Insights
Index Investing

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Why Index Investing Is Good for Markets — and Investors

- **Index-based investing has surged in popularity over the past decade, driven by investors of all types seeking transparent, low-cost ways to access broad market exposure, achieve diversification, and participate in financial markets.**
- **A group of academic researchers has published papers claiming that index fund managers' "common ownership" decreases competitiveness and hurts corporate governance.**
- **In our view, these criticisms, as well as concerns about how indexing affects market efficiency and income inequality, are based on flawed information and an inaccurate understanding of the investment industry.**

Executive Summary

A small group of academic researchers and legal scholars have published papers claiming that the rise of indexing is having a negative influence on industry competitiveness, corporate governance, market efficiency, and income inequality. These claims have caught the attention of some regulators and politicians in the United States and Europe.

As the world's third-largest asset manager, we are dismayed to see that parts of these discussions are based on misconceptions about how financial markets function as well as research that mispresents the realities of how large index managers such as State Street Global Advisors engage with companies on behalf of investors.

Our mission is to invest responsibly to enable economic prosperity and social progress, so issues such as competition, corporate governance, market efficiency, and income inequality are of utmost importance to us. We welcome the opportunity to add our voice to this important conversation. In this paper, we highlight that benefits of indexing to investors and provide our views on the criticisms that have been raised about indexing.

How Index Investing Works and Its Benefits to Investors and Society

There is no denying that index investing produces multiple benefits for investors and society as a whole. Whether accessed through mutual funds, ETFs, or separately managed accounts, index-based strategies provide a host of benefits relative to actively managed strategies:

Diversification Index strategies provide investors with a clear-cut way to achieve broad diversification in their portfolios. They are designed to track broad market segments and typically hold a greater number of individual securities than actively managed funds.

Simplicity Broad market indexes allow investors to access the market's returns with a single purchase. Rather than having to painstakingly build and monitor a basket of securities that reflects the broader market, index managers do this work for their clients.

Lower costs Index strategies typically incur significantly lower management fees than actively managed strategies. In addition to lower expense ratios, index strategies typically have lower transaction costs because their turnover is generally far lower than actively managed portfolios.

Transparency Buy/sell decisions in index strategies are based on pre-stated rules, so the investment exposures are clear and transparent. In addition, some indexing vehicles provide daily transparency; for example, exchange-traded fund (ETF) portfolio holdings are disclosed daily.

Despite these benefits, some have raised concerns about the growth of index funds. We appreciate their theoretical perspectives, which are grounded in the researchers' expertise in their respective fields. But, ultimately, we believe that these theories fail to fully consider how index investing works in practice nor do they explore how many of their concerns will never be realized. Below we analyze some of their core concerns through the lens of investing and governance.

Indexing Criticisms

Analyzing the Concerns Through an Investment and Governance Lens

The public debate about indexing's role in financial markets and the broader economy gained steam in 2014 when an academic research paper examining the airline industry suggested that index fund managers' ownership of multiple companies in a single industry decreases competition in that industry and hurts corporate governance. Critics of indexing often point to this theory, referred to as the "common ownership" critique, as well as claims that indexing exacerbates income inequality and is a threat to price discovery and liquidity in financial markets.

Subsequent papers by legal scholars have suggested policy proposals designed to remediate the supposed anti-competitive effects of common ownership. The policy proposals include:

1. Limiting each institutional investor to investment in only one large firm in a concentrated market
2. Limiting each institutional investor to one percent of the market share of a concentrated market
3. Preventing managers of index funds from voting shares or engaging with companies

At State Street, we are ardent believers in the positive impact that indexing has for investors. That is why we welcome this opportunity to examine the criticisms of indexing and explain how, in our view, these conclusions are based on faulty research and misconceptions about the asset management industry.

Questions Regarding Data and Methodology Underpinning Research on "Common Ownership" The spark that lit the debate about index investing was a paper first circulated in 2014 and later published in 2018, titled "Anticompetitive Effects of Common Ownership," by professors at the University of Navarra in Spain and Oxford University in England.[1] The paper examined the impact of common ownership of airlines by index managers. Common Ownership Data is Incorrect, Policy Spotlight, January 2019, BlackRock.

During the research period (2001–2014), the US airline industry experienced multiple bankruptcies that resulted in removal of airlines from the indexes for half the research period. The companies were delisted by the exchanges, and index providers such as MSCI and S&P removed the companies' shares from the indices. Ownership by index funds would have mirrored this, yet the authors of the paper chose to hold ownership of the airlines constant. Moreover, in the period following the bankruptcies, the airline industry experienced significant consolidation and technological advancements related to routing and ticket pricing strategies. The paper does not control for these important developments, both of which could have led to a rise in ticket prices.

Several research papers have since been published that contradict the findings of the original airline paper. Researchers from the University of Virginia and the Federal Reserve Bank of Atlanta revisited the airline ticket price study and found the results of that study to be erroneous.[2] A paper by researchers from Compass Lexecon and Bates White Economic Consulting conclude that there is "model misspecification" in the airline study.[4]

Concern #1: Indexing Reduces Competition Within an Industry

Proponents' view Index fund managers that own shares of multiple companies in an industry have an incentive to discourage competition among the companies. For example, the airline paper suggests that common ownership was at least partly to blame for the lack of price wars among airlines from 2001 to 2014.

State Street's view This theory ignores the fact that broad index funds, by definition, are invested in all of the industries and sectors tracked by the index. For a fund that is diversified across industries, any incentive to encourage anticompetitive behavior in the airline industry would be counteracted by the resulting lower profits in industries related to the airline industry, such as hotels, travel, and tourism. For example, higher airfares would cause fewer people to travel, which would hurt revenues at hotels and restaurants — and reduce the value of the fund's holdings in those sectors. Furthermore, if the largest airlines kept prices artificially high, they would become vulnerable to losing market share to smaller competitors that aren't part of the index.

Bottom line: Index funds that invest across industries don't have an incentive to hinder competition in any one sector.

Concern #2: Corporate Governance Standards Will Weaken as Indexing Grows

Proponents' view Index fund managers lack the skill and incentive to engage in meaningful asset stewardship efforts and are not adequately resourced to execute their responsibilities. These managers limit their stewardship efforts to binary choices, such as voting for or against an entire slate of board candidates or simply outsource their voting to proxy advisory firms. Furthermore, the growing influence of index fund managers will hinder the ability of activist investors to force change.

State Street's view On the contrary, we believe that engagement by index managers strengthens corporate governance. Because of the nature of index investing, fund managers don't get to decide whether a company should be removed from the index. Therefore, these managers are sources of near-permanent capital. This, together with the fact that index fund managers are fiduciaries obligated to act in their clients' best interests and maximize the probability of attractive long-term returns, means that index fund managers are uniquely positioned — and incentivized — to use their voting power to encourage governance practices that create long-term value for investors.

At State Street, we believe that asset stewardship is our fiduciary responsibility and one of the ways we add value for investors. We believe that given our size and global scope, our stewardship role in capital markets extends beyond proxy voting and engagement with issuer companies. It also includes promoting investor protection for minority shareholders in global markets through partnerships with local investors and regulators and working with investee companies to encourage adoption and disclosure of environmental, social, and governance (ESG) practices.

By engaging with boards and management teams about issues that are vital to companies' long-term profitability and using our voting power to effect change when our recommendations aren't followed, we rigorously advocate for our clients' interests. We don't outsource our proxy voting decisions to third parties. In addition to issues related to long-term strategy and board composition, we also incorporate material ESG concerns, such as climate change and gender equality, into our engagement efforts. Our annual Asset Stewardship Report makes publicly available extensive detail about our engagement efforts and voting record. Information is also provided directly to our clients and made available on our website so that clients have full transparency into our engagement on their behalf.

We continue to ensure that these activities are adequately funded. More recently, we put substantial resources behind developing R-Factor™, a transparent system that reflects the performance of a company's business operations and governance as it relates to financially material ESG issues facing a company's industry. It leverages commonly accepted ESG frameworks that are widely supported by many global investors managing both active and index strategies. Through R-Factor™, we are helping to build sustainable capital markets for all investors. More information on R-Factor™ can be found here. We are integrating R-Factor™ scores into our engagement and voting processes and are providing our stewardship and investment analysts with an objective and independent assessment of a company's sustainability and disclosure practices related to issues that are considered to be material to their business.

We believe that sharing our R-Factor™ scores with companies will play an important role in incentivizing improved disclosure on ESG practices. As we know, what gets measured gets managed. Therefore, by calling for greater disclosure and by using a transparent scoring system that explains how we arrive at our assessment, we will help companies focus on sustainability issues and provide boards and management teams with a clear-cut rationale for why they should incorporate ESG issues into their company's long-term strategy. R-Factor™ is just one example of how we execute the stewardship responsibility entrusted to us by our clients in a responsible and transparent manner for the benefit of all market participants.

Bottom line: Index managers play a vital role in holding all companies in an index accountable for good governance as well as in improving the overall quality of the index.

Concern #3: The Rise of Indexing Is Harming Market Liquidity and Price Discovery

Proponents' view Because index funds have lower turnover, they hurt liquidity in capital markets. Furthermore, the growth of passive investing will erode active investors' influence in arbitraging away pricing inefficiencies; this will negatively impact price discovery of publicly traded securities.

State Street's view Fears that the growth of passive investing will harm market liquidity — the degree to which securities can be quickly bought and sold at a price near the going rate — and price discovery — the process of reaching a price that reflects supply and demand — haven't been realized. In fact, research by the Federal Reserve Bank of Boston that looked at a broad set of US domestic equity funds found that index investing reduces risks related to liquidity transformation.[4] One area of indexing in particular, ETFs, has been shown to be beneficial for liquidity. Because ETFs trade actively in secondary markets, ETF investors generally can access layers of liquidity not available to other investors in the underlying assets. Moreover, a number of studies have found that trading associated with the ETF-arbitrage mechanism can improve intraday price discovery for the underlying stocks.[5]

In addition to this empirical evidence, there is an intuitive explanation of why fears of index investing reducing market efficiency are misguided. First, it is not just traditional passive and active investors that participate in price discovery; broker/dealers, hedge funds, high-frequency traders, non-traditional (e.g., smart beta) index managers, and asset owners all contribute to efficient pricing as well. Second, even if active managers become the minority, only a relatively small number of them are needed to drive the price discovery process. Third, and perhaps most important, the market essentially has a built-in self-correcting mechanism that would prevent asset prices from getting permanently dislocated from their intrinsic values; if excess inflows to index funds were to push asset prices further away from their intrinsic values, this would create more opportunities for active managers to capture alpha and investors would reallocate capital back to active strategies.

Bottom line: The growth of indexing is not an impediment to market liquidity or price discovery.

Concern #4: The Rise of Indexing is Exacerbating Income Inequality

Proponents' view This theory is based on the idea that the average citizen doesn't invest in stocks and bonds. Therefore, even if capital markets are fueled by economic growth, the working class wouldn't get to benefit from it; only wealthy investors and asset managers see the benefits while the average citizen is left behind.

State Street's view This idea is misguided on several levels. First, a huge portion of the assets that are invested in index funds are either owned directly by or for the benefit of individuals who are preparing for retirement. Even though pension funds — which are among the biggest investors in index funds — are institutions, the investments in these defined benefit plans provide retirement income for teachers, firefighters, and a host of other workers. For workers with defined contribution plans such as 401(k)s or individuals who are saving for retirement through an IRA, index funds provide a convenient, low-cost way for them to participate in the wealth generated by a growing economy. It isn't hyperbole to say that say indexing, by providing low fees and easy access to equity and fixed income markets, has democratized investing for millions of workers.

As mentioned in Concern #2, State Street's engagement efforts are focused on enhancing the ability of a company to produce profits that are sustainable over the long term. We engage, vote, and monitor company progress on sustainability practices such as human capital management, pay strategies, diversity, and inclusion that are material to their business. As such, we hold companies accountable to the long-term interests of all stakeholders — serving as a counterbalance for the pressures to manage for short-term profitability.

Bottom line: Index funds have made investing cheaper and more accessible for everyone everyone and have encouraged longer-term investment.

Conclusion

Without a doubt, the growth of index investing has brought significant changes to the investment industry. In a field that directly affects every aspect of the economy and touches the lives of so many people, increased scrutiny of a trend of this magnitude is appropriate. But these public discussions need to be based on facts and a proper understanding of how financial markets function and how asset managers practice their craft.

Not only is "common ownership" based on flawed premises, there is no evidence to suggest that the proposed remedies would improve corporate governance or competition in an industry.

By lowering fees and providing easy-to-use vehicles for achieving diversification, index investing has increased access to financial markets for all investors — from individual workers saving for retirement to the world's most sophisticated pension funds. At State Street Global Advisors, we are proud of the impact that indexing has made thus far, and we are excited to be part of a healthy, ongoing discussion about how it can be best used to strengthen investors' portfolios.

Interference with the ownership thresholds of index funds is unwarranted and unnecessary. Our capital markets are strong and efficient, and effective research by active investors can arbitrage any mispricing opportunity. There are many types of asset managers, and the significant and healthy competition among these managers has reduced costs for all investors globally. Targeting a select few asset managers with anti-trust regulation could set a dangerous precedent and, more importantly, would be detrimental to the average investor, who has benefited greatly from the development of index-based funds.

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Endnotes

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2 Azar et al.

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5 Anadu, K., Kruttli, M., McCabe, P., Osambela, E., and Shin, C. "The Shift from Active to Passive Investing: Potential Risks to Financial Stability?" Federal Reserve Bank of Boston. 2018. https://bostonfed.org/publications/risk-and-policy-analysis/2018/the-shift-from-active-to-passive-investing.aspx.

6 Hasbrouck [2003], Yu [2005], Chen and Strother [2008], Fang and Sanger [2012], and Ivanov et al. [2013], Glosten, Nallareddy, and Zou [2015].

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $2.9 trillion* under our care.

* AUM reflects approximately $36 billion (as of June 30, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated

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