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Forget What Regulators Say: The Biggest Asset Managers Are Too Big to Fail

By Rabih Moussawi | 03/29/16 - 09:44 AM EDT

Do asset managers create risks that are systemic in nature? In other words, are they too big to fail?

Asset managers last year avoided getting labeled as systemically important financial institutions (SIFI) by the Financial Stability Board. The international organization refrained from singling out specific institutions and instead focused on market liquidity and leverage risks. If specific asset managers had received the SIFI status, which has already been given to some big banks, they could have become subject to tougher regulation.

Although many asset managers act as fiduciary agents and do not engage primarily in risky strategies or carry substantial risks on their balance sheets, an interesting report published by the **Office of Financial Research of the Department of Treasury** in 2013 illustrated several potential vulnerabilities of the asset management industry. Some of these can be systemic in nature. For example, the largest asset management institutions increase the concentration of risks at the company level, which can become a plausible source of systemic risk.

A recent research paper, which I co-authored with Itzhak Ben-David of Ohio State University, Francesco Franzoni of the University of Lugano) and John Sedunov of Villanova University, explores risk creation by the largest asset managers. The paper found that concentrated ownership by the largest asset managers is related to the volatility and risk characteristics of the stocks they hold, as these large institutions transfer some of their idiosyncratic shocks to these stocks.

Risk creation by asset managers has become particularly significant in recent years, due to unprecedented concentration in the asset management industry. Using 13F reports for institutions with more than $1 million in equity assets, we document that ownership as a portion of total stock market capitalization by *all* asset managers has doubled from 35% in 1980 to close to 70% in 2015. More importantly, the ownership by the *largest ten* institutions has increased, proportionally to the remaining institutions, from 15% in 1980 to 35% in 2015.

To put it in a different way, the largest institution in 1980 was roughly equal to about 25 random institutions that were not among the top 10. In 2015, it takes on average 360 random institutions to construct a portfolio as large as the largest asset managers in U.S. equity markets. We find that such a fat-tailed distribution of institutional investor size is related to the risk characteristics of the stocks they hold.

How could this happen? Our research shows that large institutions are not equivalent to a collection of smaller independent entities. Rather, they have an institutional identity that leaves a large footprint in the market. They are 'granular,' and idiosyncratic shocks to those large institutions are also 'granular' in that they can't be diversified away or absorbed by the market. Rather, they end up showing up in the returns of the stocks they hold.

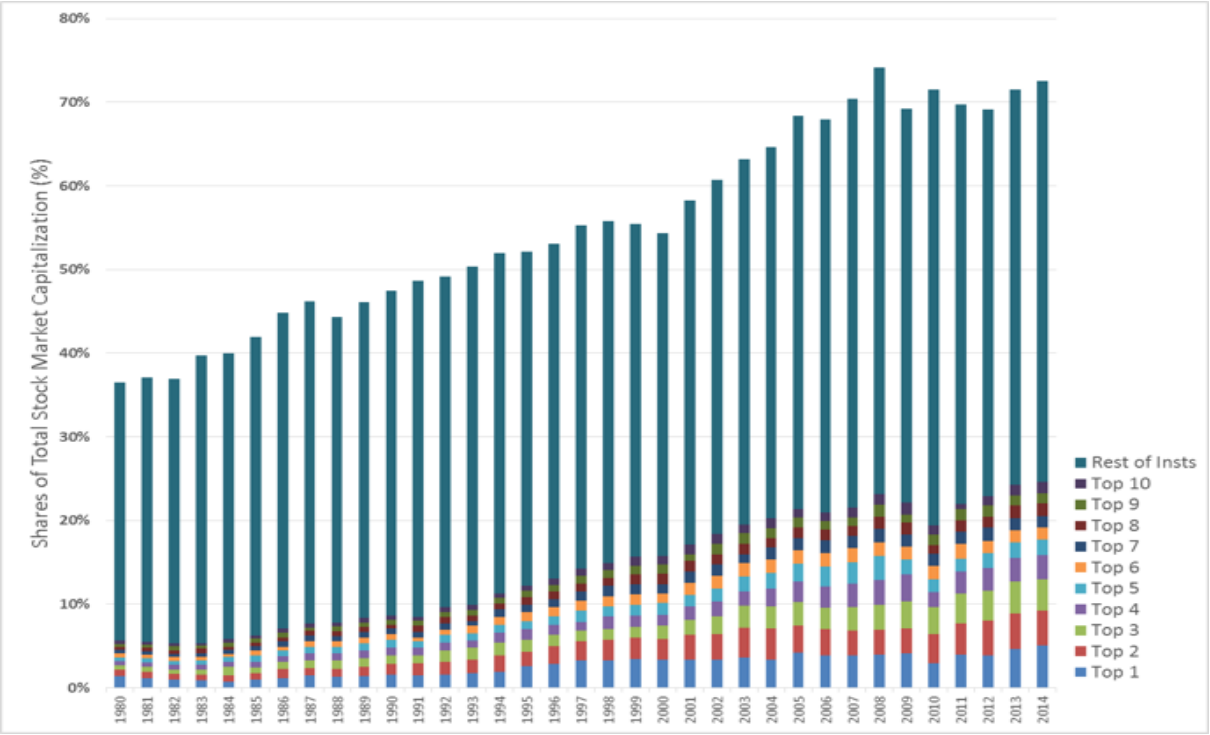

Chart 1: Ownership by the largest institutions versus overall institutional ownership in US Stocks

The concentration of assets gives rise to economies of scale but comes along with an increased concentration of risk which can have a systemic footprint. According to the OFR report, "Concentration of assets comes along with increased interconnectedness, complexity of operations, dependencies among various units that would improve the benefits from economies of scale and enhance the reputation of the large institution. However, it comes along with concentration of risks among funds or activities within a firm which may pose a threat to financial stability."

At times of market stress, counterparties might fail to distinguish between exposure to a distressed fund and exposure to the entire firm. These counterparties "could take risk-mitigating actions that could aggravate risks across the firm's funds and accounts." In a recent speech delivered to Congress last year on **Federal Reserve** policy regarding SIFIs, Federal Reserve Chair Janet Yellen suggested that such firms should "think seriously about whether or not they should spin off some of their enterprises to reduce their systemic footprint". This argument is directly applicable to the largest asset managers. Investors have been warming up to **MetLife**, the large insurer which recently announced it would split itself up, as the regulatory environment is too tough to continue trading in one piece. **GE Capital**, another of the four "SIFI" non-banks, is well on the way to getting rid of such label.

The asset management space has experienced many examples of idiosyncratic events at the institutional investor level that led to significant shocks to the financial system. At the peak of the Global Financial Crisis of 2008-2009, stocks held by hedge funds that had brokerage relations with the now-bankrupt **Lehman Brothers** experienced a drop in liquidity. In early 2012, **JPMorgan's** trader Bruno Iksil (the "London Whale") built a large short position in credit default swaps that led to trading losses exceeding $6 billion within weeks and distorted market prices of credit-linked securities. Moreover, on August 1, 2012, a glitch in an untested trading program at **Knight Capital** led to 4 million order executions in 148 stocks within 45 minutes.

These orders created losses of $440 million to Knight Capital due to the significant intraday price impact on many stocks. Lastly, the sudden departure of co-founder Bill Gross from Pimco on September 26, 2014 caused unprecedented large withdrawals from the fund. To fund the withdrawals, Pimco engaged in massive fire sales. For example, it closed more than 860,000 Eurodollar futures contracts (each with a notional value of $1 million). It is important to note that these idiosyncratic events need not be extreme to have an impact on asset prices. A large institution that initiates trades to accommodate investor flows, for portfolio rebalancing or risk management reasons may engage in trades that lead to price distortions.

Given that the evidence on the effect of large firms is so far anecdotal, our paper is among the first to show that the presence of large institutions leads to noisier stock prices. These results introduce new evidence into the debate on the risk created by large institutional investors. We control for a possible spurious relation, especially when large institutions hold more popular stocks that exhibit larger volatilities, and use two distinct identification strategies to address potential endogeneity concerns and tease out the causality in this relation.

We interpret the increase in volatility as the *causal* effect of the increase in institutional size. Our results suggest that a 1% increase in stock ownership causes an increase in stock volatility of about 12 to 18 basis points, relative to a daily average of 3.5%. This effect is economically significant given that the largest asset managers own a substantial fraction of the overall market capitalization. As the chart below illustrates, the largest three asset managers, with an average ownership of 10% in the last 5 years, are shown to impound their own shocks into the overall stock market, which leads to a 2.89% increase in the daily volatility of average U.S. common stocks.

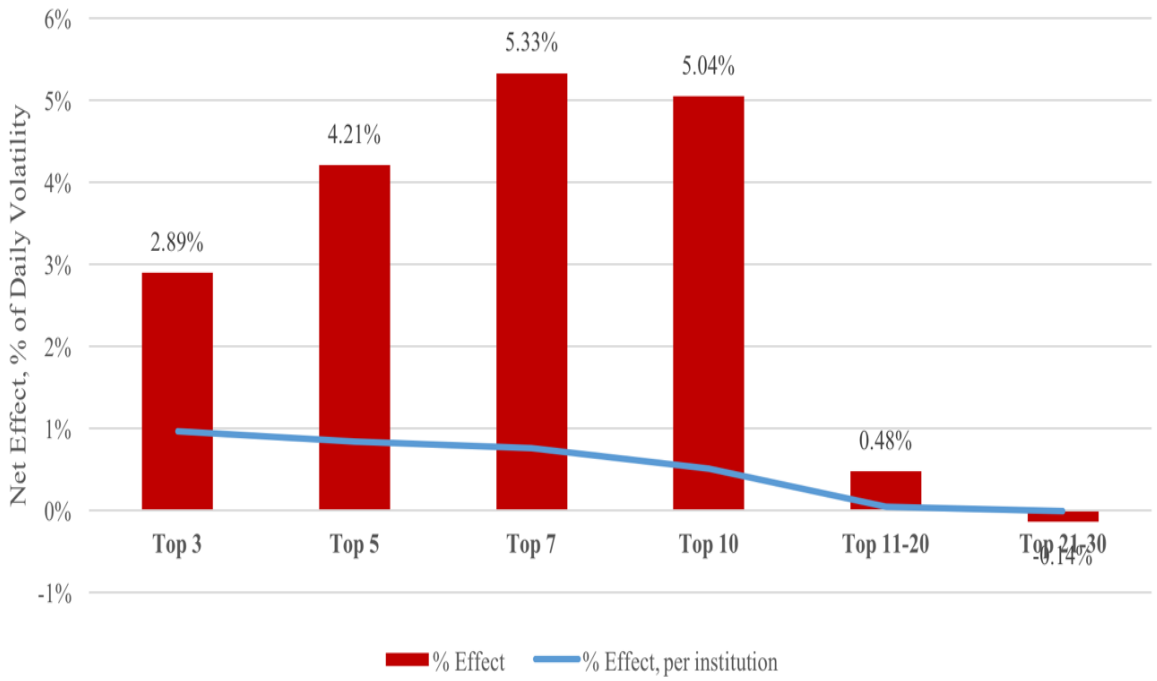

Chart 2: Net effect, as % of daily volatility, of ownership by the largest asset managers.

Overall, our study shows that ownership by large institutional investors increases the volatility in prices of the portfolio securities and noise in financial markets because of their large and concentrated trades, which translate into substantial price pressure. Moreover, large institutions have a 'granular' nature that leads them to trade in a less diversified way than a random collection of independent entities. Such evidence on the risk created by large asset managers, and spillover of such risk from large institutions into stock prices is consistent with regulators' concerns, especially that most of these risks are not observable, and they are manifested in some occasions only after it is too late.