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The New Permanent Universal Owners: Index funds, patient capital, and the distinction between feeble and forceful stewardship

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Abstract

Fundamental change is happening in global finance – the shift from active management to index funds. This money mass-migration into index funds has far-reaching socio-economic consequences, as it has the potential to transform the nature of shareholder capitalism. We call BlackRock, Vanguard and State Street the 'New Permanent Universal Owners' that are invested indefinitely in thousands of firms. We provide novel findings on the combined ownership of the Big Three in European countries and Japan and investigate how this signals a shift away from the shareholder capitalism that has been dominant for the past three decades. We discuss the future role(s) of the New Permanent Universal Owners in corporate governance including whether they foster patient capital and introduce the distinction between feeble and forceful stewardship.

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Introduction

There is fundamental change happening in the sphere of financial investment. Institutions as well as private investors are increasingly shifting money from actively managed mutual funds to passively managed index funds (Bebchuk & Hirst, 2018, 2019; Fichtner *et al.*, 2017). Index funds replicate established stock indexes, such as the American S&P 500 or the British FTSE 100 while minimizing investor fees (Petry *et al.*, 2019). Because they do not actively buy and sell stocks based on expected future earnings but merely follow the market, this is called passive asset management. For the sake of brevity we use the term 'index funds' to denote the broader category of passive investment tools, including index mutual funds and exchange traded funds (ETFs). From 2006 to 2018 almost US$3.2 trillion has flown out of actively managed equity funds, while US$3.1 trillion has flown into index equity funds (Henderson, 2019; Sushko & Turner, 2018). Figure 1 shows global flows out of actively managed equity funds and inflows to equity index funds from 2006 to 2018. The main reason for this unprecedented capital mass migration is that index funds are much cheaper but deliver similar returns compared to the vast majority of active funds. Some have already called the development that diversified investment has become cheaper the 'democratization of investment' (Novick, 2017). And it seems very likely that this money mass-migration is going to persist. In fact, it could even accelerate because the adoption of

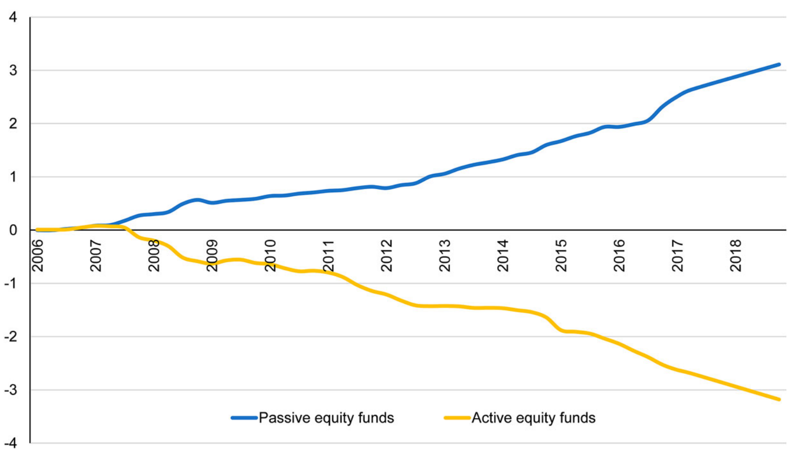

Figure 1 The global shift from actively managed to index funds in equities (trillion US$)
Source: Sushko and Turner (2018); Henderson (2019).

index funds in Europe (and other regions) has been much less progressed compared to the United States. In 2017, European index funds had a record growth rate of 40 per cent, and recently implemented EU regulation such as MiFID II is seen as facilitating further growth in the future (Thompson, 2018). Early indications in mid-April 2020 show that the downturn of financial markets in the wake of the coronavirus pandemic has not changed the flow of funds from active to passive asset management.

BlackRock, Vanguard and State Street, or simply the 'Big Three', together manage 80–90 per cent of all assets under management in US passive equity funds (Fichtner *et al.*, 2017). This is markedly different from the fragmented actively managed mutual funds industry characterized by centrifugal market forces – there is no significant advantage from being much bigger than the competitors. In contrast, first-mover advantage combined with powerful economies of scale and liquidity benefits of large index funds – centripetal market forces – make it unlikely that the dominant position of this trio of passive asset managers is going to be challenged in the near future (Bebchuk & Hirst, 2018, 2019; Bogle, 2019). Haberly *et al.* (2019) aptly characterize the Big Three as 'digital asset management platforms' that cause 'winner-take-all market share consolidation'. Competitors such as Fidelity who want to break into this market already use desperate measures such as loss-making zero fee funds to acquire market share (Walker, 2018). Breaking the dominance of the Big Three would require persistence and very deep pockets. We thus call BlackRock, Vanguard and State Street the 'New Permanent Universal Owners' as they are invested indefinitely in thousands of firms that are members of international stock indexes; they only divest when the composition of an index changes.

We believe that the ongoing debates on the rise of passive investing (see for instance Bebchuk & Hirst, 2018; Braun, 2016; Haberly *et al.*, 2019; Jahnke, 2019a, 2019b; Petry *et al.*, 2019) do not yet fully appreciate the transformative and potentially disruptive undercurrent that comes with the money mass-migration into the Big Three as Permanent Universal Owners. For instance, a growing body of literature in the fields of law and economics is concerned with the increase in 'horizontal shareholding' (Elhauge, 2016) – which means that competing listed firms now often have the same 'common owners' (Backus *et al.*, 2019; Schmalz, 2018), such as index funds or other large investors (e.g. Berkshire Hathaway). This situation could lead to less competition between listed firms active in the same market and thus potentially cause higher prices for consumers. While this is certainly of interest, we believe these studies overlook the more fundamental transformation taking place today. Indeed, the Big Three hold the relevant part of ownership from the perspective of corporate governance because they exert the voting rights of the shares they hold on behalf of others (Shenkar *et al.*, 2017; see Griffin, 2019 for proposals to 're-democratize' voting by end-investors). The persistent shift into index funds, therefore, is leading to a centralization of significant proportions of corporate control primarily in the hands of just three American asset managers. But in as far this is a renaissance of concentration of corporate control, we argue that it is in a very different guise than earlier times. The Big Three are different from shareholders as we typically tend to think about them because they do not invest in carefully picked firms. Rather, they are intermediaries for end-investors that seek exposure to entire markets. This brings about a fundamentally different orientation on the role and responsibilities as shareholders.

We therefore put forward that the rise of passive investment may fundamentally alter the incentives and strategies of large and influential shareholders as they become Permanent Universal Owners. And that this transformation requires a rethinking of key concepts such as shareholder value, stewardship and patient capital. Our argument is inspired by Hawley and Williams (2000, p. xv) who almost 20 years ago observed that 'a universal owner's cumulative long-term return is determined not merely by the performance of each individual firm it owns, but by the performance of the economy as a whole'. The meaning of shareholder value becomes more and more defined at the level of *groups of corporations* (such as markets or sectors), instead of at the level of individual firms.

We thus aim to contribute to an emerging body of work that tries to understand how global corporate governance is being transformed due to changing investment patterns following the global financial crisis. We do so by providing novel findings on the combined ownership of the Big Three in several European countries and Japan to overcome the predominant focus on the United States in previous work (Appel *et al.*, 2016; Bebchuk & Hirst, 2019; Fichtner *et al.*, 2017; Heath *et al.*, 2019). This new empirical material allows us to establish that indeed the Big Three have become universal owners, reaching well beyond their home market in the United States. Second, we introduce the distinction between feeble and forceful stewardship to better appreciate the role New Permanent Universal Owners may have for corporate governance across the globe.

The remainder of this paper is structured as follows. The next section outlines the role institutional investors have played for corporate control, discussing the relevant literatures from political economy, economic sociology and management studies. Subsequently, in section three we provide new data on the combined ownership of the Big Three in a number of European countries and Japan. Section four focuses on the role of the Big Three passive asset managers for the provision of patient capital and introduces the distinction between 'feeble' and 'forceful' stewardship. The final section concludes by reflecting on the future role(s) of the New Permanent Universal Owners in global corporate governance in light of the developing coronavirus pandemic.

Institutional investors and corporate control

The first modern institutional investors were created in the late 1920s when mutual fund companies such as State Street and Wellington offered openend funds that for the first time enabled the continuous issuance and redemption of shares. However, their size remained relatively small for nearly the next five decades and thus they did not play a key role for corporate control. Berle and Means found in their seminal study in the early 1930s that most listed companies did not have large controlling owners. Instead they argued that there was a separation of ownership and control: 'the dissolution of the old atom of ownership into its component parts, control and beneficial ownership' (Berle & Means, 1967 [1932], p. 8). The decades before the 1930s had been marked by concentrated ownership in the United States in the hands of business tycoons of the Gilded Age such as J.P. Morgan. The rise of small private investors that Berle and Means had found evidence for meant that the power over listed corporations had mostly shifted to management. About five decades after Berle and Means Chandler (1977) introduced the term 'managerial capitalism' to capture the powerful position of management vis-à-vis shareholders. About the same time in the mid-1970s, a counter movement against managerialism emerged and pushed the field of corporate governance towards a growing appreciation of the role and position of shareholders. Shareholder value became a key managerial objective (Lazonick & O'Sullivan, 2000). And when ownership was largely fragmented and dispersed over a large number of active owners and mutual funds, top management better delivered shareholder value today than tomorrow, leading to a short-term focus that became the cornerstone of shareholder value.

Two decades later, Useem (1996) coined the term 'investor capitalism' to acknowledge the fact that by the mid-1990s the management of US listed corporations had to take into account the interests of large institutional investors. According to Useem (1996, pp. 206–207), the new relations between investors and managers resembled a nonhierarchical network – 'formal "principal-agent" relations (…) have given way to negotiated relations between coequals'. Hawley and Williams (2000) have extended the work of Useem by introducing the terms 'universal owners' and 'fiduciary capitalism'. Their argument primarily focused on US public pension funds, such as CalPERS, which had become significant long-term owners in a great number of US listed corporations. As fiduciaries for their investors, they thus had an interest not in the short-term performance of single companies, but in the long-term performance of the entire economy.

However, during the next two decades the management of equity has increasingly shifted from public pension funds to private asset managers. Thus, Davis (2008) argued that there was a 'new finance capitalism' in which a small number of actively managed mutual funds, such as Fidelity, have become large shareholders in a large number of US listed firms. Though reminiscent of the era when J.P. Morgan controlled many large American corporations, Davis (2008, p. 13) found that against his expectations active mutual funds mostly eschewed active participation in corporate governance. He therefore concluded that 'networks of concentrated yet liquid ownership without control seem to be the distinctive feature of the new finance capitalism'. Davis pointed out that this was a historically unique situation because blockholdings are generally associated with influence, if not outright control. This made his finding indeed 'theoretically puzzling' (Davis, 2008, p. 21). Interestingly, Davis did look at index funds but found them of little interest as at that time a passive asset manager had 'neither concentration nor liquidity, as its strategy of indexing leads it to buy and hold *small positions* in a large number of companies rather than large positions in a small number of companies' (Davis, 2008, p. 21, emphasis added). But the money mass migration into passive funds changed this situation dramatically, and the Big Three emerged as holding *large positions* in a large number of companies.

The new era of passive investing and its impact on corporate control

Similar to other politico-economic domains, the global financial crisis has caused significant change in the sphere of investing. The most important change was the shift towards passive investing. Braun (2016) identified the development of ETFs (exchange traded funds) as a crucial new 'market device' for the 'socio-technical agencement' of passive investors. Fichtner *et al.* (2017) built upon the contributions by Davis (2008) and Braun (2016) and for the first time empirically identified that the growth of index investing has led to the rise of the 'Big Three' US passive asset managers BlackRock, Vanguard and State Street. They also found that the Big Three utilize coordinated voting strategies across their many funds in the annual general meetings of their investee companies and thus employ centralized corporate governance strategies. Moreover, they determined that the Big Three, seen together as one investor block, already constituted the largest shareholder in 88 per cent of all S&P 500 firms in 2015.

From a corporate governance perspective, the rise of the Big Three presents a puzzle. The Big Three generally are not able to sell ('exit' in the vocabulary of Hirschman, 1970), because they are almost entirely passive asset managers (Bebchuk & Hirst, 2018). Indeed, the proportion of actively managed equity funds that they offer is well below 20 per cent of their total assets under management in equities and declining. Yet, while they are passive investors, they are *not* passive owners. Fichtner *et al.* (2017) showed that the Big Three are able to 'voice' concerns to management in their thousands of 'private engagements' every year. Or, in the words of Bogle (2019, p. 252), 'their only alternative is to press the management for improvement, or change the management. Index funds as a group will soon have the voting power to do just that' (see Griffin, 2020 for an analysis of the voting power of the Big Three in the United States).

A notable feature of the Big Three is that their ownership is permanent. The institutional investors that Hawley and Williams (2000) wrote about – primarily large US pensions funds such as CalPERS – were perhaps very broad yet *transient* owners instead of truly permanent, because even though they partly used internal index tracking strategies they still retained the possibility to sell individual companies. For them, index tracking was just a discretionary strategy to reduce cost. In contrast, low-cost index tracking is the dominant business model for BlackRock, Vanguard and State Street. They only divest when the composition of an index changes, and this is decided primarily by the three major index providers MSCI, FTSE Russell and S&P Dow Jones Indices who in turn have now become private authorities of sorts (Petry *et al.*, 2019). Also, we consider firms such as CalPERS not as truly universal owners, because even though they held a large quantity of small stakes in hundreds of listed American corporations, they did not hold the entire stock market in their portfolio, as the Big Three practically do. And outside the United States, their holdings remained quite limited. Yet, the Big Three are now expanding their ownership well beyond their home market, as we will show below. The Big Three are therefore best characterized as *permanent* and truly universal owners that are unable to sell their shares of individual companies as long as these firms are part of the index. This permanent and universal character of the ownership of the Big Three has major consequences.

Permanent Universal Owners as providers of patient capital?

In particular, a crucial question is to what extent the Big Three are now providers of 'patient capital', that is, 'ownership that allows for the realization of long-term management strategies' (Culpepper, 2011, p. 26). Braun (2016, p. 268) argued that index investors are – in principle – in a good position to provide this 'patient capital' to their investee companies, which could foster the 'internalisation of externalities' and the development of long-term orientations. It has often been argued that patient capital constitutes a central feature of coordinated market economies, such as Germany or Japan, because it protects corporations from hostile takeovers, 'thus freeing them from obsessive concern with short-term market indicators' (Culpepper, 2005, p. 175). This mostly takes the form of long-term oriented banks and strategic blockholders, such as families or conglomerates (Culpepper, 2005, 2011; Hall & Soskice, 2001). In the liberal market economies of Anglo-American pedigree firm behaviour generally is much more oriented towards the maximization of short-term profits, often driven by 'impatient capital'. Activist hedge funds epitomize this impatient capital that continuously seeks to extract short-term financial gains (Buchanan *et al.*, 2018; Fichtner, 2013a, 2013b, 2015; Goyer, 2011). The rise of BlackRock, Vanguard and State Street as the New Permanent Universal Owners introduces somewhat of a paradox into this comparative political economy debate, as it is increasingly clear that these Big Three American based asset managers do not have the short-term orientation we typically connect to shareholder incentives in liberal market economies.

The CEO of BlackRock, Larry Fink, confirms this stance in his 2018 letter to CEOs (BlackRock, 2018):

> BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. In this sense, index investors

> are the ultimate long-term investors – providing patient capital for companies to grow and prosper.

The CEO of State Street, Cyrus Taraporevala (2018), concurs by stating:

> We are essentially permanent capital (…). That means we need to take a long-term perspective on behalf of our clients. At a time when some activist shareholders are keen on extracting short-term profits from companies, we provide a healthy and necessary counterweight.

Fink and Taraporevala thus suggest that the rise of the Big Three means that the United States now has its own providers of patient capital. BlackRock CEO Fink has explicitly asked corporations to formulate strategies for long-term growth and not to focus too much on quarterly results; he has called on companies to drop quarterly profit forecasts in order to curb short-termism (Norton, 2018). Another indication that BlackRock has an incentive to consider the 'well-being of the whole society' is Fink's statement that companies also have to serve a social purpose in addition to making profits: 'To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society' (BlackRock, 2018). From a publicly listed and therefore profit-driven asset manager these are strong and unprecedented words. This underscores the transformative effect that the rise of the New Permanent Universal Owners may have on corporate governance.

Deeg and Hardie (2016) have provided a very useful framework to distinguish between patient and impatient capital, which is based on three consecutive questions or dimensions. The first dimension is the investment time horizon (i.e. short or long-term), the second is whether the investor uses 'voice' to push for measures to increase the share price in the short-term, and the third is whether the long-term investor that does not engage in pursuit of short-term performance then 'exits' (sells) due to concerns regarding the short-term performance of the firm. This means that a long-term investment time horizon is a necessary but not sufficient condition for patient capital in this framework. Deeg and Hardie (2016) ascribe a high level of patience to index funds because of their inability to exit and their high degree of loyalty.

But what does a long-term perspective and the provision of patient capital actually mean for Permanent Universal Owners and how does it translate into concrete corporate governance policies and actions? With their business model based on low fees every effort spent on influencing corporate conduct is a liability as well as it increases their fixed costs (Bebchuk & Hirst, 2018). At the same time the Big Three face increasing demands by their investors and the public to actively use their enormous voting rights to improve the corporate governance of their investee companies. In fact, they have a fiduciary duty to do so (see Jahnke, 2019b). How do they deal with this? So far, it is unclear whether they really have the capacity to actively influence corporate governance at the firm level. BlackRock has increased its corporate governance department from 20 members in 2014 to 33 people in 2017 and over 40 in 2019 (out of a total staff of 13,000), Vanguard (with about 16,600 employees) more than doubled its corporate governance team from 10 in 2015 to 21 in 2017 (Bioy *et al.*, 2017). Compared to their thousands of international portfolio companies this is still very little. And previous research has found that in most cases the Big Three vote with management and rarely support shareholder proposals (Bebchuk & Hirst, 2018; Bioy *et al.*, 2017; Fichtner *et al.*, 2017). But if we view the Big Three as permanent and universal owners, they may care more about market and sector-wide policies than about firm-level decisions. After all, they are first and foremost invested in markets rather than firms. This discussion leaves us with two pertinent questions. First of all, to what extent are the Big Three indeed universal owners with an impact in political economies beyond the United States? And second, how can we best understand their position as crucial actors in corporate governance? In the next sections we address these pressing questions.

Mapping the global corporate ownership of the New Permanent Universal Owners

To shed empirical light on the claim of universal ownership by the Big Three we collected data from Orbis, an authoritative and often used database for research of corporate ownership (Fichtner *et al.*, 2017; Garcia-Bernardo *et al.*, 2017; Vitali *et al.*, 2011). Orbis is a widely used ownership database in academic research but it is not perfect. In part this is because of large differences across countries in ownership disclosure requirements. Whereas the data quality for ownership in US listed firms is relatively high due to mandatory filings this is not the case in other countries, such as France or Germany. Especially smaller ownership stakes often remain undisclosed until the ownership reaches a 3 or 5 per cent threshold. Orbis sources its ownership data from several data providers. The large majority comes from FactSet (FS), which covers the vast majority of listed firms. For instance, of all 420,000 records on shareholdings by BlackRock in our database, 394,000 are from FS. Yet, FS under-reports the ownership of BlackRock, Vanguard and State Street in many cases. For a much smaller number of firms (and only for some years) there is ownership information provided by the national stock exchange (SE), these data seem to be much more accurate than the FS data because they are based on mandatory filings when crossing ownership thresholds (such as 3, 5 and 10 per cent). In Germany, for instance, Big Three shareholdings reported by SE are on average 20 per cent larger than those reported by FS. Yet only a fraction of all shareholdings has SE information. Where we report ownership over time, we choose to rely only on the FS data. While this means a significant underreporting of the ownership stakes, we expect that the error is relatively consistent and that therefore this is the best way of representing change.

Where we report the combined mean ownership of the Big Three we use both the FS and SE data.

Building on this novel dataset, a few numbers demonstrate the near universal ownership by the Big Three passive asset managers. By early 2019, BlackRock held ownership in well over 10,000 listed corporations around the world. Vanguard even held positions in over 10,500 companies. State Street is smaller and held ownership in approximately 6,000 firms. The best comparison to these new private universal owners is the large sovereign wealth fund (SWF) of Norway, which held shares in over 8,500 listed firms globally. However, most of its holdings are much smaller compared to the Big Three.

BlackRock, Vanguard and State Street are American asset managers. Both index mutual funds and ETFs have been developed in the United States, and it is here that the adoption of these passive investment vehicles is most pronounced. Hence, it is understandable that most of this emerging literature on passive asset managers has focused on the United States (Appel *et al.*, 2016; Fichtner *et al.*, 2017; Heath *et al.*, 2019). Yet, this leaves a number of blind spots, and we therefore have analysed the holdings of the New Permanent Universal Owners in 25 countries. Table 1 shows the 3 and 5 per cent blockholdings of BlackRock, Vanguard and State Street by early 2018. Three per cent is the threshold when ownership in a listed corporation has to be reported in many countries, 5 per cent is the reporting threshold in the United States. As a comparison we have added the Norwegian SWF, which is the largest state-owned investor. The majority of blockholdings of the Big Three are located in the United States. Vanguard owns 3 per cent blockholdings in over 2,500 listed US firms, and BlackRock owns only slightly less. However, it becomes evident that BlackRock has 'deeper' ownership as it holds over 2,000 five per cent blocks, whereas Vanguard owns 'only' about 1,800. State Street also has a very broad ownership profile in the United States with almost 1,300 three per cent blocks but is generally smaller than the other two index fund giants.

The country in which the New Permanent Universal Owners have their most blockholdings after the United States is, perhaps unsurprisingly, the United Kingdom. The United Kingdom is also considered a liberal market economy, in which financial markets play a central role. BlackRock and Vanguard hold hundreds of blockholdings in British listed corporations. State Street is smaller, but the United Kingdom is also the second largest country for them. But there are also some significant regional differences. BlackRock has 190 three per cent holdings in Japanese corporations, whereas Vanguard only has 12 and State Street none. In contrast, Vanguard has significantly more blockholdings than BlackRock in Australia and Taiwan. This can either be because of specific index funds investing in these countries that have become popular with American (or European) investors, or because BlackRock and Vanguard have gained significant assets under management from investors based in these countries that invest domestically.

Also evident in Table 1 is the surprisingly high number of blockholdings in three small jurisdictions that act as prominent offshore financial centres catering

Table 1 Global ownership profiles of the New Permanent Universal Owners

	BlackRock		Vanguard		State Street		Norway	
Country	3%	5%	3%	5%	3%	5%	3%	5%
US	2428	2011	2523	1797	1283	355	22	4
UK	346	229	216	12	47	4	63	9
Japan	190	141	12	0	0	0	39	2
Australia	81	70	135	31	5	5	15	1
Germany	65	35	21	1	1	0	67	7
Taiwan	60	6	204	0	0	0	0	0
France	51	31	8	0	1	0	12	2
Canada	46	25	31	5	1	0	0	0
Bermuda	41	29	33	26	13	3	4	1
Ireland	33	25	26	17	16	4	1	1
Netherlands	29	15	12	5	5	1	6	2
Cayman Isl.	28	13	16	7	2	1	1	1
Brazil	26	10	12	0	0	0	3	0
South Korea	25	4	1	0	0	0	12	2
Switzerland	24	9	10	2	3	0	8	0
Spain	22	6	6	0	0	0	15	0
South Africa	17	4	52	0	0	0	5	0
China	17	16	2	0	0	0	2	2
Mexico	15	4	7	0	0	0	5	0
Italy	15	14	1	0	0	0	7	0
Sweden	14	5	7	0	1	1	15	4
Finland	12	6	3	0	0	0	4	0
India	10	0	8	0	0	0	10	0
Belgium	9	2	2	0	0	0	4	0
Hong Kong	7	2	3	0	1	1	0	0
Total	3611	2712	3351	1903	1379	375	320	38

Source: Authors' calculations based on Orbis (2018).

to multinational corporations: Bermuda, the Cayman Islands and Ireland (Fichtner, 2016; Garcia-Bernardo *et al.*, 2017). Big Chinese corporations domicile holding companies in the Cayman Islands to list their shares abroad (e.g. Alibaba and Tencent), whereas some large US corporations have shifted their legal domicile for tax reasons to Ireland through so-called 'corporate inversions' (e.g. Accenture and Medtronic). Hence, the blockholdings in these tax havens in reality mostly are ownership positions in large American and Chinese corporations. In general, the global ownership profiles of the Big Three are concentrated in OECD countries.

The comparison with the Norwegian SWF is instructive. The state-owned fund is not bound by any specific investment strategy, such as index tracking or particular country weights but does follow a long-term portfolio approach to diversify its investments internationally. Therefore, the ownership profile is more evenly balanced than those of the Big Three. The number of blockholdings in American corporations is much smaller than those of State Street.

However, it has to be noted that in hundreds of companies this SWF holds stakes of 1 or 2 per cent, which thus do not appear in Table 1. Thus, Norway is a quasi-universal owner but in contrast to the Big Three it is not necessarily a permanent owner as the SWF is continually adjusting its strategy and has decided to divest from coal, tobacco and weapons-producing companies (Carrington, 2015).

Figure 2 shows the rise in the average combined ownership of the Big Three in six key US, European and Japanese stock indexes from 2011 to 2018. The ownership is increasing in all countries but passive investing is clearly most progressed in the United States where the Big Three, seen together, hold a combined ownership of over 21 per cent in 2018. In the British FTSE 100 they have grown from nine to almost 11 per cent. In the Japanese Nikkei, the Big Three have increased significantly from a low value of 2 per cent in 2011 to about 6 per cent in 2018. A similar development is visible for the Dutch AEX and the French CAC indexes.

The absolute number of blockholdings and the combined ownership are important aspects of the influence by the Big Three index fund providers in different countries. However, both indicators are not sufficient to estimate the extent of corporate control potentially exerted by the New Permanent Universal Owners because they do not take into account the different national

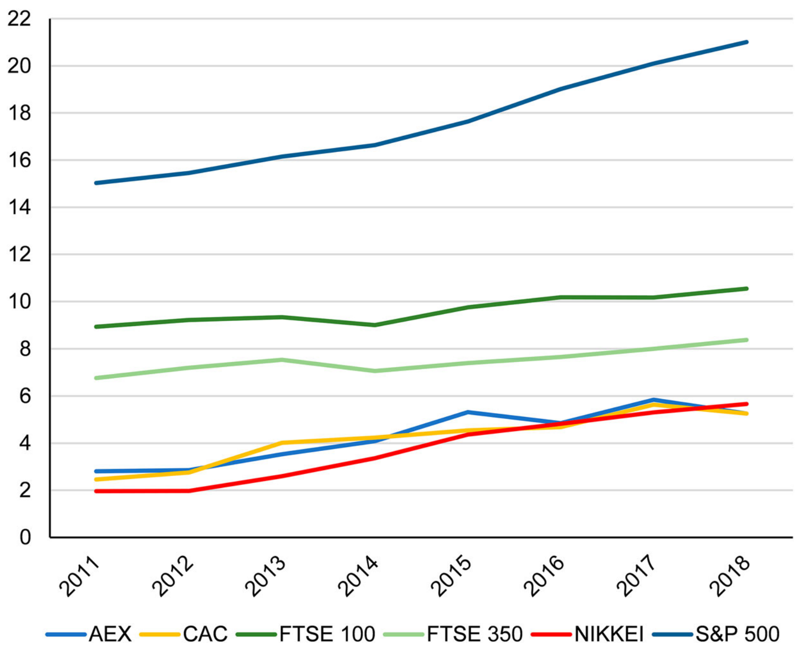

Figure 2 Combined ownership of the Big Three in key indexes in per cent, lower bounds (2011–2018)
Source: Authors' analysis of Orbis (2018).

ownership structures. The traditional view is that in LMEs (United States and United Kingdom) the ownership of listed corporations is dominated by many different small investors and thus remains fragmented (i.e. the separation of ownership and control). In contrast, the corporate ownership in coordinated market economies (CMEs) has been more concentrated in the hands of strategic blockholders. In Germany, for many decades this had been large private banks and insurance companies, but in the late 1990s these investors mostly sold their blockholdings (Höpner & Krempel, 2004). Their position as large owners was mostly taken over by private investors, such as families, which held blockholdings of at least 25 per cent in almost one third of the 160 largest listed German corporations in 2011 (Fichtner, 2015). In Japan, large conglomerates (keiretsu) still have many block- or cross holdings in listed corporations, although their role has declined in the last two decades. In other countries, such as France, the state is a large owner of listed corporations (Babic *et al.*, 2019). Hence, existing national corporate ownership structures largely determine the level of corporate control that (foreign) private investors, such as BlackRock, Vanguard and State Street are able to exert.

To estimate the extent of potential corporate control exerted by the Big Three in different countries we looked at the proportion of firms in which BlackRock, Vanguard and State Street, seen together, are the largest owner. In the S&P 500, the Big Three are the largest owner in almost 90 per cent. The remaining roughly 10 per cent are dominated by large private blockholders, e.g. Larry Page and Sergey Brin control Alphabet (i.e. Google), Facebook is controlled by Mark Zuckerberg, and the Walton family owns the majority of Walmart. The United Kingdom is the second largest market for BlackRock, Vanguard and State Street, with a mean ownership in the FTSE 100 companies of almost 11 per cent, which means the Big Three are the largest owner in approximately 60 per cent.

In continental Europe, the three US passive asset managers are already the largest owner in 40 per cent of the largest 30 German listed corporation with a mean ownership of almost 8 per cent. Their position is slightly less dominant in France and the Netherlands, where the proportion of firms in which the Big Three are the largest owner is 22 per cent in the AEX index and 20 per cent in the CAC 40 index. Clearly, the Big Three are increasingly occupying an influential position in European corporate governance. For Japan, we have analysed the two dominant stock indexes, the TOPIX 100 and the Nikkei 225. Although the mean ownership of the Big Three is relatively low in both indexes with around 6 per cent, the proportion of firms in which they are the largest or second largest owner is surprisingly large: over 50 per cent in the TOPIX 100 and almost 40 per cent in the Nikkei 225. In short, BlackRock, Vanguard and State Street have become influential corporate owners in a growing number of markets. Note that these observations are based on the lower bound of reported ownership (FactSet) and actual levels will be higher.

Hence BlackRock, Vanguard and State Street have become major corporate owners in liberal and coordinated market economies alike. It is clear that they have indeed become truly universal owners.

The role of index funds for patient capital, and the distinction between feeble and forceful stewardship

This increasingly global ownership of the New Permanent Universal Owners poses the question of what kind of impact this will have on different political economies. And more particularly, what kind of position does a Universal Permanent Owner take in matters of corporate governance? If the Big Three are indeed providers of patient capital, what does that mean for corporate governance of the firms in which they are invested? The answer to this question is not so obvious. We illustrate this with the case of share buybacks.

Share buybacks represent immediate payoffs to shareholders and the funds used for buybacks cannot be used for measures that could increase long-term firm value, such as research and development or the retraining of employees; similarly, money spent for repurchasing stock cannot be used as a safety buffer to weather major economic crises. The main intended effect of share buybacks is that they reduce the number of outstanding (i.e. publicly traded) shares. This improves a range of financial firm ratios that have been advocated by proponents of shareholder value maximization, such as earnings per share (EPS). As such, share buybacks constitute short-term financial engineering to increase the share price; they have no effect on firm revenues or total profits. In fact, in the United States share buybacks had been considered as illegal market manipulation until 1982 when the Securities Exchange Commission under John Shad, the first ex-Wall Street banker to lead the agency, allowed them (Lazonick, 2015).

Lazonick (2015) has argued that the ascent of the 'buyback corporation' and the concomitant paradigm shift of many listed corporations from a model of 'retain-and-reinvest' to 'downsize-and-distribute' has led them to overly focus on short-term financial aims. The volume of buybacks in the United States alone is staggering. In fact, in the period from 2000 to 2018 the US stock market has facilitated negative net equity issuance (gross equity issuance minus retirements, which comprise stock repurchases as well as mergers and acquisitions) of over US$5,900 billion (Federal Reserve, 2019). Hence, the US stock market has reversed its function during the last 30 years, changing from an institution that transports capital from investors to firms that use it for investment into a mechanism that channels money out of listed corporations to their owners. One consequence of this process is that companies become less resilient against external shocks. While we certainly need more research on the consequences of buybacks it seems reasonable to conclude that they constitute a form of corporate short-termism that favours 'easy' and seemingly certain financial benefits over more difficult and uncertain long-term strategies that involve research and development.

In past annual letters to CEOs, BlackRock has argued against an excessive use of share buybacks. And this is clearly consistent with the statement that 'with BlackRock's growth, especially in our index business, comes an evolving responsibility. A crucial part of that responsibility is advocating on behalf of our clients for practices that we believe enhance long-term returns' (BlackRock, 2017, p. 20). Surprisingly, in the United States it is not mandatory for management to let shareholders vote on buybacks. If BlackRock (as well as Vanguard and State Street) were really concerned about buybacks, the rational reaction would be to launch a campaign together with other asset managers to force management to put buybacks up for vote by shareholders. This would be only logical, as most other issues that significantly impact corporations, such as mergers and acquisitions, are voted upon by shareholders. Hence, BlackRock could do much more to curb short-termism that is driven via massive buybacks.

For single companies, buybacks occasionally may make sense in order to maximize short-term shareholder value, even though there are serious concerns that most firms also buy shares when they are expensive, thus potentially destroying shareholder value. However, if the vast majority of listed corporations spend billions (or even trillions) on buybacks this is a very different thing. Proponents of buybacks argue that this is just a tax-efficient way to give back money to shareholders, but in fact there is no direct financial transfer to shareholders (as in dividends) but only an indirect transfer via an assumed increase in the share price. However, even if the share price of one company really increases due to buybacks there is no way for investors in index funds to immediately realize these gains because they necessarily hold the entire index. Hence, buybacks mean that effectively capital stays within the financial sphere without flowing back to the 'real' economy. Maximizing buybacks is not a sustainable long-term *purpose* for a corporation, it is the *financialization* of the firm (Fichtner, 2020). This directly connects to what Larry Fink stressed in his last letter to CEOs: each firm should think about its purpose for customers, shareholders and society.

Rethinking shareholder power in the era of index investing

The New Permanent Universal Owners have at least one conflict of interest that could impede them from exercising true long-term oriented stewardship in their thousands of investee companies: their fees are calculated as fractions of assets they have under management, and engagements always involve costs (Bebchuk & Hirst, 2018). The future role of the New Permanent Universal Owners is thus not yet clear. Table 2 shows a continuum of how institutional investors may act as corporate owners, ranging from what might be called 'conventional' and 'careful' shareholder value to what we call 'feeble' and 'forceful' stewardship.

Under 'conventional' and 'careful' shareholder value institutional investors follow a paradigm of maximizing short-term financial gains, including buybacks and M&A (mergers and acquisitions), largely without using 'voice' to influence

Table 2 Four models of corporate ownership by institutional investors

Orientation:	Conventional Shareholder Value	Careful Shareholder Value	Feeble Stewardship	Forceful Stewardship
Share buybacks	For	Indifferent	Sceptical	Mostly against
M&A	For	Indifferent	Sceptical	Mostly against
High Exec. Pay	Indifferent	Sceptical	Sceptical	Against
ESG	Mostly against	Indifferent to favourable	Indifferent to favourable	For
CG Team	Minimized	Small	Medium	Large (?)
CG initiatives aiming at entire sectors	Indifferent	Indifferent to favourable	Indifferent to favourable	Strongly for
Vote against management	Rarely	Occasionally	Occasionally	Regularly
Example	Active mutual funds, hedge funds	Pension funds, some SWFs	Big Three (now), some SWFs	NPUOs (in the future?)

Source: Compiled by authors.

management. Actively managed mutual funds, many pension funds as well as many sovereign wealth and hedge funds fall into these two categories (except activist hedge funds, which rely on 'voice'). We contrast this with what we call 'feeble' and 'forceful' stewardship. Feeble stewardship means being sceptical about high executive remuneration as well as about buybacks and M&A as long-term value creating strategies. Employing a larger corporate governance team such institutional investors (e.g. the contemporary Big Three or the Norwegian sovereign wealth fund) give a higher priority to ESG (environmental, social, governance) issues and occasionally vote against management to pursue their aims while shying away from forcefully imposing their aims (see Briere *et al.*, 2018). We argue that – potentially – the New Permanent Universal Owners could exert what Covington and Thamotheram (2015a, 2015b) have called 'forceful stewardship', which means putting pressure on corporations to implement genuine long-term strategies that take into account important ESG issues, such as climate change or loss of biodiversity, which most other investors disregard (Galaz *et al.*, 2018). Large Permanent Universal Owners might uniquely be able to internalize such negative externalities (Braun, 2016; Condon, 2019). In addition, high executive remuneration which contributes to increasing economic inequality would be opposed by forceful stewardship.

We argue that forceful stewardship would entail voting against management regularly and taking a stance against share buybacks and many M&A deals, which can be seen as an indicator for short-termism (Jackson & Petraki, 2011; Rappaport, 2011), and which involve large payments to investment banks and law firms. Arguably only very large asset managers such as the Big Three have the potential to exert forceful stewardship as they have attained unprecedented scale (Jahnke, 2019a). We have done a first analysis using ProxyInsight data how the Big Three have voted on buybacks and M&A in five countries (United States, United Kingdom, France, Germany and Japan) between 2012 and 2017. In total, we studied 8,125 resolutions voted on at annual general meetings (AGMs) concerning share buybacks and 2,570 resolutions concerning M&A. In the vast majority of countries and years the Big Three have voted with the management recommendation and thus for buybacks and M&A. This suggests that, in these six years, BlackRock, Vanguard and State Street clearly exhibited voting behaviour that would be classified as feeble stewardship.

Exerting forceful stewardship would normally imply having a large corporate governance team that has the knowledge and the capacity to engage with thousands of companies in many different countries each year. Such a large corporate governance team consisting of at least several hundreds of highly trained staff would be a substantial cost factor even for large passive asset managers. Therefore, we see a potential alternative in the form of corporate governance initiatives that focus on entire industries or sectors. While most other investors are generally indifferent or favourable towards such initiatives, Permanent Universal Owners arguably are especially inclined to favour such mechanisms for facilitating change in corporate governance. The reason for this is that such initiatives involve low costs but potentially influence thousands of listed companies in different countries. This implies that, for these universal and permanent owners, the meaning of shareholder value becomes more and more defined at the level of *groups of corporations* (such as markets or sectors), instead of at the level of individual firms.

Recently, there have been signs that BlackRock and State Street have begun to slowly move towards a more forceful form of such stewardship – at least in ESG issues. BlackRock announced in January 2020 plans to double its offering of ESG-focused ETFs and to significantly increase engagement with the management of portfolio companies on sustainability-related factors. Moreover, the giant asset manager has demanded that all its portfolio companies provide more detailed reports according to frameworks developed by the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD). In the public statement the company claims to become more forceful: 'BlackRock will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and […] plans underlying them' (Mooney & Nauman, 2020). State Street has announced it will start voting against the boards of large companies that lag behind on ESG standards in the next few years. Vanguard, however, has remained rather silent on these issues so far. Future research has to verify whether the recent announcements by BlackRock and State Street will translate into concrete measures that have a lasting impact on the thousands of companies in which they hold substantial ownership in ESG issues. Demanding that all their portfolio companies follow certain standards is a very cost-efficient way of exerting change; this could also be applied to executive remuneration, for instance. The ratio between the CEO remuneration and the pay of the average worker in large US corporations has been well over 200:1 in recent years. To curb excessive CEO pay the New Permanent Universal Owners could demand their portfolio companies reduce this ratio to 100:1 (or lower, of course) and announce that they are going to vote against directors of companies that do not reach this ratio in a given amount of time. State Street has already begun to follow such an approach in recent years concerning board diversity. The decisive question is going to be whether the Big Three will pursue their market-wide initiatives forcefully (i.e. vote against management of companies that fail to comply) or if they will remain feeble.

Conclusion

Fundamental change is happening in asset management – the shift from actively managed funds to index funds. While the former sector is fragmented, the passive fund industry is highly concentrated in just three large US asset managers – BlackRock, Vanguard and State Street. The ongoing capital migration into passive investment is therefore leading to a concentration of corporate ownership. Our analysis shows that the Big Three, taken together, are the largest owner in almost 90 per cent of the S&P 500 firms, holding on average 21 per cent of the ownership. The Big Three have emerged as what we call the New Permanent Universal Owners in many other markets beyond the United States. The Big Three have thus become major corporate owners in liberal and in coordinated market economies alike. The rise in passive asset management is therefore anything but a narrow technical phenomenon that only affects businesses and processes in the asset management industry. It may well change the fabric of capitalism, impacting the concentration of corporate control, corporate behaviour concerning short-termism and other key issues.

As the New Permanent Universal Owners, the interests of these asset managers diverge from the dominant notion of shareholder value. Rather than seeking to invest in tomorrow's winners in a specific market, they invest in entire markets as intermediaries for their end-investors. Not only can they not pick and choose; they are also unable to exit and sell their shares. Their interest is therefore with the long-term performance of markets, and this is indeed what they claim themselves as well. However, when we critically scrutinize whether they use their sizable and growing shareholder power to push management away from short-term and towards a long-term orientation, we have to conclude this is not (yet) the case. By and large they support management, including decisions to boost short-term shareholder value through massive share buybacks. From a strategic point of view, it may have made sense in recent years to avoid public discussions and therefore refrain from actively using the voting power while at the same time slowly but steadily engaging with management. We see some support for this strategy when BlackRock used its shareholder power and asked tough questions to gunmakers in the aftermath of the early 2018 school shooting in Florida (Kerber, 2018); moreover, there have been the first instances in which BlackRock and Vanguard have voted against management of large corporations, e.g. ExxonMobil and Occidental Petroleum. While this behaviour was arguably still more feeble than forceful, it may signal a slow development towards a more active role by the New Permanent Universal Owners, which could ultimately lead to what we have called forceful stewardship.

At the time of writing in mid-April 2020, it seems extremely likely that the coronavirus pandemic is leading to a deep global crisis – both in human and in economic terms. We argue that this pandemic represents an important, if tragic and partly preventable, natural experiment and crucial test for the future stewardship by the Big Three in the 2020s. The pandemic has led to a steep drop in financial markets and thus caused a drastic decline of the assets under management of BlackRock, Vanguard and State Street. A major part of the revenues of the New Permanent Universal Owners derives from fees that clients pay as a fraction of their assets under management. As a result, the revenues of the Big Three will decline substantially. While the Big Three are, of course, not able to directly prevent a catastrophic event such as a pandemic, they are able to directly influence how thousands of corporations in many countries of the world use their profits. One key example is the US airline industry. During the last decade, the largest US airlines have spent 96 per cent of their free cash flow on share buybacks (Kochkodin, 2020). The result is that they now exhibit a low resilience against the exogenous shock of the pandemic. Their focus on maximizing short-term shareholder value has made them fragile. This also holds for companies such as Boeing or General Electric. The firms of the S&P 500 index as a whole allocated about 50 per cent of their free cash flow for share buybacks in the last 10 years (Kochkodin, 2020). Much of this cash could have been used to build up cushions against external shocks of all kinds. Hawley and Williams (2000, p. xv) argued 20 years ago that universal owners, such as the Big Three, 'occupy a quasi-public policy position as having an economic interest in the long-term health and well-being of the whole society'. Arguably, in 'normal times' of steadily growing economies and financial markets this may be true, but is not overtly visible and can be ignored to a certain extent by the New Permanent Universal Owners. In extreme crises, however, this reality comes starkly to the fore.

Future research should study various different aspects of whether the Big Three engage with their portfolio companies and develop forceful stewardship in order to increase the resilience of the economy. Relevant aspects in this respect could include a minimum amount of sick days for all employees, a ban or significant reduction of share buybacks, and the avoidance of high levels of corporate debt. Furthermore, a key question is whether the Big Three act forcefully against excessively high executive remuneration, which drives economic inequality. Last but not least, researchers should focus on how the New Permanent Universal Owners develop and use forceful stewardship to tackle the relatively slow moving but ultimately very profound external shock of global climate change.

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