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Portfolio Strategy

The Impact Of Concentration Of Assets At Institutional Fund Managers

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by: Larry Swedroe

Summary

- The trend to passive investing has led to a dramatic increase in the share of assets concentrated in the hands of a few large institutional fund companies.
- Their rising share has begun to raise concerns by regulators.
- There is a significant relation between ownership by top institutions and stock-level volatility - top institutions trade in larger volumes and have a greater impact on prices.
- During times of market turmoil, stocks with higher ownership by large institutions display significantly larger price drops.
- Large institutions impound liquidity shocks into prices, which then revert and lead to noisier prices.

The trend to passive investing has led to a dramatic increase in the share of assets concentrated in the hands of a few large institutional fund companies. The largest asset manager in the world, BlackRock Inc., best known for its iShares brand of exchange-traded index funds, has more than $7 trillion under management. Index pioneer, The Vanguard Group, has more than $6 trillion. The No. 3 indexer, State Street Corp., manages about $3 trillion. In January 2020, Bloomberg reported that “some 22% of the shares of the typical S&P 500 company sits in their portfolios, up from 13.5% in 2008. Their power is probably greater, given that many stockholders don’t bother to vote their shares.”

Their rising share has begun to raise concerns by regulators. Among the concerns are antitrust worries about index funds involving common ownership, when the same large investors own a big chunk of the shares in the major corporations in the same industry. In addition, regulators have expressed concerns about systemic risks that could result from the high concentration of assets under a few large actors. The main threat is that institutional investors, when experiencing redemptions, liquidate their portfolios and destabilize asset prices, propagating the effect to other investors’ balance sheets.

Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi and John Sedunov contribute to the literature with their July 2020 study, “The Granular Nature of Large Institutional Investors.” Their data sample covers the first quarter of 1980 to the fourth quarter of 2016 and contains 41 unique institutions that fell within the top 10 institutions at some point during the sample period. Following is a summary of their findings:

> "There is a significant relation between ownership by top institutions and stock-level volatility — top institutions trade in larger volumes and have a greater impact on prices. The economic magnitude of this effect has grown over time, coinciding with the rise in the importance of large institutions in financial markets. The effect is economically large: By the end of the period, a one-standard-deviation increase in the largest 10 institutions' ownership was associated with 16% of a standard deviation increase in volatility (over the full period, the increase was only about 3% of a standard deviation). During times of market turmoil, stocks with higher ownership by large institutions display significantly larger price drops. Behavior within subunits of a large firm display some correlation that limits internal diversification and exacerbates market impact — capital flows and trading strategies are more correlated across different entities within the same institution than across independent managers (likely a function of centralized operations such as research and risk management). And changes in portfolio holdings are significantly more correlated for mutual funds in the same family. Large institutions impound liquidity shocks into prices, which then revert and lead to noisier prices. In turmoil periods (the bottom 5% of the quarterly distribution), stocks with higher ownership by large institutions experienced significantly lower returns. A one-standard-deviation increase in ownership by the top 10 institutions was associated with lower quarterly returns by 9% of a standard deviation There was no effect on the level of returns in normal times."

Summary

Ben-David, Franzoni, Moussawi and Sedunov concluded that "ownership by large institutions is associated with higher stock price volatility, autocorrelation in returns (a measure of price inefficiency), and a greater magnitude of price drops at times of market stress (a measure of price fragility)." They added that during periods of market turmoil, large institutions, when engaging in liquidations, impose a high liquidity demand on the market: "This evidence supports regulators' concern that large institutions may be destabilizing during times of turmoil. … This last consideration supports regulatory concerns, and suggests that excessive concentration in the asset management industry may pose a systemic risk. Of course, any regulatory action should weigh the decrease in price efficiency and the increased potential of large price drops against the economies [of] scale in information production and trading that large institutions can achieve and can pass on to their clients."

Keep these issues in mind as you consider the relatively high level of valuations for the top few stocks in the S&P 500 Index. Their outperformance has increased their weight so that the top five — Microsoft (NASDAQ:MSFT), Apple (NASDAQ:AAPL), Amazon

(NASDAQ:AMZN), Facebook (NASDAQ:FB) and Alphabet (NASDAQ:GOOG) (NASDAQ:GOOGL) — now make up just over 20% of the entire index and more than the market cap of the bottom 350 stocks.

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