BROOKINGS

Report

The common ownership hypothesis: Theory and evidence

Matthew Backus, Christopher Conlon, and Michael Sinkinson Tuesday, February 5, 2019

The common ownership hypothesis asks: when large investors own shares in many firms within the same industry, do those firms have an incentive to soften competition by producing fewer units, raising prices, reducing investment, innovating less, or limiting entry into new markets? The core of the question is simple: firms maximize shareholder value, but shareholders hold stakes in competitors; thus, firms may want to maximize some combination of their own profits and their competitors' profits to maximize the value of their investors' portfolios.

If true, the implications of this idea are enormous: if firms place positive weight on rivals' profits when making strategic decisions, publicly traded firms may have incentives to soften competition, resulting in harm to consumers.

In "The Common Ownership Hypothesis: Theory and Evidence" (PDF), Matthew Backus, Christopher Conlon, and Michael Sinkinson survey recent literature examining the relationship between ownership of firms in the financial space and the strategic decisions made by firms in product markets, paying particular regard to the common ownership hypothesis.

This hypothesis is an old idea, with a history dating back to the 1980s.[1] What has renewed interest in this hypothesis is the increasing concentration among investment managers and new instruments for investing in diversified portfolios. The introduction of 401(k) defined-contribution retirement plans led to a rise in diversified portfolios because of the rise of mutual funds, index funds, and exchange-traded funds. At the beginning of 2018, the four largest asset managers managed over $16 trillion in assets, and for 88 percent of firms on the S&P 500 Index, the largest shareholder was one of those four asset managers.

Under one model of corporate governance that embraces a strict interpretation of the common ownership hypothesis, the authors calculate that in 1980 an average S&P 500 firm would have valued a dollar of profits to another randomly chosen S&P 500 component firm at 20 cents. By the end of 2017, this more than tripled to approximately 70 cents. If common ownership incentives translate to firm behavior, this rise would give firms an incentive to raise prices even in the absence of collusion (which would be illegal).

This creates a fundamental tension for households that both consume goods and invest in diversified retirement funds. As consumers, they might be harmed if firms don't compete as fiercely as possible in markets for goods and services. As investors, they benefit from low-cost diversified investment products such as index funds or ETFs. A large number of households don't hold any investments and do not receive the benefit of the latter, but they pay the cost of the former. This has led to an intense debate about whether large institutional investors have caused indirect harm to consumers, and what, if anything, policymakers should do about it.

Does common ownership affect firm behavior and prices in practice? While the existing correlations explored in this growing literature are provocative and important, the methods and measures used to date make it difficult to draw clear conclusions. The authors say that a stronger empirical framework is needed to provide rigorous testing of conduct and policy analysis. And, before policy measures can be debated, we need to test these hypotheses in more settings.

Read the full working paper here.

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Footnotes

1. 1 See Rotemberg (1984); Bresnahan and Salop (1986).