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Concentration In The Asset Management Industry: Implications For Corporate Engagement

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Yesterday I published an article in the *Harvard Business Review*, "The Investor Revolution: Shareholders Are Getting Serious About Sustainability," which I wrote with Svetlana Klimenko of the World Bank. We give six reasons in support of the article's title, one of which is the sheer size of the largest asset owners and asset managers. We argue that their size makes them "universal owners" who cannot diversify away from system-level risks. Consequently, they are becoming increasingly conscious of whether their portfolios are making these risks greater (threatening their ability to deliver expected long-term returns) or smaller (in which case they will more likely be able to meet the needs of their ultimate beneficiaries—which is all of us).

We also note that size was accompanied by a high degree of concentration, citing one source that the top five asset managers hold 22.7 percent of externally managed assets, and the top 10 hold 34 percent. Industry concentration is always a legitimate issue of concern because of its potential anticompetitive effects. Thus, in this post I want to briefly analyze concentration in the asset management industry. I will also discuss what I see is one of its largest advantages that I don't think has been sufficiently appreciated—increasing the effectiveness of corporate engagement.

Larry Fink, chief executive officer of BlackRock Inc., gestures as he speaks ahead of a Bloomberg Television interview at the Blackrock Inc. wealth symposium in Zurich, Switzerland, on Thursday, March 7, 2019. Policy mistakes such as a hard Brexit pose the greatest risk amid a synchronized global slowdown, according to Blackrock Vice President Philipp Hildebrand. Photographer: Stefan Wermuth/Bloomberg

The asset management industry is getting more concentrated. A report by the Thinking Ahead Institute of investment advisor Willis Towers Watson states that in 2017 the top 20 of the largest 500 asset managers controlled a larger percentage (43 percent) of assets under management (AUM) than any time since 2000. This was the fourth straight year in which their market share has grown. Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi, and John Sedunov have calculated that the share of U.S. stock ownership by institutions has increased from around five percent in 1980 to about 22 percent in 2015.

The asset management industry isn't the only one experiencing increased industry concentration. Gustavo Grullon, Yelena Larkin, and Roni Michaely observed that more than 75 percent of U.S. industries have experienced an increase in concentration levels over the past two decades and conclude that, in general, this structural shift has weakened competition. However, while a recent OECD report agrees that concentration is increasing in the U.S. (although not in Europe) it does not believe this has resulted in a decrease in "competitive intensity."

Bill McNabb, Chairman, Vanguard at The 2018 CECP Summit, Time Warner Headquarters in NYC; 2/26/2018
SOURCE: CECP

Is concentration in the asset management industry a good thing or a bad thing? Opinion varies. Ben-David et al. see this as a bad thing, arguing that it leads to greater stock price volatility. A recent article in Pensions&Investments is more sanguine, noting that much of this concentration is due to the increase in passive index products by the largest asset managers for which very low prices are charged due to economies of scale. However, it also questions whether high levels of concentration create dangers to the health of stock markets, the financial system, and the larger economy. It also asks whether the rise of passive investing will lead to less efficient stock pricing.

Amanda Tepper further notes that some of these large asset managers are actually collections of boutiques which mitigates any anticompetitive effects from concentration. A recent report from the Federal Reserve Bank of Boston concludes that the rise of passive investing, and the concentration in the asset management industry it is causing, can have both positive and negative effects on financial stability. David Feldman, Konark Saxena, and Jingrui Xu have developed a theoretical model they test empirically and conclude that “Higher market concentration levels imply better utilization of industry resources and the existence of more unexplored investment opportunities, making managers’ efforts more productive” in terms of fund net alphas.

Cyrus Taraporevala, president and chief executive officer of State Street Global Advisors Inc., speaks during the Bloomberg Invest Summit in New York, U.S., on Tuesday, June 5, 2018. The summit brings together influential and innovative figures in investing for an in-depth exploration of the challenges and opportunities posed by a rapidly changing financial landscape. Photographer: Victor J. Blue/Bloomberg

In short, many questions remain about the costs and benefits of industry concentration in the asset management industry.

The concentration of the asset management industry should be put in perspective by comparing it to some other industries. For example, using a measure of concentration as the market share of the top four companies, in the 10 most concentrated industries the percentage ranges from 90.0 percent for major household appliance manufacturing to 98.5 percent for search engines. In contrast, based on data compiled by IPE for the 400 largest asset managers in 2018, the four largest asset managers (BlackRock, Vanguard Asset Management, State Street Global Advisors, and Fidelity Investments) only had 20.9 percent

(€13.7 trillion in assets under management out of €65.7). The smallest 12 had between €6 and €7 billion in AUM, still substantial firms.

A more sophisticated way to measure concentration is the Herfindahl-Hirschman Index (HHI) which is calculated as the sum of the squares of the market share of every firm in an industry. It ranges from nearly 0 (the case in which there are thousands of firms all with a very low market share) to 10,000 (one firm having 100 percent market share). An HHI of less than 1,500 is considered to be a competitive marketplace, of 1,500 to 2,500 is considered to be a moderately concentrated one, and an HHI of 2,500 or greater to be a highly concentrated one. Judith Stroehle of the Said Business School at the University of Oxford has estimated the HHI for the asset management industry at 173.4 for 2018, down from 182.5 in 2017, showing that asset management is a very unconcentrated industry. By comparison the HHI for smartphone operating systems is 7,000, is nearly 6,000 for search engines, averages 3.468 for all U.S. banking markets, and ranges from 600 to 1,200 for airlines, automotive, automotive (electric vehicles only), and smartphone vendors.

I have already noted that most industries, at least in the U.S., are becoming more concentrated. From the perspective of how the capital markets affect sustainable development, what's more important is the degree of concentration in the world's largest companies. It is substantial. Roger Martin has noted that in the U.S., "In 1978 the 100 most profitable firms earned 48% of the profits of all publicly traded companies combined, but by 2015 the figure was an incredible 84%." Today there are about 3,600 domestic listed firms in the U.S., down from a peak of around 7,500 in 1998 but whose total market cap is about same percentage of GDP (150%) as its peak. Globally, according to Forbes, the largest 2000 firms (4.7 percent of the world's 43,000 domestic listed companies) account for $39.1 trillion in sales, $3.2 trillion in profit, $189 trillion in assets, and $56.8 trillion in market value (about 75.5 percent of the total). The largest 100 companies in the world have a market cap of $21.4 trillion. This means .23 percent of the world's listed companies account for 27.0 percent of world market cap.

While I could not find the necessary data to calculate the percentage of sales, profits, and assets, the most important number is market cap since it means that three quarters of the world's investors' equity holdings are in less than five percent of listed companies. A sustainable society heavily depends on the extent to which the world's largest companies are effectively managing their material environmental, social, and governance (ESG) issues and the eternal impact of their products and services. For example, the investor group Climate Action 100+

has identified 100 companies which account for two-thirds of annual global industrial emissions. And since society is looking to the private sector to close the annual $2.5-3.0 trillion funding gap to meet the 2030 Sustainable Development Goals, most of this investment will inevitably come from a relatively small number of firms.

The logical consequence of this is that investors will focus their engagement activities on these large firms. If share ownership is widely dispersed, it means that it will take a large number of asset managers acting in concert to exert any significant influence on the company. This is a very difficult collective action problem with high coordination costs. In this case, there will hardly be any incentive for the asset manager to undertake engagement activities. They will be incurring private costs in both engagement and coordination to create a public good.

But if a small number of very large investors with a long-term view together hold a substantial portion of a company's stock, it is in the economic self-interest of these universal owners to encourage good ESG and impact performance by these companies. As noted in a recent paper by Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo this can be done in both public (e.g., proxy voting) and private (e.g., engagement) ways. They also note that the "Big Three" of BlackRock, Vanguard, and State Street Global Advisors—each of which has 80 percent of its equity holdings in long-term passive investments—are together the largest owner in 88 percent of the S&P 500. They constitute the largest shareholder in 40 percent of listed firms in the U.S.

A good example of how focused engagement can make a difference is the work of Hermes Equity Ownership Services (Hermes EOS), one of the leading providers of corporate engagement, intelligent voting, portfolio screening, public policy engagement, and advisory services. They help some 40 long-term asset owners and asset managers (representing $496.0 billion of assets under advice) from across the world meet their fiduciary responsibilities and become active owners of public companies. This is done through engagement services with companies—with both the C-Suite and directly with the board of directors—that form part of the public equity and corporate fixed income holdings of their clients.

According to Dr. Hans-Christoph Hirt, Head of Hermes EOS, Hermes Investment Management, "Through active stewardship and meaningful engagement, we aim to protect and enhance the value of our clients' assets and safeguard their reputation. Now in our 15th year, we look forward to continuing our global growth and helping to protect the value of the companies our clients invest in by addressing a wide range of sustainability issues."

Hans-Christoph Hirt, Executive Director, Hermes Equity Ownership Services, Hermes Investment Management
HERMES EQUITY OWNERSHIP SERVICES

Hermes EOS has a 33-person team of engagement and voting specialists that monitor the investments of clients in companies and intervene where necessary to help improve ESG and financial performance. This is done through challenging management and the board on ESG issues, focusing on those with the greatest potential for positive outcomes for investors and their beneficiaries.

In 2018, Hermes EOS engaged with 746 companies on 2,084 environmental, social, governance, strategy, risk and communication issues, and objectives. The aggregate market cap of these companies is approximately $30 trillion. This scale of engagement can produce positive changes at the system level.

I conclude that when it comes to influencing the world's largest companies—something absolutely necessary for the capital markets to support sustainable development—some degree of concentration in the asset manager industry is a good thing. Of course, there are other issues to consider such as pricing and common ownership (a topic for a future post). But any analysis of concentration in the asset management industry must take into account the positive impact through effective engagement it can have on corporate behavior.

The focus of my work is leveraging the capital markets for sustainable development through the integration of ESG factors into the strategic decisions of companies and investors' investment decisions.

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