'The Specter of the Giant Three,' and Other Gripping Yarns

By Editorial Staff *Thu, Aug 1, 2019*

Four recent research papers that we think will interest you are summarized here. Topics include the dominance of shareholder voting by Vanguard, BlackRock and SSgA, the limits of stock-picking skills, a new way to design group variable income annuities, and a refutation of the idea that welfare reform devastated a lot of Americans.

In this edition of RIJ's periodic roundup of recent academic research on retirement-related topics, we consider three recent papers and one from 2014 that we previously overlooked:

- "**The Specter of the Giant Three**." A warning about the rapid growth of three index fund providers—Vanguard, BlackRock and State Street Global Advisors—and the concentration of shareholder voting power in their hands.
- "**Skill and Fees in Active Management**." A Wharton professor shows that active fund managers can be so good at cleaning up inefficiencies in the equities market that they eliminate opportunities for further gain.
- "**Accounting and Actuarial Smoothing of Retirement Payouts in Participating Life Annuities**," which proposes an improved design for variable income annuity products.
- "**The Use and Misuse of Income Data and Extreme Poverty in the United States**," which provides evidence that, even after welfare reform, government transfers have vastly reduced poverty in the U.S.

The Only Three Voting Shareholders?

Research Roundup

With the sustained popularity of passive investing, the "big three" index fund managers—BlackRock, Vanguard, and State Street Global Advisors—are expected to keep growing. If so, they will eventually become the "Giant Three" and will dominate shareholder voting in most large public companies.

In their paper, "The Specter of the Giant Three" (NBER Working Paper 25914), Lucian A. Bebchuk and Scott Hirst "document that the Big Three have almost quadrupled their collective ownership stake in S&P 500 companies over the past two decades" and that

- They have captured the overwhelming majority of the inflows into the asset management industry over the past decade.
- Each of them now manages 5% or more of the shares in a vast number of public companies.
- They collectively cast an average of about 25% of the votes at S&P 500 companies.
- The growth in the share of index funds at the expense of active funds has been partly due to growing levels of investment in ETFs.

More than 80% of all assets flowing into investment funds has gone to the Big Three over the last decade, and the number of positions in S&P 500 companies in which the Big Three hold 5% or more of the company's equity has increased more than five-fold. Their average combined stake in S&P 500 companies quadrupled over the past two decades, from 5.2% in 1998 to 20.5% in 2017.

The proportion of total funds flowing to the Big Three has been rising through the second half of the decade, the authors write. Within two decades, the "the Big Three could well cast as much as 40% of the votes in S&P 500 companies within two decades," the authors point out.

The paper warns that "the stewardship decisions of index funds in general, and the Big Three in particular, are afflicted by agency problems, including incentives to under-invest in stewardship and incentives to be excessively deferential to corporate managers. …These agency problems deserve the close attention of researchers, policymakers, and market participants."

The Limits of Successful Stock-Picking

After adjusting for management fees and trading costs, does it make any difference in the long run whether you invest in actively managed funds or index funds? In his paper, "Skill and Fees in Active Management" (NBER Working Paper 26027, July 2019), Wharton finance professor Robert F. Stambaugh makes the case that, all else being equal, it doesn't.

But the more investors herd into active or passive strategies, he told *RIJ*, the more likely that the advantages of doing so will decrease. "If there's too much money under active management, then it will underperform, and if there's too much money under passive management, then it will underperform," he said in an interview this week.

"It's like telling everyone about the best road to take to get to work. Eventually too many people will take it and it won't be the best road anymore."

Active managers labor under an irony: The better they get at identifying and taking advantage of mispriced securities, the higher their fees and trading costs and the fewer opportunities they have.

That's not necessarily a bad thing for investors, Stambaugh points out in his paper. "Even though the industry can earn less by becoming better at what it does, the model does imply that greater skill produces stronger price correction in stocks. With this positive externality, there can still be a societal benefit to having active managers be more skilled. Having prices more accurately reflect underlying fundamentals can allow more efficient resource allocations."

"The market provides new mispricing opportunities all the time, and in every quarter active managers will find a way to make money," he told *RIJ*. But, net of fees, they won't outperform passive funds, he added. "There may be some active managers that consistently outperform others, but they will charge higher fees. I'd love to be the last active investor after everyone else has gone into passive funds. That would be ideal."

Towards a better group variable income annuity

"Participating life annuities" enable retirement plan participants to draw a variable but stable lifetime income from a pooled investment fund managed by a life insurance company. TIAA has offered that type of product for 60-some years, and the concept is gaining favor in Europe.

The challenge for the life insurer is this: how to manage and account for the investments, which fluctuate in value, so that retirees receive a smooth and potentially rising lifetime income stream, while also enabling the insurer to make a profit and comply with current accounting standards.

In their paper, "Accounting and Actuarial Smoothing of Retirement Payouts in Participating Life Annuities" (Insurance: Mathematics and Economics 71 2016), four economists from the U.S. and Germany propose a way for insurers to combine the use of an actuarial reserve fund with the fair market value accounting method—increasingly preferred over the historical cost value accounting method—to stabilize payouts from a variable fund while also allowing annuitants to reap "mortality credits" as members of the pool die off.

The authors, Raimond Maurer and Ivonne Siegelin of Goethe University, Olivia S. Mitchell of the Wharton School, and Ralph Rogalla of St. John's University in New York, demonstrate that their approach yields payouts comparable to those of TimePension, a Danish annuity model. TimePension distributes a stable income from a primary account owned by each investor and from (during down-market years) a buffer fund managed by the product provider. Under a transparent formula, the buffer fund absorbs part of the investors' gains during up-market years.

"We have implemented both approaches, the traditional accounting/actuarial smoothing versus the formula-based buffer fund," Maurer told RIJ in an email. "We find that from the policyholders perspective (i.e., the demand side) the two approaches result in similar outcomes. Yet the traditional approach is (slightly) better from the insurers perspective (i.e., the supply side) in terms of lower shortfall risk. The intuition behind that is, that the traditional approach is more flexible compared to a 'static,' formula-based approach."

Are We Overestimating the Number of Poor in the U.S.?

Despite benefits-reducing welfare reform, U.S. government transfer payments are still quite effective in reducing poverty and many people who are supposed to be poor are not. So say Bruce D. Meyer, Derek Wu, and Victoria R. Mooers of the University of Chicago and Carla Medalia of the U.S. Census Bureau, in their paper, "The Use and Misuse of Income Data and Extreme Poverty in the United States" (NBER Working Paper 25907).

"Recent research suggests that rates of extreme poverty, commonly defined as living on less than $2/person/day, are high and rising in the United States," they write. "But of the 3.6 million non-homeless households with survey-reported cash income below $2/person/day, we find that more than 90% are not in extreme poverty once we include in- kind transfers, replace survey reports of earnings and transfer receipt with administrative records, and account for the ownership of substantial assets."

Many Americans have been misclassified as poor, the paper says. "Nearly 80% of all misclassified households are initially categorized as extreme poor due to errors or omissions in reports of cash income. Of the households remaining in extreme poverty, 90% consist of a single individual. An implication of the low recent extreme poverty rate is that it cannot be substantially higher now due to welfare reform, as many commentators have claimed."