard owns 10% of all of the Exxon stock. BlackRock owns another 7%. And then there are a couple of other index fund providers at the very top. State Street is one and Fidelity is another. If you add the two of those, you have an aggregate of about 25% of all

of the stock of Exxon owned by those four index fund companies. As you move down the ranks of funds, it falls off very fast. So, there's no one else that owns even half as much as Fidelity and that's half as much as Vanguard for Exxon. The same thing would be true if you went to Pfizer, the big drug company - to be specific, 9% Vanguard, 8% BlackRock, 5% State Street, 3.5% Fidelity.

LT: That is just shocking.

JC: And then one other thing, just to make it even more shocking. This has been the result of continuous growth, which shows no sign of stopping. Over the past 25 years, they've gone from less than 2 or 3% in aggregate to 25%, which is amazing. It's the biggest single change in the way companies are owned and controlled in my lifetime, certainly in my career.

LT: Before we explore the implications of this power, in order to understand how Vanguard and BlackRock amassed this power, let's go back to Princeton professor, Burton Malkiel and his book, A Random Walk Down Wall Street. What was Burt's insight?

JC: He realized that if you look carefully at the pattern that stock prices followed, there was essentially no pattern, [chuckle] in the short run at least. That if you knew where a stock had been over the last few days, that told you very little, if anything, about where it might go over the next few days. And so that insight said there's a whole lot of randomness to the way that stock prices move around over time. They do trend upwards on average in aggregate, but individual stocks just go all over the place. And that's because they're buffeted by macroeconomic forces, international relations, Russia invading Ukraine, commodity prices, the CEO dying. There's just so many different things that can come into the picture that it was exceedingly difficult, and sometimes depending on the moment, he would claim impossible, to do better than the market. That if you just simply bought all the stocks and stopped trying to beat the market, you'd do fine, 'cause as I mentioned, on average equities, stocks do tend to go up more than other kinds of investments, but you would do at least as well as if you tried to pick and choose. And that insight really is the foundation for the modern index funds that we've been talking about.

LT: And what did John Bogle, the founder of Vanguard, do with that insight?

JC: He took Burt Malkiel’s and other theoreticians’ ideas and put them into practice. He specifically came up with the idea that he would offer an investment fund, a mutual fund, that would tell you right up front, "We're not going to try to pick and choose stocks. We're going to take your money and we're going to do as little as possible with it. We're going to basically go out and buy all the stocks that are available." Back then it was initially the Standard and Poors 500, and these days that's still the most common kind of index. And here's the crucial part, "We're not going to pay professionals, professional money managers, investors, the very large salaries that they can command on the labor market to do anything. We're just not going to have them. We're going to have minimal services. You give us your money; we'll keep it safe. We'll follow the law. We'll have a bank account. We'll do the minimal things to have custody. But we're not going to really do more than that."

JC: They obviously have to do some more things, record keeping and taxes, but these are sort of basic services. And so, the result of that business model that Bogle came up with is he could afford to charge rock bottom fees. And then finally here's the real kicker. If you pay fees to professionals who can, on average, just barely beat the market, if at all, those fees accumulate over multiple years

going into your retirement, for example, and they can add up to a giant amount of money that you're giving away, that they have to out earn by beating the market not just a little, but by a lot.

JC: And so initially, Bogle's idea didn't really take off because it sounds so strange, "You're going to give you our money and we're not going to even try to beat the market." But after 20 years, from roughly 1975 when the first Vanguard fund was created to roughly '95, that 20-year period produced data that everybody could look at, and lo and behold, Vanguard just consistently beat most other mutual funds. Here's the other piece of this. Ordinary investors including, I put myself in that category, we don't know [inaudible]. So, if we're giving our money even to the possibility of there being somebody beating the market, we don't know until long after the fact, if ever. So that's the basic idea of Vanguard. And it really wasn't until the late '90s it sort of became instead of a hard to believe story, now to a kind of taken for granted story. And that's really when the index funds collectively, not just Vanguard, but BlackRock and State Street and Fidelity, they all started taking off. That's been their sustained growth period ever since about 2000.

LT: And to be clear, when you're talking about randomly picking stocks, you're talking about money managers or investment advisors randomly picking stocks, active money managers versus investment in passive index funds that track an index like the S&P 500?

JC: Yeah. The idea of that random... the dart throwing, was just to test whether the active people could do better than just random, and the answer was no. And if that's true, then buying an index at a very low fee is obviously much more compelling as an idea.

LT: And who invests in index funds? Is it just individuals or is it also pension funds, investment managers and other types of firms?

JC: It runs the gamut. They were designed initially, I think, for individuals with modest means who couldn't afford the fees that money managers, professional money managers, would charge, especially if you wanted to get a very diversified portfolio. But also, if you look at what the biggest pension funds in the world invest in, a lot of their money is invested through indexes now. And in fact, even the most active mutual funds, a traditional kind of mutual fund that tries to pick and to choose, they're basically index funds too, and then they have a few stocks that they pick and choose and then they add to an index. And so, indexing has become the standard way that money at a scale or modest amount is invested.

LT: How large now are the equity index funds of Vanguard or BlackRock?

JC: Yeah. They're in the trillions. I think in aggregate the index industry is about $12 to $15 trillion and most of that is in the big four.

LT: What potential power comes from being the largest owner of the shares of companies? Can you tell us about what happened with a small investing firm, Engine No. 1 and Exxon?

JC: Yeah. That's a great way to illustrate what's happening. So, for most financial services or products, you pay a fee, you get a service, you pay for a credit card every year, or whatever, and you get the right to borrow and whatever. It has no real impact beyond your immediate transactions. Sometimes, as with housing, it can have a big impact on the economy. What's unique about the index fund world and people investing through them is that when you invest through a fund you not

only have your money invested and then you get a return as the companies hopefully do better over time on average and they pay dividends, but you also get votes, because our corporate system is set up so that the shareholders elect the board of the company and then the board of the company picks the CEO.

JC: So, the investments you make also convey power. Now, for most people if you bought a single share of stock, trivial power. It's like you have one vote out of a million shares. It's not really going to matter. But once you own, as the index funds do, 5, 10, 15, 20, 25, 30% of all of the shares, that means you have 30% of all of the votes concentrated in those small number of hands. And that practically means enormous potential influence, and actual influence. So, to tell the Exxon story, two years ago, a tiny investment fund, not an index fund, a hedge fund called, Engine No. 1 based in San Francisco, basically created just for the events I'm about to tell you about, proposed that four people get put on the board of Exxon. And these people were not people that had any connection to Exxon and Exxon was not in favor, they had no interest.

JC: The board of Exxon had no interest in welcoming these four people onto their board. So, there was what's called a proxy fight, meaning that the small fund had to try to convince the other shareholders of Exxon to vote with it in the election of directors and tried to get them to take their votes away from the ordinary traditional Exxon board and give it to their people. Now, these kinds of proxy fights are rare, in part, because it's very rare for them to win, even when they are brought. And particularly if the person bringing it has a tiny amount of stock as Engine No. 1 did. I think they had less than 0.1% of Exxon shares. It'd be almost like me trying to run a proxy fight.

JC: Except this time, and I think this was a shock, frankly to Exxon, I'm fairly sure of that, this little fund convinced BlackRock, Vanguard, State Street and a few other major institutional shareholders to vote with it and they swung the election. They didn't all vote for all four, but they voted for three of the four [board of directors nominees]. And then the overlap meant that three of the four board members got put on the Exxon board, including a sustainability consultant, somebody interested in the transition from carbon-based oil and gas to lower carbon energy future, not something that Exxon traditionally was known for.

JC: And that was actually part of the point of the proxy fight. It was an attempt to push Exxon, in effect, in a greener direction through this. And the index funds were pivotal to that outcome. So that's an example that might, for some of you listening, might make it seem like a good thing, 'cause if you're in favor of getting Exxon to be greener, that sounds like a good outcome. But power is power and it doesn't always work in that same direction. In fact, in the most recent year, the big index funds, including Vanguard, have been remarkably unwilling to vote for climate proposals, in part because of their worries about political reaction to the Exxon fight. They also have, on occasion, blocked things that people in favor of climate change have been in favor of. So, the point of the Exxon story is not it's all good, but rather these index funds are really making major decisions that are affecting the biggest companies in the world on a routine basis.

LT: John, do Vanguard and BlackRock essentially control or have a major influence over the largest 500 public companies in the US?

JC: They do. Control would be putting it a little stronger than is fair. And the reason is they're careful not to take control. There are legal consequences, there are liabilities, there's insider trading risks, there's all kinds of things that come with real active control. So, I don't want people to

imagine the heads of these funds calling up the CEOs and telling them to buy this and sell that and change their policy here and fight the Union there. It's not like that. But influence is maybe too weak of a word. It's somewhere in between influence and control. They engage, as they put it, with the largest companies on a routine basis. What they mean by that is they call them up and they have conversations just like the one we're having and they tell them their views. So, a lot of their influence is aimed to try to get companies to be more open with them about what they're doing.

JC: But they also have real power too. So, whenever a company does a merger, merger and acquisitions occur all the time, they have to get shareholder approval, and these funds can block the merger from going through. And it's not just a theoretical possibility, Vanguard talks about the fact that they've voted no for hundreds of mergers over the past few years, and CEOs know that. So even if they don't have a merger pending, they will really want to be sure to be on the good side of these big index funds because if they do bring a merger to a vote, they know they'll be determining the outcome.

LT: How do you think that these firms will use their influence going forward? Do you think they'll use their influence more aggressively?

JC: I think they're doing a very careful dance right now, in part because the Exxon fight was such a shock that the political system was immediately engaged. Oil and gas interests persuaded the governor of Texas and the governor of Florida and the governor of West Virginia to start to threaten the big index funds with pulling their money out or even suing them under antitrust law. And so that reaction has led to the big index funds being, as I mentioned a minute ago, less green in some of their votes over the last couple of years and probably a little more cautious overall about how they use their influence. I think they're going to be struggling over the next few years; how do they continue to grow and get even more power while not offending someone?

LT: John, you said that you expect index funds to continue to grow, which means that these index fund managers will have more and more influence and power. Do you think that the big index funds should be broken up?

JC: So, I'm a fan of index funds. And a large part of why I'm focused on this as a research topic is because I don't want the product, the idea of index fund investment, to be made uneconomical or even difficult for your average American investor. So, broken up, I would not be in favor of at their current levels. Even I start to get a little queasy, though, when I think about three or four of them owning more than half of the shares, which would then mean, as a practical matter, they could simply dictate who's on the board of every listed company. So, there are some existing laws that kind of make it a little more complicated once they get above 10% per fund family. And I think that's a good bright line, because then even the four biggest would only have 40% and that's not far off from where we are.

JC: So personally, if we were going to cap or limit them, I think it's a little bit over the horizon, but not too far over the horizon. I'm not in favor of breaking them up at their current levels because I don't think they're quite there yet in terms of real control. And I think the risks they pose can be managed at the current levels. But I would worry, frankly, if nothing else happened and they just kept growing. And if we got to more than 50%, yes, I do think that's something that would be bad for the American economy and democracy.

LT: John, what are the three takeaways you'd like to leave the audience with today?

JC: The first is that you should just be aware and track, that your money, if you invest in a way that's typical, is not only being hopefully managed well through an index fund at a low fee, either in your 401K or the like, but it's also part of a pool of money that's generating enormous and increasing amounts of influence over companies. And your money is giving votes to other people to use to influence companies without you necessarily being aware of it. And it's getting pretty striking how much they control and influence. So that's the first takeaway. Your money is being used to concentrate power in other people's hands.

JC: The second thing I would say as a takeaway is, I worry as much about the way that Washington and politicians might react to what I've just said, as I am to the power that index funds are accumulating. I worry that one set of political responses might be to make the index funds no longer a good product and that would be a bad financial thing. I want to save democracy from the index funds, but I also want to save the index funds from democracy. So not only do you need to be aware there's this growing concentration of power, but you have to be paying attention to what your elected officials are saying.

JC: And don't just take... Maybe this will be my third takeaway. When you hear stories like BlackRock is "woke" [chuckle] or is too green or whatever, go deeper. That's almost always a superficial summary. The index funds are not nearly so straightforward in the way they use their power, they divide among themselves, etcetera. And therefore, the political response needs to be a little bit more nuanced, which I know is hard in the world of politics. But I would encourage anyone listening to encourage their elected officials to not simply treat it as a zero: one, win: lose, good OR bad thing. Drive home how you want them to preserve index funds while controlling their power.

LT: Thank you, John. This has been eye-opening, as has your book, The Problem of Twelve.

JC: Thank you. Happy to be here.

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