MUTUAL FUNDS DISCOURAGE COMPETITION: How institutional investors are increasing airfares and hurting consumers

Mutual funds make investing easier but discourage the companies they invest in from competing, leading to higher prices for consumers. That is the central finding of research by **Jose Azar**, **Martin Schmalz** and **Isabel Tecu**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015.

The rise of institutional investors that own large chunks of companies has led to many being owned by the same group of investors. BlackRock, for example, is the largest shareholder in each of the largest three banks in the United States, while pharmacy rivals CVS and Walgreens have the exact same top five shareholders. The study focuses on the airline industry to explore how this sort of common ownership discourages companies from competing and keeping their prices low. It finds that common ownership of airlines increases airfares by 3-11%.

A similar effect can be seen at in the chemical industry, where hedge funds who had already invested in Monsanto blocked the manager of another fund from being appointed to the board of DuPont because he would have demanded that DuPont up their game. It has also been suggested that this effect leads to rising economic inequality, and other academics have proposed that mutual funds should be restricted to owning shares in only one firm in each industry.

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Mutual funds have a dark side: while they make it easy for small investors to own shares in many different companies, they reduce the incentives of these companies to compete, leading to higher prices for consumers. This is what a new study by economists José Azar, Martin Schmalz and Isabel Tecu finds. The authors show that common ownership of airlines by institutional investors increases airfares by 3-11%.

The rise of institutional investors that own large chunks of companies has led to many companies being owned by the same group of investors. Many of these companies are natural competitors. For example, BlackRock is the largest shareholder of each of the largest three banks in the United States; while Vanguard, State Street and Fidelity are among the top six shareholders in each of these banks as well. The top five shareholders of US pharmacy rivals CVS and Walgreens are identical.

Economists have long theorised that such common ownership reduces incentives to compete: if one firm competes aggressively and gains customers, it does so at the expense of firms that are part of the same investors' portfolio. Azar, Schmalz and Tecu show that this is not just a theoretical prediction, but can be clearly seen in real-world data.

The authors document that common ownership is a ubiquitous feature of today's economy, to an extent that should be alarming to antitrust authorities. In the airline industry, common ownership adds to market concentration almost as much as if four airlines merged to two. This increase is ten times larger than what is 'presumed likely to enhance market power' by the US antitrust authorities.

Not only are they largely owned by the same investors, but airlines also compete less because they have their common owners' profits in mind. The study comes to this conclusion by comparing airfares on a given route when the airlines serving the route have high common ownership with airfares on the same route when there is less common ownership.

It estimates that US airfares are 3-11% higher because of common ownership between airlines. The study also shows that the single acquisition of Barclays Global Investors (BGI) by BlackRock, which led to the combination of their airline portfolios, caused airfares to increase by 0.6% on average.

While the study focuses on the airline industry as a laboratory, it suggests that findings could be similar in other industries. Schmalz points out that a recent proxy fight at US chemical giant DuPont is best understood in the light of common ownership: DuPont's largest shareholders, the institutional investors Vanguard, BlackRock and State Street, are also among the largest shareholders of Monsanto, DuPont's largest competitor in the seeds business.

Their incentives are thus squarely at odds with Nelson Peltz's, whose hedge fund Trian is not invested in Monsanto and demanded that DuPont compete more aggressively. Vanguard, BlackRock and State Street voted to block Peltz from gaining a seat on DuPont's board.

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'Anti-Competitive Effects of Common Ownership' by Jose Azar, Martin Schmalz and Isabel Tecu is published as Ross School of Business Paper No. 1235 and available at SSRN.

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