Discussion of Brav & Lund:

Fund Flows, Financing Decisions, and Institutional Ownership of U.S. Public Equity

Martin Schmalz, Oxford SBS, CEPR & ECGI

Disclaimer: my personal views.
Not the opinion of the PCAOB, its board, board members, or staff.

Overview

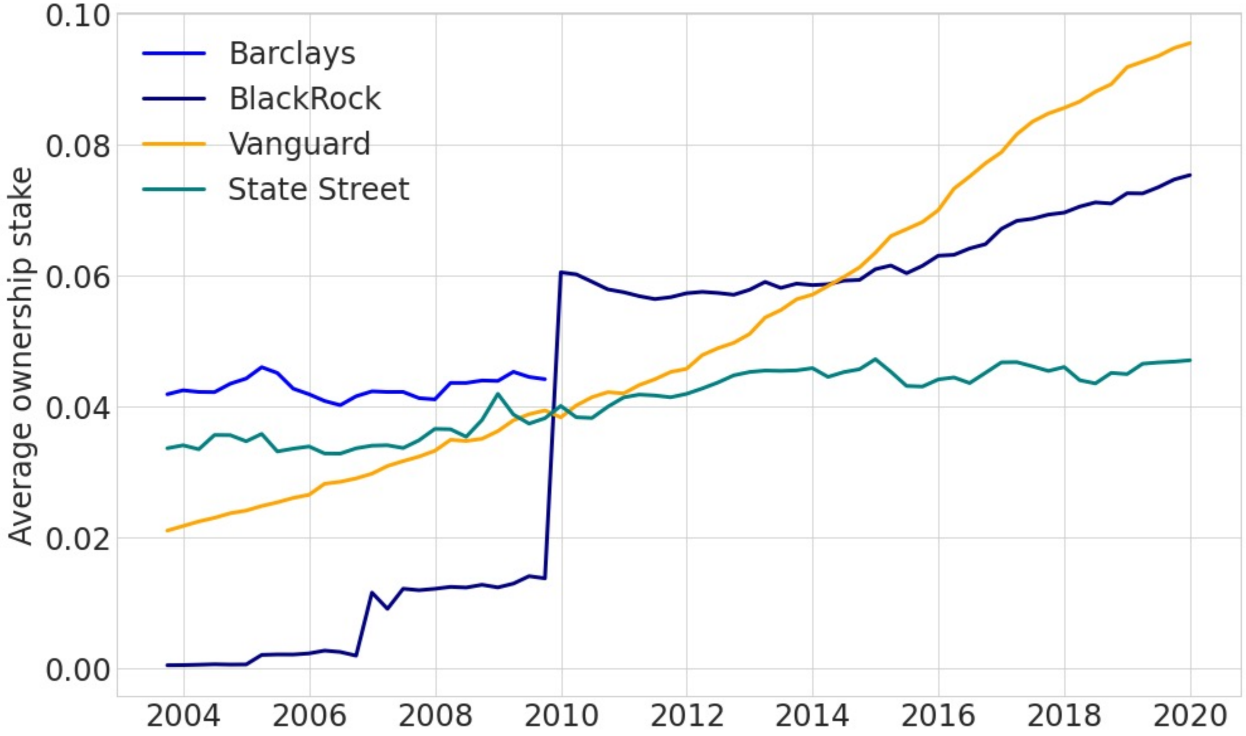
- My priors before reading this paper
- Challenges to my prior from this paper
  - A subset of the facts from the paper seriously challenge my priors
    - Great! Sufficient reason the paper makes an important contribution!
  - Trigger warning: some of my priors challenge the paper's priors

Comments

1. Clarification of the research question
2. Some questions on measurement (mostly for the authors)
3. Conversation starter: do the new facts support the policy messages?

My priors (with apologies for self-references)

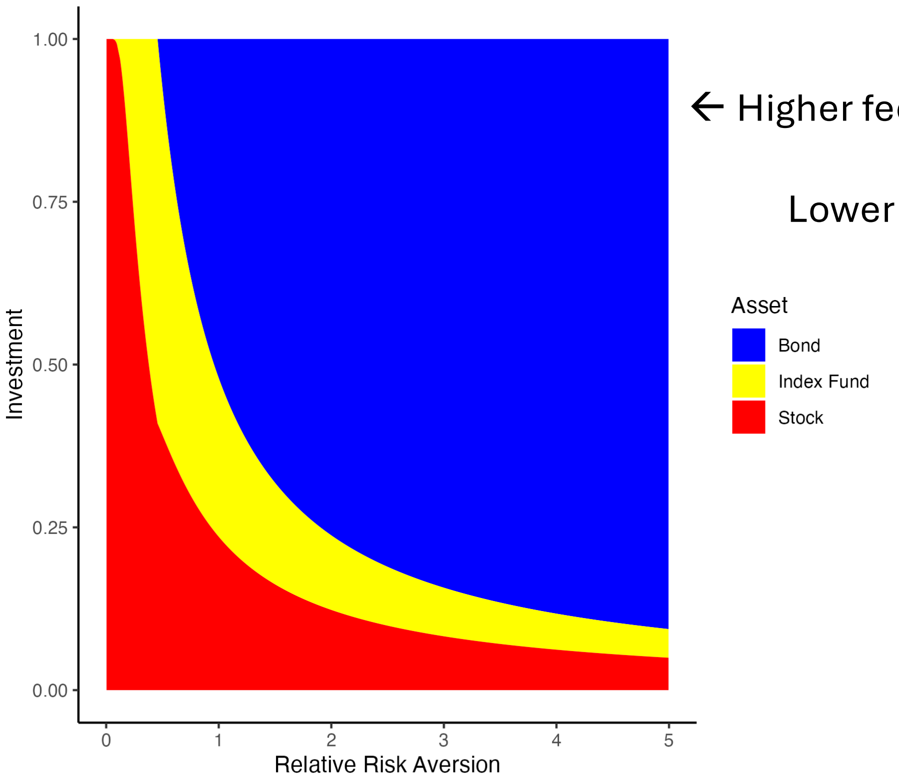
My prior #1: Mergers & low fees drive increase in corporate ownership concentration by the Big-3



Sample: S&P 500 single-class firms

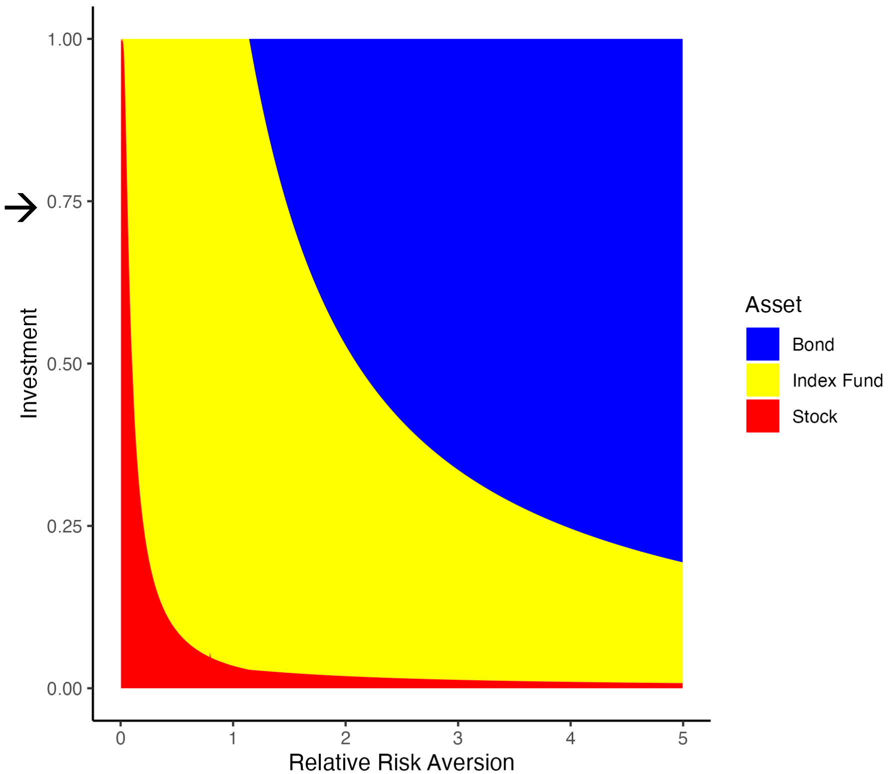
Amel-Zadeh, Kasperk & Schmalz (2023), "Mavericks, universal, and common owners"

My prior #2: declining “passive” fees shift savings from “bonds” to equity; from stocks to index funds



← Higher fee of passive fund

Lower fee of passive fund →



Schmalz & Zame (2023) “Does cheap diversification benefit investors?”

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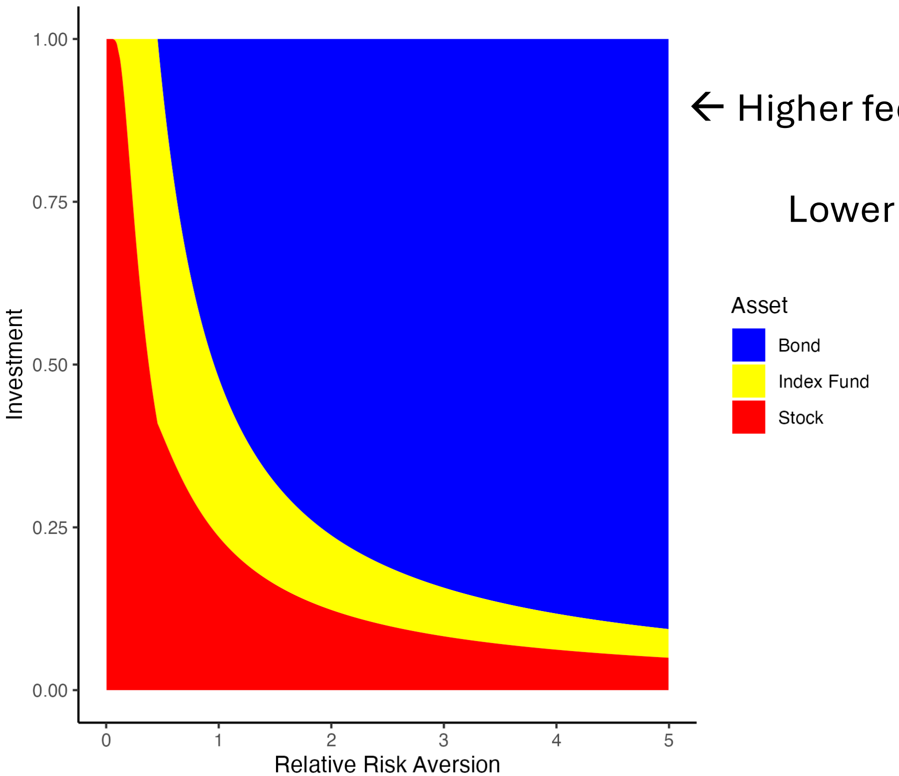

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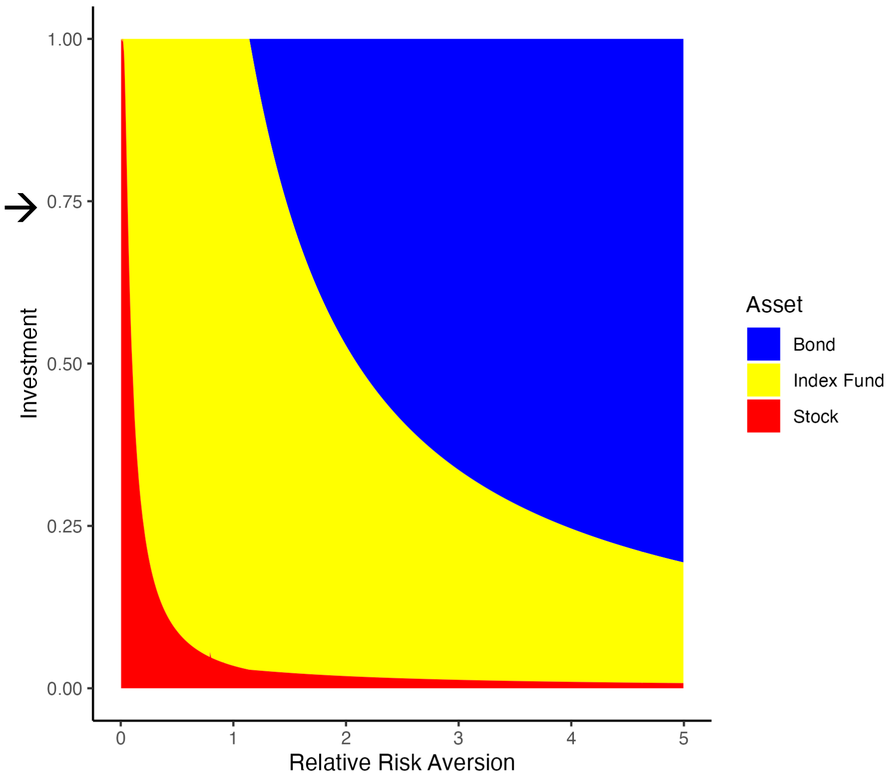

Not wrong (underline added): “previous studies have focused <u>almost</u> exclusively on the idea that investors withdraw funds from actively managed funds and invest it in passive funds. “

My prior #3: a big part of aggregate payouts to equity holders are financed with debt

Financing Payouts

Journal of Financial and Quantitative Analysis, Forthcoming

82 Pages • Posted: 9 Dec 2014 • Last revised: 26 Apr 2024

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University of Illinois at Chicago - Department of Finance

Roni Michaely
The University of Hong Kong; ECGI

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CEPR; University of Oxford - Finance; CESifo; European Corporate Governance Institute (ECGI)

Date Written: February 15, 2024

Abstract

We find that 43% of firms that make payouts also raise capital during the same year, resulting in 31% of aggregate payouts being externally financed, primarily with debt. Most financed payouts cannot be explainec by payout-smoothing in response to volatile earnings or investment—rather, they are the result of firms persistently setting payouts above free cash flow. In fact, 25% of aggregate payouts could not have been paid without the firms simultaneously raising capital. Profitable firms with moderate growth use debt-financed payouts to jointly manage their leverage and cash, thus highlighting the close relationship between payout and capital structure decisions.

- Debt-financing of payouts implies gross flows to the equity market do not equal net inflows
- So we knew that.
- What we don't know: How big is the difference? Does it matter?

Farre-Mensa, Michaely & Schmalz, JFQA, 2024

My prior #4: variation in common ownership and driven by mergers and by active portfolio decisions

Republic S	%	File		**Waste Mgmt**	%	File		**Rollins**	%	File
Cascade Inv	34.1	13-D		Vanguard	8.3	13-F		LOR Inc	45.1	13-D
BlackRock	6.3	13-F		BlackRock	7.2	13-F		Vanguard	5.5	13-F
Vanguard	5.7	13-F		State Street	4.8	13-F		Stichting Pe.	3.7	13-F
State Street	3.3	13-F		Gates Found.	4.4	13-F		BlackRock	3.6	13-F
TRowe Price	3.2	13-F		Cascade Inv	3.9	13-G		State Street	2.2	13-F

Top 5 owners Q4 2020

Schmalz (2017), Amel-Zadeh, Kasperk & Schmalz (2023)

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Top 5 owners Q4 2020

- Similar: Pershing's holdings of Domino's Pizza, Burger King, Chipotle's
- Variation <u>*not*</u> driven by passive index funds' holdings. Red herring.

Schmalz (2017), Amel-Zadeh, Kasperk & Schmalz (2023)

My prior #5: buybacks can impact ownership structure of individual firms

A Wells Fargo branch is seen in the Chicago suburb of Evanston, Illinois, February 10, 2015. REUTERS/Jim Young *Purchase Licensing Rights*

(Reuters) - Warren Buffett's Berkshire Hathaway Inc is seeking permission from the Federal Reserve to increase its ownership stake in Wells Fargo & Co , after reaching the 10 percent level that could prompt increased regulatory scrutiny.

According to papers obtained by Reuters on Friday, Berkshire said it learned in mid-March that its Wells Fargo stake, including 2.01 million shares held by Buffett, had reached 10.01 percent because of buybacks by the San Francisco-based bank, which decreased the number of shares outstanding.

Not just once.

Berkshire's BofA Stake Climbs Past 10% Amid Bank's Buybacks

- Buffett's company said it owns 950 million shares in lender
- The 10% threshold in banks often requires regulatory review

By Katherine Chiglinsky

July 26, 2019 at 12:02 AM GMT+2
Updated on July 26, 2019 at 1:56 AM GMT+2

Save

This article is for **subscribers only**.

Berkshire Hathaway Inc.'s stake in Bank of America Corp. crept above 10%, crossing a threshold that's caused the conglomerate headaches in the past, as the bank bought back its own stock.

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Not a video made with generative AI.

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What we know and didn’t know

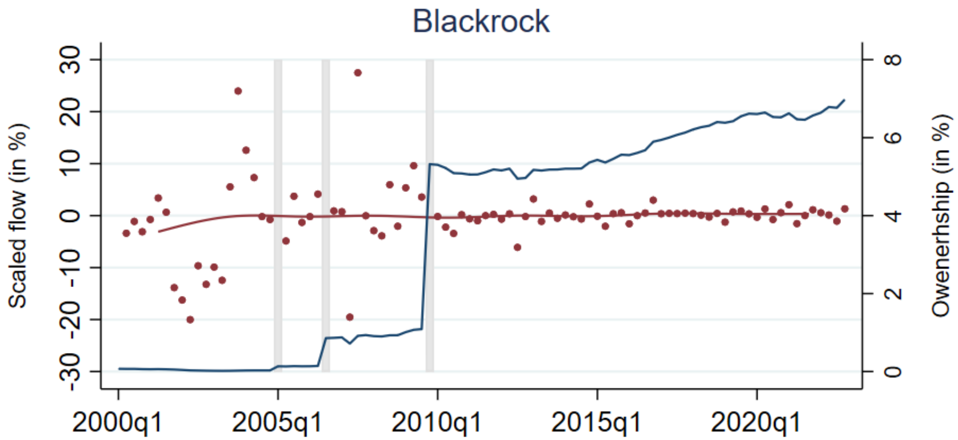
- So, I also knew buybacks can and occasionally do increase ownership stakes of non-participating shareholders

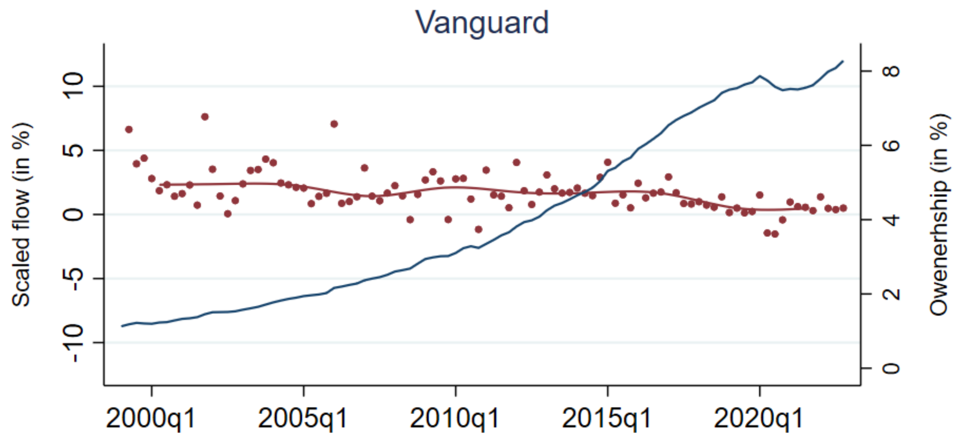
- What we didn’t know (I think):
  - How big is the difference between gross and net flows into equity?
  - How big is the effect of buybacks on the increase in % ownership of particular investors?
  - Does it quantitatively matter to help understand (or “explain”?) the growth of institutional ownership in U.S. equities?

How the paper challenges / moves / complements my priors

How this paper moves my priors

- **<u>Quantitatively speaking</u>**, the increase of “Big-3” % U.S. corporate ownership is ***<u>not</u>*** due to gross inflows into Big-3 funds but due to relative shifts & buybacks causing negative equity market flows.





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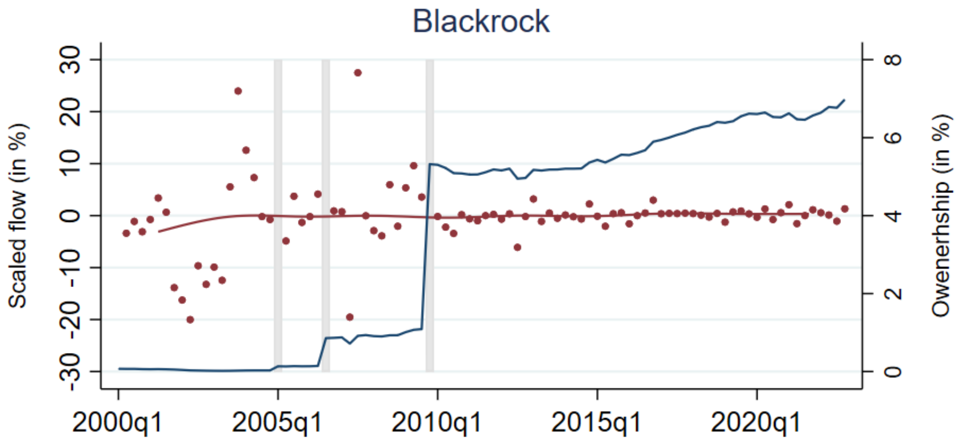
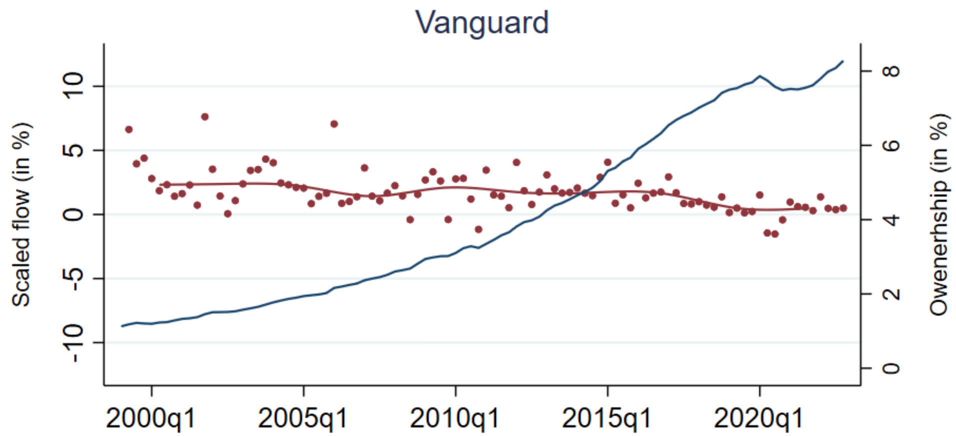




- **That seems to matter for macro-finance models!**

Comment 1: Clarification of the research question

Clarification of the research question

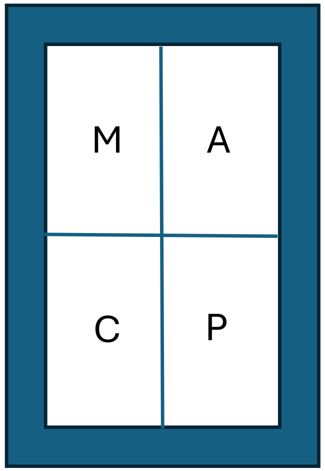
- Do you wish to offer a decomposition of the growth of ***institutions***? Or of growth of ownership at the **issuer level**?
  - Why this matters: Cascade is a small firm, but a big common owner.
  - Growth of institution only implies growth of issuer-level ownership if everyone holds a value-weighted portfolio. That is not so.
  - Ownership in paper: hard-wired feature of *institution;* doesn't vary by *issuer.*
- Or is it about "why certain institutions have / their ownership has grown faster than others"?
  - Then, that's a cross-sectional question? (My prior: fees, mergers.)
  - Not a question about whether negative market flows explain slow increase in institution size in the time series?

Comment 2: questions on measurement

Check on assumptions behind decomposition

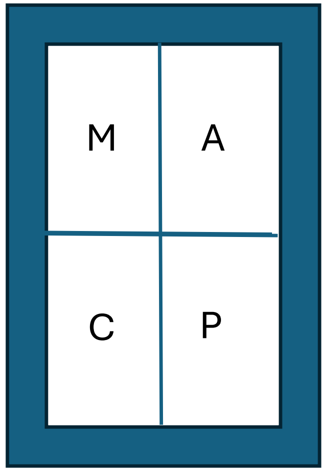
- Paper: passive funds don’t participate in repurchases
  - Is that so?

Issuer 1



Market Cap: 2
P Market Cap: 1
P ownership: 50%

Issuer 2



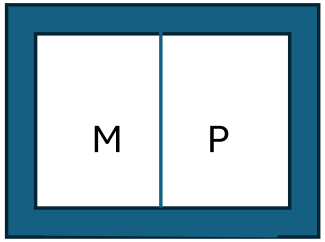
Market Cap: 2
P Market Cap: 1
P ownership: 50%

P is holding a value-weighted “market” portfolio

Illustration of an arguable assumption

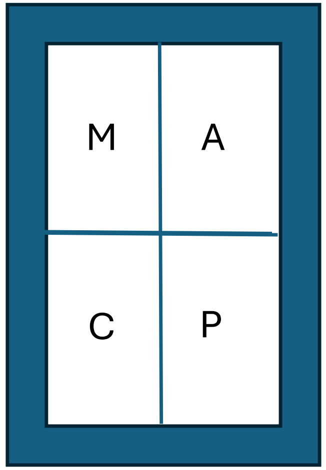
- Picture after issuer 1 repurchased 50% of its shares, without P participating

1



Market Cap: 1
P Market Cap: 1
P ownership: 100%

2



Market Cap: 2
P Market Cap: 1
P ownership: 50%

P is no longer holding a value-weighted market portfolio!

Makes me wonder: do passive funds really not sell into repurchases / rebalance?

More questions on assumptions

- “The sum of all funds’ assets under management must equal the value of the market: $\sum AUMit = Mt$.”
    - If institutional ownership is 100% of the market at all times, how can there be % ownership growth of institutional investors?

Questions on other assumptions

- In the appendix, for the authors

Why only use 13-F institutional investor data?

- Calculating Tesla ownership without E. Musk seems problematic?
  - Also: should we really call all non-13F owners “retail investors”?
  - LOR, Inc?
- Corporateownershipdata.com also has Form-3/4/5 data
  - Publicly available. Join in the effort and help improve!

Comment 3: do policy suggestions follow from the analysis?

Do the policy conclusions necessarily follow from the analysis?

- To be clear: The facts, taken at face value, move my prior!
  - They clearly matter for macro models. Sufficient, to my taste!

- But do they have the implications for policy the authors suggest?
  - "Radical" proposals to address anticompetitive effects of common ownership
  - "Premature" concerns about lacking effort to improve governance by "passive" institutions depend on assuming continued growth. (Do they?)
  - "Drastic" changes to the industrial organization of asset management (concretely: whether voting should be under centralized control)

Findings vs policy conclusions

- "Big-3 cumulatively own less than 20% of the market."
  - Yes. That's on average. Driven by smaller, non-S&P 500 companies.
  - In single-class S&P 500 firms, average ownership approaches 25%.

Why does average ownership matter for governance? Isn't what matters the ownership of particular firms / industries?

Findings vs policy conclusions

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Why does <u>average</u> ownership matter for governance? Isn't what matters the ownership of particular firms / industries?

CoreCivic Holder	Common Stock Equivalent Held	% Of CSO
BlackRock, Inc. (NYSE:BLK)	18,634,409	16.749
The Vanguard Group, Inc.	12,431,888	11.174
River Road Asset Management, LLC	8,659,179	7.783
FMR LLC	5,067,435	4.555
State Street Global Advisors, Inc.	4,263,987	3.833

GEO Holder	Common Stock Equivalent Held	% Of CSO
BlackRock, Inc. (NYSE:BLK)	19,299,229	14.479
The Vanguard Group, Inc.	13,576,093	10.185
FMR LLC	8,350,131	6.265
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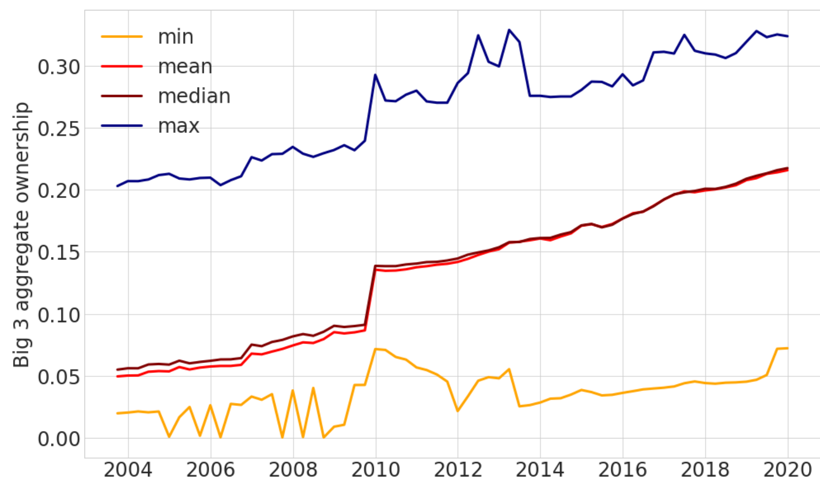

Findings vs policy conclusions

- Take at face value, the result that corporate actions drive % growth in Big-3 ownership

- Does that invalidate Bebchuk & Hirst (2019) prediction that

  "the combined average ownership stake of the Big Three will rise to 27.6% in ten years, and to 33.4% of S&P 500 equity in twenty years."

  ?

  - Or are you saying the prediction may be valid, but not for the reason they state?

Findings vs policy conclusions

- "Vanguard's ownership continues to trend upward, <u>but</u> its scaled flows have declined more recently towards zero."

  Does the <u>latter</u> make previous proposals to improve governance less urgent?

  Isn't whether rather than why Vanguard continues to grow the question?

  Recall: The effect of V's ownership doesn't depend on the <u>intention</u> to own a lot, or an intention to have effects on governance or competition.

  Competition concerns are <u>NOT</u> about collusion. (Antón et al. JPE 2023)

  (Similar: banking regulatory ownership thresholds don't depend on intent?)

  Provocative claim: It doesn't really matter <u>for governance</u> which mechanical feature caused the growth in ownership. The level of ownership matters.

Findings vs policy conclusions

- Antitrust regulators should scrutinize mergers of asset managers for their impact on product market of portfolio firms
  - I agree!
  - Does that follow from the novel part of the analysis, that % ownership growth comes from buybacks?

- In sum, I think the findings matter! In particular for quantitative macro-finance models.
  - Do they also matter for governance?

Summary

Summary

- Exceptionally careful writing (e.g. not: “index funds”)
- Clear contribution (AFAIK) to document to which extent growth of % ownership by institutions is driven by corporate actions vs market inflows vs relative shifts across funds.
- Conversation starter: do the facts support the policy conclusions?

Appendix

Appendix

- Do passive flows react to past performance?
- Is that right? "a dollar flow to a small institution affects ownership far more than it does at a larger institution."
- Aren't there taxes on distributions / realized gains that should get reflected in the accounting?

Comments on IV, Implications for law

- Most correct and complete coverage of the common-ownership literature in a recent law review paper. Thank you!
  - (Though misses responses to Dennis et al. showing their claims are factually incorrect.)
- No: the idea of common ownership is <u>not</u> that horizontal shareholders would prefer "collusion"
  - All shareholders, horizontal or not, prefer collusion
  - Horizontal ownership obviates the need for collusion because it reduces incentives to compete (Rotemberg 1984), or it causes higher prices because it reduces incentives to invest in cost-reducing governance (Antón et al. JPE 2023)
- Harm need not come from ***institutional*** common ownership!
  - Non-13F data are important! Bill Gates! Pershing!