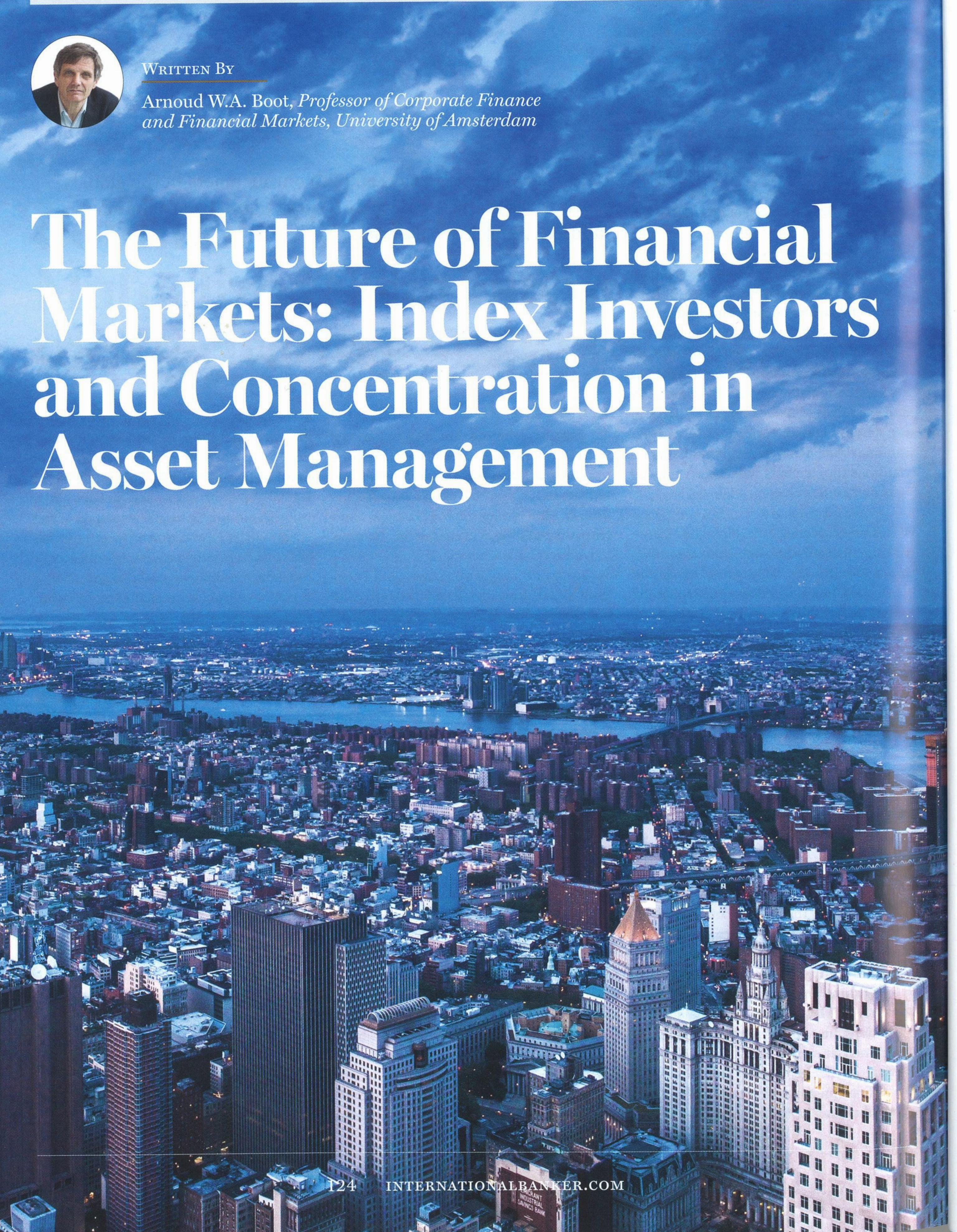

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The Future of Financial Markets: Index Investors and Concentration in Asset Management

Millions of people in Western societies have recently become investors in financial markets. The number of brokerage accounts has mushroomed, and sizable numbers of people invest indirectly via their pension funds. This has gone hand in hand with the growth in passive index investing concentrated in a few large asset managers, particularly Vanguard, BlackRock and State Street. The question is how concentration in the asset-management industry and investor preferences for passive, low-cost index investing affect financial markets' functioning in allocating societal resources. Index investing seems at odds with price discovery for individual securities, and concentration lowers the number of independent voices in financial markets. Similarly, asset managers may rely on specialized proxy advisory firms for voting advice. That activity is a duopoly, which could further reduce independent voices and price discovery. As these trends seem unstoppable, what do they entail for the future?

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Financial markets are typically characterized as public trading places where many investors come together and, via trading, set prices for the assets (bonds, stocks and so on) being traded. The collective wisdom of all parties involved leads to prices that should indicate underlying fundamentals. In more technical jargon, markets aggregate information—diverse pieces of information, assessments and preferences among investors that come together in supply and demand and are then reflected in market prices. And, yes, this price-formation process is a key element of the modern market economy in which markets provide optimal capital allocation—in other words, they let capital flow to the biggest opportunities. Simultaneously, markets function as corporate-governance mechanisms—for example, investors will hold a firm's board to account if its share price lags.

So much for the ideal world of financial markets, which many have challenged. One direction of thought concerns the question of for which types of firms the financial market could suit as a funding source. Note that the discussion so far has focused only on the investor side and not on firms seeking access to markets for funding. Financial markets may not be suited for financing a small mom-and-pop store nor be accessible for an entrepreneur with a business idea in its infancy. Banks and venture-capital (VC) firms may better serve these endeavors. We know that. Access to financial-market financing requires a certain scale beyond a mom-and-pop store or infant startup; business ideas may require hands-on venture-capital investors. What this means is that the financial sector should include different types of institutions: banks, venture capitalists, all kinds of other investors (e.g., private equity, informal investors) and, yes, financial markets. Diversity is key, but there are complementarities between these different types of institutions and funding sources. Financial markets are thus not the only games in town but are indispensable for a healthy financial sector and a blossoming market economy.

Challenges may defeat financial markets' purposes

What this tells us is that financial markets have limitations. This is good to realize and understand. However, financial markets might be challenged in ways that may defeat their main purpose. This challenge could come from within, particularly from developments on the investor side. Concentration on investor sides of financial markets is growing, with institutional investors having more than 43 percent of all listed equity worldwide at the end of 2022 and even 70 percent in the United States, according to the Organisation for Economic Co-operation and Development (OECD) (*OECD Corporate Governance Factbook 2023*, Page 18, Figure 1.5[1]). This may go hand in hand with active price discovery by different large professional investors and support markets. However, further concentration and the increasing demand for passive index investing among the population could undermine the functioning of financial markets, with fewer voices being heard. Austrian Nobel Prize winner Friedrich August von Hayek expressed best what a free-market economy entails: It lets a thousand flowers bloom. But that does not bode well with an increasingly concentrated asset-management industry with just a few large asset managers, particularly if they are driven toward index investing.

The trend toward low-cost index funds (for example, funds and exchange-traded funds [ETFs] linked to the S&P 500 [Standard and Poor's 500] index) puts asset managers in a passive role. Investing in an index seems at odds with assessing individual stocks' merits. And *low cost* means doing even less on the evaluation side. What is left of "the diverse pieces of information, assessments and preferences among investors that come together in supply and demand?" Indeed, it seems difficult to reconcile this mindset with von Hayek's notion of letting a thousand flowers bloom.

In parallel, a market for proxy advice has developed. Specialized proxy advisory firms help asset managers decide how to vote in shareholder meetings. While this could help smaller asset managers economize on the costs of assessing individual stocks, the concentration in the proxy advisory market—Institutional Shareholder Services (ISS)

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and Glass Lewis essentially have a duopoly—may further reduce independent voices and price discovery.

Regulators are not blind to these issues and have tried to require asset managers to take their fiduciary duties seriously. Asset managers may have to vote at shareholder meetings, make their own assessments, and distill and account for their fund investors' preferences. Proxy advisory may still have a positive role if it helps counter the trend toward concentration in the asset-management industry; smaller players may benefit most from the presence of proxy advisory firms. (In my work with American and German coauthors, I have analyzed the market for proxy advisory firms, including regulatory developments.[2])

Reality is more benign...so far

It is good to keep in mind that recent empirical research is still benign about these issues, typically showing that financial markets have become more, not less, efficient over time, with prices more reflective of underlying fundamentals. This, though, should not be surprising. Information technology (IT) developments may have contributed to the better functioning of markets by dramatically increasing access to information. Passive index investing, as a percentage of total institutional investment management, is still contained. Also, concentration so far may have been made benign by making these larger investors more effective.

This may not last, as further concentration could harm financial markets' functioning and price formation. Concentration in asset management is an ongoing process. Many asset-management firms still exist, but the trend toward concentration (and consolidation) is accelerating. It is also the most commonly mentioned trend in the financial-services industry. The increasing importance of index investing is the other force that will weigh on price formation in financial markets. Market concentration for passively managed index funds (including ETFs) has already reached unprecedented levels, with Vanguard, BlackRock and State Street as the dominant players.

While the trend toward more concentration is ongoing, counterforces may develop. The political backlash against large asset managers in the US (BlackRock in particular) underscores the risks of continued concentration.

Interestingly, financial research had for many years advocated that more concentration among investors was desirable. A key research area has focused on free-rider problems in financial markets. It emphasizes that small investors may not monitor individual firms because that is too costly, *and* the benefits would go to all investors (the free-riding part). If all investors make the same trade-offs, no information is produced, price formation suffers, and firms are not monitored, undermining their governance and accountability. Having investors with larger stakes in individual stocks is desirable, as these investors more readily take active roles, considering their scales and costs less of an issue. A sizable amount of literature on the value of blockholders has made this point. The literature also emphasizes that other costs remain. In particular, large investors' more active roles could reduce the liquidity of their holdings. That is, as they are seen as more informed investors, others might be wary of trading with them, making it more difficult to get in and out of stock holdings.

Low cost and common ownership as challenges

Two other challenges have emerged in the world of more concentrated asset management. Large asset managers may have sizable stakes in competing firms, which may bias their incentives. This is the so-called "common ownership problem". The other issue is that the increasing demand for passive broad index funds is based only on low costs.

Let me first discuss the issue of low costs. The popularity of index investing applies enormous pressure on asset-management firms to keep costs to a bare minimum. Indeed, as many index funds (and ETFs) are based on market indices (e.g., the S&P 500), cost is the deciding factor. This means that these funds (asset managers) will minimize their engagements with the firms in which they invest. Being as passive as possible (or as is allowed) is optimal. Engagement with firms is neither optimal nor a consideration for investors, as they are interested only in which index funds offer the lowest costs.

The common ownership problem is best illustrated by considering the objective of a large investor who holds stakes in many firms. He aims to maximize the combined shareholder values of all firms in his portfolio. However, this objective may not be the same as maximizing an individual firm's shareholder value. For example, if he holds shares in both Pepsi and Coca-Cola, he may favor a lower degree of competition among these two firms than shareholders in either of those two firms would. This could affect the desired functioning of a market economy that does not look favorably at such (implicit) collusion.

As one would expect from academic research, a more favorable view on this might

also exist. An argument could be made (in theory) that an all-encompassing owner may go for higher "societal welfare"—i.e., maximizing the portfolio value of all stocks in the economy may help limit harmful behaviors by each firm individually. For example, it might be in the interests of all shareholders and firms put together to limit pollution drastically and quickly, while an individual firm could benefit from following a slower approach at the expense of the others. Common ownership may help prevent self-serving behavior. While definitely interesting, these thoughts may depend too much on idealistic considerations. In particular, one could question how such a portfolio approach to corporate governance could lead to the effective disciplining of individual corporations.

What now?

Where does all this leave us? Developments in financial markets are not necessarily benign. Thinking about the future of financial markets is therefore important. What I have in mind is that markets thrive on diversity, and the trend toward more and more concentration in asset management and index investing may be at odds with this. The key is preserving or strengthening Friedrich von Hayek's mantra, "Let thousands of flowers bloom".

What can be done to discourage the acceleration of concentration in the asset-management industry? Adjustments to regulations and other government actions may be needed. As it stands now, only macro-prudential (financial stability) concerns seem to put limits on (extreme) concentration. Imposing stricter anti-trust laws and enforcement could be another course of action. Facilitating smaller players and encouraging entry seem like worthwhile public-policy objectives. We must keep markets dynamic.

An important caveat is that many measures and regulations that were often well intended implicitly led to concentration. Regulation is typically more of a burden for smaller and newer players. It may have reinforced concentrations in the asset-management industry and proxy advisory activity. It may also have bolstered the trend toward low-cost index investing. Arguably, strict Know Your Customer (KYC) requirements have probably encouraged this.

Somewhat cynically, the increasing polarization of society with large asset managers being accused of being "woke" (e.g., when recognizing the importance of climate risks) or the opposite (being tone deaf, "going for fossil") may encourage them to remain smaller and stay below the radar screen. «

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