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Common Sense Doesn't Support Common Ownership Hypothesis

Would it surprise you that your savings in mutual funds and exchange-traded funds (ETFs)—including in your individual retirement account (IRA) or 401(k)—pose anticompetitive concerns, possibly harming consumers by driving up the prices of goods and services? Seems odd, right? But it's a notion put forth by some academics and it's been picked up by regulators too.[1] When you look at the diversified portfolios of these funds, which people use to save for their most important goals, this idea just doesn't add up.

The idea, called common ownership, goes something like this.

- To meet its investment objectives, each fund will typically hold an array of investments including, let's say, both United and Southwest Airlines. You might see both airline stocks in the portfolios of mutual funds investing in mid-cap equities, and both would certainly be included in the holdings of an S&P 500 index fund—a very popular investment choice for American savers. If your fund holds both United and Southwest, your fund is an owner in common for the two airlines (i.e., a "common owner").
- But how does common ownership—the presence of a common owner—drive up airline ticket prices? Normally, one would assume airlines such as United and Southwest will compete vigorously for travelers' business. But the common ownership idea hypothesizes that because your fund—a common owner—owns stock in both airlines, the two airlines will compete *less* intensely, driving up airline ticket prices.[2]
- Why, you might ask, does the fact that my fund holds both United and Southwest encourage them to compete less? Well, common ownership posits that executives at United realize that some of their stockholders—your fund—also own stock in Southwest (this can be determined from publicly available data). United executives surmise that their shareholders—including your fund and others like it—will prefer that, and will benefit if, United doesn't compete vigorously with Southwest. Similarly, Southwest executives assume that some of their stockholders—your fund—also own stock of United and thus will benefit if Southwest does not compete vigorously with United.
- But why would my fund benefit if United and Southwest compete less? Well, common ownership posits that, if United competes vigorously, it will take customers away from Southwest, lowering Southwest's profits and stock price, which will harm *United's* stockholders (your fund, because it holds both Southwest and United). The same kind of thing happens if Southwest competes vigorously against United. Common ownership asserts that if United and Southwest compete less intensely, ticket prices

for both airlines will rise, driving up their profits and stock prices. You benefit because your fund (the common owner) holds both stocks.

Some take this idea seriously.[3] In fact, they believe novel and extreme measures—forced stock sales, caps on stock holdings, prescribed allocations of stocks to certain investors, or forgoing the right to vote proxies—are needed to prevent the supposed harms of common ownership.[4] Imagine your fund being limited to holding only Southwest. Imagine this applying to other companies and industries—such as banks or cereal makers—where one fund could hold only one company in an industry.

What would that mean for fund investors? For one thing, your funds' holdings could become less diversified, creating avoidable risks. Funds might have to fundamentally alter their investments and strategies. If no fund can hold both United and Southwest and you wanted exposure to both companies, you might now have to purchase multiple funds.

How index funds would operate under these types of limits is totally unclear. Many broad-based index funds are likely to hold both United and Southwest (or, say, banks such as JPMorgan Chase and Bank of America) because those stocks are in the funds' target indexes. Index funds cannot just choose to drop stocks in their target indexes from their portfolios. In addition, an actively managed fund could be in an untenable situation if it is not allowed to buy a stock that is consistent with its investment objective and strategy and that the fund manager believes is in the interests of the fund's shareholders. In such a world, some funds presumably would have to change their objectives and strategies, or shut down and liquidate—to the detriment of the more than 100 million Americans that own mutual funds and ETFs.

Do the Data Support the Common Ownership Hypothesis?

How strong is the empirical evidence—the data—supporting common ownership?

Proponents of common ownership have studied markets such as airline tickets and retail bank accounts, interpreting their evidence as indicating that common ownership significantly raises prices of these items.[5]

However, other researchers have challenged such evidence, citing issues such as problems with the hypothesis and with the statistical methods used to test the hypothesis, data errors, and lack of evidence for the hypothesis across a broad range of industries or across time.[6] Overall, it's fair to say that the evidence supporting common ownership is, at best, mixed and, at worst, deeply flawed.

Would Common Owners Really Benefit from Weaker Competition?

But even if one assumes common ownership effects *are* real and present, would common owners—such as fund shareholders—really benefit? That's far from clear, as two related examples show.

Example 1: Investors in Diversified Funds Might See Very Tiny Benefits from Common Ownership

Suppose all airlines simultaneously raise their ticket prices by 4 percent.[7] Would that boost the return on a well-diversified fund, such as an S&P 500 index fund? At most, it would only be a very small amount.

For example, suppose (generously but unrealistically) that the 4 percent rise in airline ticket

prices doesn't reduce the demand for tickets. In that case, the 4 percent increase drops to the airlines' bottom line, perhaps raising their stock prices by 4 percent.[8] Currently, the weight of airline stocks in the S&P 500 is 0.20 percent.

Under these circumstances, a 4 percent increase in airline ticket prices would translate into a 0.008 percent increase in the S&P 500 index (4% x 0.20%). It's unlikely that diversified investors would feel much benefit from that, especially considering that it would be swamped by daily variation in the return on the S&P 500 index, which in recent years has been more than 100 times greater.[9]

And it's more than likely that a rise in airline ticket prices would reduce the demand for airline travel. Precisely how much is difficult to say, but a reasonable estimate might be that a 4 percent increase in prices would cause demand to fall by half that amount, or 2 percent.[10] In that case, the potential benefits that common ownership might convey to a diversified investor would be even smaller. A 4 percent rise in ticket prices would be somewhat offset by a 2 percent fall in demand, perhaps leaving airlines revenues and stock prices 2 percent higher. That might result in an increase in the return on the S&P 500 of just 0.004 percent (2% x 0.20%).

Example 2: In Fact, Investors in Diversified Funds Might Be Harmed If Airlines Raised Ticket Prices

But the analysis can't stop there. Diversified funds typically hold an array of companies besides airlines. And the drop in demand for air travel might harm some of these other companies.

For instance, if demand for air travel falls, the demand for jet fuel could also decline. Companies that supply jet fuel could see their profits and stock prices fall. Companies in the hospitality industry might see their profits and stock prices fall if demand for their products weakens (e.g., with fewer air travelers, hotels might have higher vacancy rates and restaurants might have fewer patrons).

Consequently, whether investors in diversified funds benefit or not from a rise in airline ticket prices depends on what stocks their funds hold and how those stocks react to a fall in the demand for air travel.

To shed some light on this, we turned to the data.[11] We looked at whether stock prices of industries in the S&P 500 index (other than airlines) rise or fall when airline passenger volume falls. In doing so, it's important to first remove business cycle influences; for example, passenger volumes, jet fuel prices, and oil prices might naturally all fall during a recession. Elsewhere, we describe how we did this.[12] Here, we cut right to the chase.

The results indicate that a business strategy of pricing airline tickets less aggressively would be more likely to harm than to help investors who hold a diversified portfolio of S&P 500 companies. We analyzed stock returns on 144 industry groups, and found that companies in 65 industries, which account for 40 percent of the weight in the S&P 500 index, might see their stock prices *rise* with an increase in airline ticket prices, as might be the case if airline customers substitute away from air travel toward other options (e.g., automobiles).

That leaves companies in the 79 other industries, which account for 60 percent of the weight in the S&P 500. After adjusting for business cycle influences, we found that

companies in these 79 industries tend to see their stock prices *fall* as the demand for air travel falls. One example is the petroleum and coal products manufacturing industry, which includes companies that transform crude petroleum into jet fuel. Another example is the aerospace product and parts manufacturing industry. Investors who hold stocks in these industries might prefer to see airlines *cut* ticket prices.

Overall—taking into account the relative weights in the S&P 500 of companies that might see their stock prices rise (40 percent) versus those that might see them drop (60 percent)—we estimated that a 4 percent increase in airfares would in aggregate reduce the value of the non-airline stocks in the S&P 500 by -0.0494 percent.[13] This would more than offset the small (0.004 percent) increase in the S&P 500 index from airline stocks rising in response to less-aggressive ticket pricing.

In short, investors who hold diversified portfolios, such as S&P 500 index funds, would more likely be harmed than helped by hypothetical anticompetitive efforts of airlines to raise ticket prices.

Conclusions

Where does this leave us? Well, the common ownership hypothesis—the idea that Company A in an industry competes *less* with Company B in the same industry to help *Company B's* stockholders—seems hard to credit. One reason is that common ownership fails to account for the effects that weaker competition in one industry may have on other industries, and on investors—such as those in mutual funds and ETFs—who hold diversified portfolios of stocks. Contrary to what some researchers have implied, regulators cannot simply assume that "common shareholders" would benefit if competing companies practice anticompetitive pricing.

Endnotes

[1] Federal Trade Commission, "FTC Streamlines Consumer Protection and Competition Investigations in Eight Key Enforcement Areas to Enable Higher Caseload," news release, September 14, 2021 (in which the FTC announces streamlined investigations in eight priority areas, including common ownership). See also Hearing #8: Common Ownership, FTC Hearings on Competition and Consumer Protection in the 21st Century (December 6, 2018).

[2] For a detailed description, see José Azar, Martin C. Schmalz, and Isabel Tecu, "Anticompetitive Effects of Common Ownership," *Journal of Finance* 73, no. 4 (2018): 1513–1565.

[3] Eric A. Posner, Fiona Scott Morton, and E. Glen Weyl, "A Proposal to Limit the Anticompetitive Power of Institutional Investors," *Antitrust Law Journal* 81, no. 3 (March 2017).

[4] Id.

[5] See Azar, Schmalz, and Tecu 2018. See also José Azar, Sahil Raina, and Martin C. Schmalz, "Ultimate Ownership and Bank Competition" (working paper, May 4, 2019).

[6] For a discussion of the theory, see Daniel P. O'Brien and Keith Waehrer, "The Competitive Effects of Common Ownership: We Know Less Than We Think," *Antitrust Law Journal* (2017): 81. For discussions of empirical issues, see Pauline Kennedy, Daniel P.

O'Brien, Minjae Song, and Keith Waehrer, "The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence" (working paper, 2017); Edward B. Rock and Daniel L. Rubinfeld, "Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance (NYU Law and Economic Research Paper, 17-05, March 1, 2017); Jacob Gramlich and Serafin Grundl, "Testing for Competitive Effects of Common Ownership" (Federal Reserve Board Finance and Economics Discussion Series, 2017-029, 2017); Patrick J. Dennis, Kristopher Gerardi, and Carola Schenone, "Common Ownership Does Not Have Anticompetitive Effects in the Airline Industry" (working paper, 2018); Keith Klovers and Douglas H. Ginsburg, "Common Sense About Common Ownership" (working paper, 2021); BlackRock, "Common Ownership Data Is Incorrect," *Policy Spotlight* (2019); Matthew Backus, Christopher Conlon, and Michael Sinkinson, "Common Ownership and Competition in the Ready-to-Eat Cereal Industry" (working paper, 2021). See also Thomas A. Lambert and Michael E. Sykuta, "The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms" (University of Missouri School of Law Legal Studies Research Paper No. 2018-21, 2018).

[7] Azar, Schmalz, and Tecu 2018 provide evidence that they interpret as indicating that common ownership among airlines raises ticket prices by 4 percent.

[8] In theory, a 4 percent increase in prices could lead to a 4 percent increase in stock prices if: (a) there is no decrease in demand; (b) the airlines' costs are unchanged; and (c) the price increase is viewed by the markets as permanent.

[9] On average over the past 10 years, the return on the S&P 500 index has varied about 1 percent per day (as measured by the standard deviation of the daily percent change in the S&P 500 index).

[10] In the jargon of economics, the percent change in demand for a percent change in price is known as the "price elasticity of demand." Studies indicate that the price elasticity of demand for airlines is less than 1.0 in cases where airlines all raise ticket prices at the same time on all domestic flights. See, for example, "Estimating Air Travel Demand Elasticities" (prepared for IATA by Prepared for InterVISTAS Consulting Inc., December 2007).

[11] Our data cover the same period examined in Azar, Schmalz, and Tecu 2018.

[12] ICI Letter to Bilal Sayyed, Director of Policy Planning, FTC (November 4, 2019). The letter's appendix contains more detail on this analysis.

[13] See ICI letter and accompanying appendix.

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