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A new finance capitalism? Mutual funds and ownership re-concentration in the United States

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Abstract

American households have vastly increased their participation in equity markets since the early 1980s, primarily through the purchase of shares in mutual funds. The resulting growth in assets managed by the mutual fund industry has been concentrated in a few fund complexes. Some of these – Fidelity in particular – have ended up holding very large ownership positions simultaneously in hundreds of US companies in the past few years, creating a latent network reminiscent of that operated by JP Morgan a century ago. Yet unlike the Morgan interests, mutual funds are relatively transient owners, rarely holding large ownership blocks for as long as 5 years. Moreover, funds are reticent to exercise their power, in part due to conflicts of interest. The result is that even the largest mutual funds are more likely to exit than to exercise voice, making the current version of American finance capitalism rather different from its predecessor.

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Introduction

Corporate ownership networks are common around the world, from the traditional bank-centered system in Germany to the chaebol in Korea and the cross-holding networks in Japan. Different national systems of corporate finance and governance breed different network formats, each with its own dynamics – centralized in the case of the German system, Balkanized in the case of Japan, and diffuse or even absent in the case of the United States. Yet it is evident from recent history that such systems are not immutable, as German banks sought to unwind their large-block holdings during the 1990s and keiretsu members in Japan reduced their mutual ownership positions. In this paper, I document the surprising re-concentration of corporate ownership in the United States over the past 20 years and argue that the United States has evolved a distinctive system of corporate ownership in which a small number of investment funds find themselves with substantial ownership positions in hundreds of corporations simultaneously. By global standards, these affiliation networks, in which firms are connected through common owners, are remarkably dense. Yet the large funds at their center typically eschew active participation in corporate governance, in stark contrast to other national ownership networks. I label this system of ownership without control the 'new finance capitalism', and argue that it entails a historically unique combination of concentration and liquidity. The system may be short-lived – financial crisis and political interventions aimed at limiting the power of 'Wall Street' have both played prominent parts in the history of American corporate ownership – but it is theoretically anomalous and worthy of investigation. This paper provides a preliminary exploration of its emerging features and aims to prompt further research.

Networks of corporate control centered around financial institutions are hardly new. A century ago, at the dawn of the corporate industrial age, theorists on both sides of the Atlantic described a new system of 'finance capitalism' in which banks effectively controlled large-scale industry. Industry had become concentrated due to cartels and trusts, on the one hand, and the advent of large-scale production, on the other (Chandler, 1977). At the same time, the professional managers at the top of these firms faced their own controllers. In the United States, banks had taken a hand in creating the new industrial system by engineering mergers among competitors, and the capital requirements of the new behemoths were too great to allow continued family control. Moreover, just as industry had become concentrated, so had finance, leaving a handful of banks holding positions of control across industry. Rudolf Hilferding (1910/1981) labeled this new system of oligopolistic industry controlled by oligopolistic banks 'finance capitalism', and Louis Brandeis (1914) described its operations in the United States on the verge of the First World War. Bankers – particularly JP Morgan – exercised their dominance of industry through networks of directors placed on the boards of their subject firms, yielding relatively stable interest groups with banks at the center. In some places, these systems had long-lasting effects: Kogut and Walker (2001), for instance, find that German firms were more likely to merge in the 1990s when they were connected through short paths of common ownership.

In contrast to other countries, however, bank-centered finance capitalism did not last long in the United States. Chandler (1977) and Roe (1994) point to several reasons: companies found that they could rely on retained earnings rather than debt provided by banks; a political backlash against the power of 'Eastern bankers' gained influence as high as the presidential administration of Woodrow Wilson after 1912; and bankers had minimal operational knowledge to contribute as board members. Moreover, large-scale public participation in the stock market after the First World War led to the dispersion of corporate ownership, a trend that accelerated during the late 1920s (Cox, 1963). Thus, by the early 1930s, Berle and Means (1932) found that 44% of the largest 200 corporations were under effective management control, with no ownership block large enough to exercise influence. This 'separation of ownership and control' held for decades, in large part due to political interventions intended to prevent financial institutions from gathering concentrated ownership positions again, from the Glass-Steagall Act of 1933 to the many subsequent regulations limiting ownership and influence by banks and funds (Roe, 1994).

The past 25 years have seen an even more dramatic growth of participation in the stock market than in the 1920s, coming to include over half of American households by 2001 (Aizcorbe *et al*., 2003: Table 6). But this time households participate primarily by buying mutual funds, not through direct ownership. Although referred to by enthusiasts at the Federal Reserve and elsewhere as the 'democratization of ownership' (e.g., Duca, 2001), the new system of widespread ownership is very much a *representative* democracy rather than a direct democracy, as financial intermediaries have come to own upwards of three-quarters of the average large corporation in the United States (author's calculations from Spectrum 13F database, 2005). In the early 1990s, commentators noted the growth of institutional ownership and contemplated its implications for corporate control, as activism by a handful of public pension funds (e.g., CalPERS, the California Public Employee Retirement System) seemed to be a harbinger of corporate governance reform driven by activist institutional investors (Davis and Thompson, 1994; Useem, 1996). Yet as legal scholars pointed out, there was little reason to expect a reprise of finance capitalism – networks of ownership organized around financial institutions – due to onerous legal restrictions that made it extremely difficult for financial institutions to accumulate ownership positions sufficient to exercise influence in any given company. 'Whether such networks are good or bad is worthy of discussion…the point here is not to evaluate the networks; the point is that politics either makes them costly or prohibits them' (Roe, 1990: 21).

A quarter-century into the age of shareholder capitalism in the United States, we now have a better sense of the contours of the new system of institutional ownership. Since the mid-1990s, a small handful of mutual funds – not public or private pension funds – have become the most significant large-scale corporate owners, due in large part to their management of 401k (personal pension) plans and the growth of retail investment. As a group, mutual funds hold almost 30% of US corporate ownership today, compared with 8% in 1990. Moreover, the industry's assets are highly concentrated in a few institutions. On any given day, the Fidelity mutual fund family is the single largest shareholder of roughly 10% of corporate America, and no other entity comes close. Mutual funds have discretion over buying, selling, and voting corporate equities, giving some of them the potential to exercise influence over large networks of corporate America. This is a concentration of corporate ownership in a few hands not seen since the early days of finance capitalism.

But it is also clear that Fidelity is not JP Morgan. There is no latter-day Brandeis or Hilferding decrying the power of financial oligarchs; if anything, commentators chastise Fidelity for *failing* to exercise its potential for corporate control, and for remaining overly passive in the face of widespread corporate scandals (e.g., Bogle, 2005). Such concerns were behind a campaign to require mutual funds to disclose their votes in corporate elections in the early part of this decade, a proposal that was opposed by virtually the entire mutual fund industry but was ultimately adopted by the US Securities and Exchange Commission in 2003 (Taub, 2007). This ruling has allowed researchers to document the degree to which mutual funds use their ownership positions to influence corporate governance, or avoid such influence.

In this article, I argue that a unique set of historical circumstances has led the United States to evolve a distinctive (and perhaps short-lived) system of finance capitalism in which ownership is concentrated in a few financial institutions that scrupulously avoid exercising active control. After describing the rise and fall of bank-based finance capitalism in the early 20th century, I analyze the arguments around concentrated ownership in the literature on corporate governance and the functionalist interpretation of dispersed ownership in the United States. I argue that mutual funds in particular – not institutional investors in general – have become the most significant corporate owners in the United States, due in large part to a shift in pension financing in the United States. I show the prevalence of different blockholders over the past decade and document that a small number of actively managed mutual fund families – Fidelity in particular – persistently dominate the list of the largest corporate blockholders, thus sitting at the center of a vast ownership network. Yet I also show that, in the case of Fidelity and Capital Group, these large ownership positions are not particularly long-lived, with most gone within 3 years. Drawing on prior research, I argue that conflicts of interest prevent Fidelity from taking a substantial role in governance reform, in spite of the seemingly compelling reasons for doing so. Networks of concentrated yet liquid ownership without control seem to be the distinctive feature of the new finance capitalism.

Finance capitalism and the rise and fall of managerialism

Although bank-centered systems of corporate governance are relatively common around the world, the United States has long been held as an exemplar of market-centered corporate governance. But from the merger wave of the 1890s until the First World War, the American corporate economy was largely centered around a small number of New York banks. As documented by Louis Brandeis in *Other Peoples' Money* in 1914, three banks and their leaders – George F. Baker at First National, James Stillman at National City, and JP Morgan – formed a powerful 'money trust' that exercised wide-ranging control over the largest railroads and industrial companies and prevented 'unhealthy competition' among the oligopolists that they had helped create or grow. Through a combination of concentrated ownership, debt provision, and by placing their associates on corporate boards, members of the money trust 'joined forces to control the business of the country, and "divide the spoils"'(Brandeis, 1914: 27). Bank-centered networks of shared directors were the most visible manifestation of finance capitalism. Baker personally served on 22 boards, and other First National directors served on 27 more; Stillman served on seven boards, while his National City colleagues were appointed to another 41 corporate boards; and members of JP Morgan held '72 directorships in 47 of the largest corporations of the country' (p. 32). Brandeis surely counts as one of the original corporate network theorists, declaring that 'The practice of interlocking directorates is the root of many evils. It offends laws human and divine. It is the most potent instrument of the Money Trust' (p. 51). Such network ties could be used to dominate subject firms: 'When once a banker has entered the Board – whatever may have been the occasion – his grip proves tenacious and his influence usually supreme; for he controls the supply of new money' (p. 11). They could also be used for collusion at the expense of consumers; for instance, JP Morgan affiliates simultaneously served on the boards of rivals Westinghouse and General Electric, as well as competitors in railroads and other industries.

More recent research has documented some of the features of the system and helped to disentangle whether the ties served primarily for domination, collusion, or some other purpose. De Long (1991) showed that between 1910 and 1912, having a JP Morgan partner on a firm's board was associated with a 30% higher equity valuation relative to comparable firms. He asked how Morgan was able simultaneously to charge high fees, place directors on corporate boards, and maintain a huge market share in an industry with few obvious barriers to entry. His proposed answer is the one provided by the bankers themselves at the time: 'Without domination of boards of directors by the investment banking oligarchs, there would be no effective way for scattered individual shareholders to monitor the performance of corporate managers. Only investment bankers could effectively monitor firm managers, and so the presence of investment bankers on boards signalled to ultimate investors that the firm was competent and industrious'. Moreover, the bank's incentives favored maintaining a reputation as an honest broker on even the smallest deal: their large market share would be threatened by failing to exercise good judgment at all times, and thus the investing public – realizing this – would prefer firms under Morgan control. The firm's reputation was such a valuable asset that it compelled the bank to play fair. Indeed, buyers of a firm's securities might even demand that Morgan place a representative on the firm's board as a sign that their interests would be looked after.

Simon (1998) provided further evidence on this question by examining what happened to the share prices of firms inside and outside the Morgan circle when the bank announced that its directors would resign from the boards of 30 of its 'subject' firms but maintain board membership on several others. (The resignations were aimed at forestalling legislation intended to limit bank control, a potent political issue at the time.) The results showed that firms in which Morgan directors resigned declined in value relative to the market – but so too did their competitors, indicating that much (but not all) of the value added by Morgan's men came from their ability to maintain cartelization, rather than by acting as superior monitors on behalf of shareholders.

But by all accounts, finance capitalism in the United States rapidly fell apart around the time of the First World War. All four presidential candidates in 1912 favored greater regulation of big business, and banks were particularly vulnerable (see Roe (1994) on the long-standing popular mistrust of concentrated finance in the United States). The Clayton Act of 1914 forbade shared directors among competitors and prevented bank representatives from serving on the boards of competitors. Morgan's men had withdrawn from dozens of companies in 1914, and the old 'communities of interest' highlighted by Brandeis unwound. Moreover, during the 1920s firms increasingly relied on retained earnings rather than bank loans, further limiting the influence of bankers. And perhaps most importantly of all, households greatly expanded their equity ownership during the market boom leading up to the crash of 1929. Efforts to sell war bonds during World War I created a retail distribution channel for securities that, for the first time, brought Wall Street to Main Street. Retail brokerages built on this precedent, and acceptance of stock ownership by those outside the wealthiest tier grew during the 1920s as the stock market boomed (see Fraser (2005) for an accessible history). The number of shareholders doubled from 2.4 million in 1924 to 5 million in 1927, and doubled again to 10 million by 1930 (Cox, 1963). The result, amply documented by Berle and Means (1932), was widespread dispersion of stock ownership in an increasing number of the largest US corporations – the famous separation of ownership and control.

The consequences of dispersed ownership could be malign – managers might overpay themselves, build unwieldy empires, and stack the board with cronies to evade responsibility to their shareholders. Or they could be benign, with the corporation's professional managers treating the organization as a social institution with obligations to its employees, customers, and communities. But in either case, the absence of a single owner holding a significant block of shares meant management was in control, at least according to Berle and Means (1932) and four decades of subsequent scholars. Finance capitalism, centered around profit-oriented banks wielding control of capital, had been replaced by managerialism. As C. Wright Mills (1956: 125) put it in *The Power Elite*, 'Not "Wall Street financiers" or bankers, but large owners and executives in their self-financing corporations hold the keys of economic power'. Networks of shared directors were still a pervasive feature of corporate America, according to Mills, but they had little to do with financial control; they were, in effect, a manifestation of elite cohesion among a relatively autonomous managerial class.

By the 1960s, however, theorists in law and economics began to question the orthodoxy around managerialism. Although the *presence* of an outside ownership block was clear evidence that outsiders had control, the *absence* of such a block did not thereby imply that management was in control, or that shareholders could be ignored. Manne (1965) argued that the stock market provided a running scorecard on management performance as well as an enforcement mechanism for shareholder interests. Firms whose share price dipped low enough provided an attractive opportunity for outsiders – particularly competitors in the same industry – to buy the firm on the cheap, fire its managers, and turn it around for a profit. Jensen and Meckling (1976) gave a more pointed critique of managerialism on logical grounds: 'How does it happen that millions of individuals are willing to turn over a significant fraction of their wealth to organizations run by managers who have so little interest in their welfare?' (p. 330). Perhaps JP Morgan could not personally keep a leash on management, but surely investors were smart enough to avoid handing their money over to firms run by unaccountable managers – and without investors, managers would be unemployed.

Following on Manne's argument, Jensen and Meckling argued that managers have incentives to pay attention to share price even in the absence of a large shareholder, and that they spontaneously structure the corporation to be appealing to shareholders. Moreover, ownership dispersion did not just happen – dispersion or concentration were endogenous: 'If the costs of reducing the dispersion of ownership are lower than the benefits to be obtained from reducing the agency costs, it will pay some individual or group of individuals to buy shares in the market to reduce the dispersion of ownership' (p. 352). Demsetz and Lehn (1985) documented such an effect in the early 1980s, finding that firms with large ownership blocks tended to be those that would most benefit from monitoring and control by an outside blockholder, such as those with more variable performance. Furthermore, ownership concentration had no subsequent effect on performance. Ownership concentration, in other words, was an effect, not a cause, and in equilibrium firms got the level of ownership concentration they deserved.

This work in law and economics marked a sea change in thinking about corporate governance in the United States, and there followed a proliferation of theorizing about the mechanisms that led corporations to orient around shareholder value. Following the lead of sociobiologists, scholars reconsidered the functions behind prevalent features of the so-called managerialist corporation and its institutional surround (see Davis (2005) for a review and critique of the 'functionalist theory of corporate governance'). Working backwards from the assumption that share price is an accurate indicator of corporate value, theorists argued that the American 'shareholder value' system was a miracle of efficiency that could be documented and exported as a blueprint for other nations as they expanded their financial markets. Dispersed corporate ownership was described by Berle and Means as a lamentable consequence of large scale, but it was now seen as a positive accomplishment of a well-articulated institutional matrix. Indeed, based on comparisons of ownership concentration around the world, financial economists in the late 1990s argued that it was *concentrated* ownership that should be a cause for concern, as it indicated that minority investors were not well-protected (e.g., in nations suffering from code law; see Davis and Useem, 2002).

Ironically, just as the theoretical case for dispersed ownership was being made by academics, corporate ownership in the United States was becoming more concentrated in the hands of institutional investors. The proportion of shares owned by institutions increased from about 35% in 1980 to half by 1990, and to almost three-quarters by 2005. Yet it was also clear that the 'institutions' covered under the umbrella term 'institutional ownership' were a diverse group with potentially divergent interests, ranging from public and private pension funds to mutual funds to proprietary funds run by banks. Different institutions had different stances with respect to activism on corporate governance: most avoided it entirely, and activists varied in what issues they pursued, from straightforward reforms (e.g., requiring annual election of directors) to more politically charged questions (e.g., divesting from particular countries or industries on ethical grounds). Nearly all shareholder proposals failed to achieve a majority of votes; and those that did were generally merely advisory (Del Guercio and Hawkins, 1999; Gillan and Starks, 2000; Karpoff, 2001; for a review see Davis and Useem, 2002).

Moreover, the growth in *aggregate* holdings by institutional investors was accompanied by a similar growth in the *number* of institutions, meaning that ownership may have remained just as dispersed as it always had been. CalPERS, for instance, did not own as much as 5% of a single New York Stock Exchange-traded company as of 2000. Without a large ownership stake it was unclear how influential any particular institution could be. And this situation was itself the result of a long political history aimed at preventing the revival of finance capitalism. As Black wrote in 1990, '[I]nstitutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes or undertake joint efforts. Legal obstacles are especially great for shareholder efforts to nominate and elect directors, even to a minority of board seats' (Black, 1990: 523). Thus, the two primary features of finance capitalism – networks of concentrated ownership and board representation – were both infeasible for institutions.

In the next section, I analyze the changes behind the partial reversal of this situation during the 1990s. While institutions still avoid seeking board representation, a few of them have amassed substantial ownership blocks in hundreds of companies, due in large part to changes in pension financing and tax laws. Although these laws were by no means passed to encourage institutional blockholding, this has been their effect.

The expansion of household participation in equity markets

As theorists were documenting the American system of shareholder-oriented corporate governance, the number of shareholders began a long rise that was even more expansive than the one in the 1920s. Beginning around 1982, the level of household participation in the market increased from roughly 20% (where it had been since the early 1960s) to over 50% in 2001. (See Figure 1. Data in this section come from the Federal Reserve Board's triennial *Survey of Consumer Finances* – see http://www.federalreserve.gov/ for data and publications.)

There were several related trends behind this movement (see US Congress Joint Economic Committee, 2000). First, bank savings accounts lost their allure as the government-mandated cap on interest rates failed to keep pace with inflation. The proportion of households with a bank savings account declined from 77% in 1977 to 44% in 1989. Financial innovations such as money market accounts and mutual funds, typically invested in corporate and government bonds, provided a more appealing outlet for savings and introduced savers to mutual funds. Second, the transaction costs for equity mutual funds declined substantially, as did the minimum required investment, thus opening mutual funds up to mainstream clients. Duca (2001) documents a strong correlation between declining transaction costs and levels of household investment in mutual funds.

Finally, tax laws favored the creation of private retirement accounts, particularly since 1982, and corporate employers increasingly replaced defined benefit plans (corporate-run funds that pay specified benefits to workers upon their retirement) with defined contribution plans (i.e., accounts in which employees contribute pre-tax earnings into individual accounts, often with a matching contribution by their employer). These plans are ultimately owned by the employee, not the employer, making them transferable when workers change jobs. The most common plans offer employees a set of five to ten mutual funds as options, and well-known equity funds are particularly popular

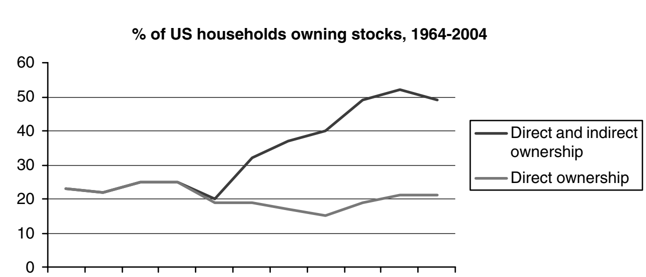

Figure 1 Household stock ownership in the United States (from Federal Reserve Survey of Consumer Finances, various years).

choices. Moreover, rampant concern about the long-term viability of Social Security (the US government's mandatory pension plan) has further encouraged participation in private pension plans. Thus, the growth in assets managed by mutual funds was in large part attributable to the growth of so-called 401k individual retirement accounts.

The result of these mutually reinforcing developments was an unprecedented flood of household savings into the stock market. Household savings seemed to migrate from bank savings accounts, to money-market accounts, to equity mutual funds. According to Fraser (2005: 583), 'More was invested in institutional funds between 1991 and 1994 than in all the years since 1939'. This provided the raw material for a stock market boom in the 1990s and a vast increase in the prevalence of institutional ownership. By 2005, roughly 72% of the median Fortune 1000 corporation was owned by institutions rather than directly by individuals, up from 35% in 1980 (author's calculations from 13F filings compiled by Spectrum). Corporate ownership had become overwhelmingly intermediated by institutions rather than held directly by individuals.

The primary beneficiaries of this growth in equity ownership in the United States are mutual funds (known in the UK as 'unit trusts'). Equity mutual funds take in investments from buyers and invest them in shares. Their organizational structures are occasionally Byzantine, and thus the entity that is the 'owner' for legal purposes is the fund adviser (e.g., Fidelity Management & Research in the case of the Fidelity funds; Capital Group in the case of the American Funds; see Taub, 2007 for details about mutual fund organization). Mutual funds have been around in the United States since the 1920s but were generally the province of the well-off prior to the 1980s, and most of their purchasers were the kinds of households that would also be likely to purchase shares directly. Mutual fund organizers can either be free-standing institutions (e.g., the Fidelity and Vanguard families) or part of a larger financial institution (e.g., the Dreyfus funds, owned by Mellon Financial, formerly the parent of Mellon Bank).

Most large funds are actually complexes or families of funds, each with different objectives and orientations. Fidelity, for instance, includes both huge funds such as its flagship Magellan as well as dozens of smaller funds, with well over 300 funds in total (see www.fidelity.com). Fund families also differ on whether they manage funds internally or contract with external managers. The three largest fund families – Fidelity, Vanguard, and American Funds, each with over $1 trillion in assets – are primarily internally managed. They also differ in their investment approaches: Fidelity and American Funds are actively managed, meaning that fund managers seek to buy shares in companies expected to go up in value and sell shares in companies expected to go down. (Mutual funds have historically been restricted in their ability to sell shares short, thus limiting their ability to bet on downward movements.) Vanguard, in contrast, is best known for its index funds, in which specific mutual funds track a specific index (such as the Standard & Poor's 500) by buying balanced positions across all firms in an index. Index funds thus typically end up with smaller ownership positions in a larger number of companies.

Thanks to the flood of new investment, the mutual fund industry has grown enormously since 1982. The number of mutual funds increased from 564 in 1980 to over 8000 in 2000 at the end of the 1990s market boom. And their assets under management increased from $134 billion in 1980 to over $10 trillion in 2006. According to the Investment Company Institute, the trade association for mutual funds, about half of US households are now invested in mutual funds, typically due to participation in 401k plans. (Data on mutual funds come from the Investment Company Institute's *Investment Company Factbook*, various years – see http://www.icifactbook.org/.)

Although these figures might give the impression that the industry's growth has been even, in fact the lion's share has gone to a handful of fund families that are known to typical consumers. According to figures compiled by the Investment Company Institute, the market share of the top five fund families has stayed roughly constant at approximately 38% since 1990. Thus, the brand-name funds – Fidelity, Vanguard, American Funds, T. Rowe Price, Janus – have become the largest owners of corporate America. Fidelity's assets under management, for instance, increased from $111 billion in 1990 to $1.1 trillion in 2005. This ongoing concentration is due to a number of factors. Mutual funds are able to use a portion of their assets under management for marketing purposes, and so the bigger the fund, the more the resources available for advertising (which accounts for the ubiquity of advertisements for Fidelity and Vanguard in the financial pages). Larger funds are also in a better position to be included among the choices offered to participants in 401k plans, perhaps the most important source of new fund purchases. Finally, the largest funds were among the first to capitalize on the opportunities offered by the shift to defined contribution pension plans. Fidelity, for instance, is the 'recordkeeper' for pension plans at dozens of large corporations (Davis and Kim, 2007).

Who are the new blockholders?

Data on ownership block document the fact that it is a small number of mutual funds – not public pension funds, banks, or other institutions – that account for the most significant growth in block ownership. Owing to amendments over various years to the Securities Exchange Act of 1934, Section 13, particular categories of owner must file forms with the Securities and Exchange Commission documenting the size of their ownership positions and, in some cases, their control intentions. First, any entity (including a 'group') that passes a threshold of 5% of any class of stock in a listed company must divulge its stake and control intentions (a) when it crosses the 5% mark (form 13D) or (b) annually for some kinds of investors (form 13G). Second, any institutional investor holding more than $100 million in equity assets must disclose the contents of its portfolio each quarter (form 13F). The Act is fairly expansive in its definition of who (or what) counts as an owner, defining a 'beneficial owner' as 'any person who, directly or indirectly, through any contract, arrangement, understanding relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of such security; and/or (2) Investment power which includes the power to dispose, or to direct the disposition, of such security…All securities of the same class beneficially owned by a person, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person'. Thus, investment advisors such as Dimensional Fund Advisors and Wellington Management are frequently considered blockholders by this definition because they 'directly or indirectly…direct the disposition' of securities by advising dozens of institutional clients.

Table 1 shows the five largest blockholders of all corporations traded on the New York Stock Exchange and included in the Compact Disclosure database from 1999 to 2005 inclusive. (The data were compiled by the author from the Spectrum database of 13D and 13G filings, as reported in various years of Compact Disclosure.) The number of NYSE-traded firms reporting at least one 5% ownership block varied between 1450 and 1600 during this time period, which represented about three-quarters of listed firms during any given year. Notably, in every year Fidelity held by far the largest number of substantial ownership blocks of NYSE-traded corporations. (As investment advisors, DFA and Wellington both filed a large number of 13Gs due to the technical requirements of the Exchange Act, but unlike integrated mutual funds they did not necessarily exercise combined investment and voting control on behalf of their clients. AXA was required to report aggregate holdings on behalf of the corporate parent, but this typically combined ownership positions independently controlled or advised by its various subsidiaries, including Equitable Life Insurance, Alliance Capital Management (now AllianceBernstein), and other entities.)

Capital Research, advisor for the American Funds, was the second largest 'integrated' owner through 2002, when it was replaced by Barclays Global Investors, sponsor of the iShares exchange-traded funds (ETFs). ETFs are analogous to indexed mutual funds but they trade directly on the market, allowing individual investors to buy or sell them like other securities. Also like integrated mutual funds, their investment advisor (in this case, Barclays Global Fund Advisors) directs the proxy votes controlled by the fund.

The implication of this discussion is that mutual funds – particularly the very largest mutual funds, such as the Fidelity and American Funds families – have become by far the most significant owners of corporate America. Unlike other large institutions, they have the ability to buy, sell, and vote the shares of large blocks of hundreds of corporations. Thus, when we speak of the potential power of 'institutional investors', it is appropriate to specify that it is a few mutual funds, through their relatively concentrated ownership, that have the greatest potential influence on corporate governance. Notably, it is not the mutual fund industry in the aggregate that is powerful; it is those funds that are *both* very large *and* actively-managed, as they are the ones able to amass (and liquidate) large ownership positions in a large number of firms. Vanguard, for instance is large but not concentrated; its ownership almost never passes the minimum threshold of 5% that is widely regarded as necessary for some degree of control. It is, in short, Fidelity and the American Funds that matter most.

In the next section, I contrast the distinctive features of the original finance capitalism with its contemporary echo and ask how the ownership networks of the largest mutual funds compare with those of their predecessors.

Table 1 Five largest holders of 5% blocks in firms traded on the New York Stock Exchange, 1999–2005 (compiled from Spectrum 13D and 13G databases; number of blockholdings in parentheses)

1999	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Fidelity (352)	Fidelity (320)	Fidelity (369)	Fidelity (416)	Fidelity (427)	Fidelity (434)	Fidelity (464)
DFA (273)	DFA (299)	DFA (277)	DFA (260)	Barclays (264)	Barclays (307)	Barclays (345)
Capital Research (192)	Capital Research (224)	Capital Research (161)	Capital Research (207)	DFA (228)	DFA (211)	DFA (209)
Wellington (91)	AXA (134)	AXA (135)	Wellington (163)	Capital Research (201)	Wellington (183)	Capital Research (185)
Putnam (80)	Wellington (126)	Wellington (155)	AXA (142)	Wellington (187)	Capital Research (175)	Wellington (166)

Concentrated ownership by mutual funds: a new finance capitalism?

The original finance capitalism in the United States arose out of the consolidation and growth of industrial corporations and their vast needs for capital. Three banks – JP Morgan, National City, and First National, all headquartered in New York – each exercised control over a network of firms through a combination of ownership, access to debt, and placing representatives of the bank on the boards of their subject firms. It was evident to both insiders and outsiders which network a firm belonged to, and indeed the stock market gave a premium to corporations in the Morgan network (De Long, 1991). In many cases, the banks had taken a hand in the creation of the corporation by arranging mergers among competitors and suppliers. The result was a set of discrete interest groups organized around particular banks, reminiscent of the bank-centered networks in other advanced industrial nations.

The new finance capitalism differs from the original in several ways. First, mutual funds acquire their ownership by buying shares on markets through an arms-length process. There is no equivalent of a JP Morgan, creating the firms through shear force of finance. Indeed, Fidelity has become the largest US shareholder through a process that the firms themselves may be unaware of. Many corporate executives may only learn that Fidelity is their largest shareholder when they find out about it through a securities filing by the fund. Second, mutual funds have no obvious influence over the financing decisions of firms, and in any case do not have privileged control over access to debt. And finally, large mutual funds studiously avoid nominating directors, with extremely rare exceptions. Black (1990) notes that 'The SEC, stretching the case law as is its usual wont, takes the view that an institution that has "expressly or impliedly "deputized" an individual to serve as its representative on a company's board of directors" is deemed to be a director for both reporting and profit-forfeiture purposes' (p. 546). The fund, in other words, becomes an insider, with all that this implies. Thus, 'When Peter Lynch, a Fidelity director and the manager of the Fidelity Magellan mutual fund, became a director of W.R. Grace, Fidelity required *all of its funds*, not just Magellan, to sell their Grace stock' (Black, 1990: 547–548).

I next turn to a brief examination of Fidelity. I focus on Fidelity not because it is somehow representative of the mutual fund industry in general – it is not – but because it is particularly significant on its own. Fidelity is now perhaps the largest shareholder in the United States, holding the single largest position in roughly one on 10 public corporations, a situation that even JP Morgan could not claim in its turn-of-the-century heyday. Figures 2 and 3 show how Fidelity's ownership position has increased since the early 1990s. The population of firms includes all corporations traded on Nasdaq and the New York Stock Exchange and covered by the Disclosure database. (Data in these figures were compiled by the author from the Spectrum databases of 13D and 13G (blockholder) and 13F (institutional ownership) filings, various years.) In 1990, when Peter Lynch retired from managing the Magellan Fund after 13 years, Fidelity held stakes of 10% or larger in just over a dozen companies and was the largest

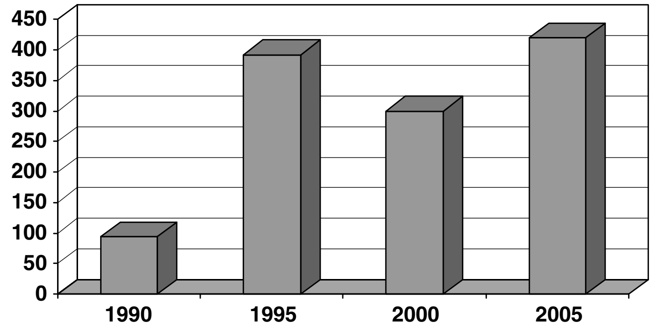

Figure 2 Number of companies traded on Nasdaq and the New York Stock Exchange in which Fidelity is the largest shareholder (compiled from Spectrum 13D, 13F, and 13G databases).

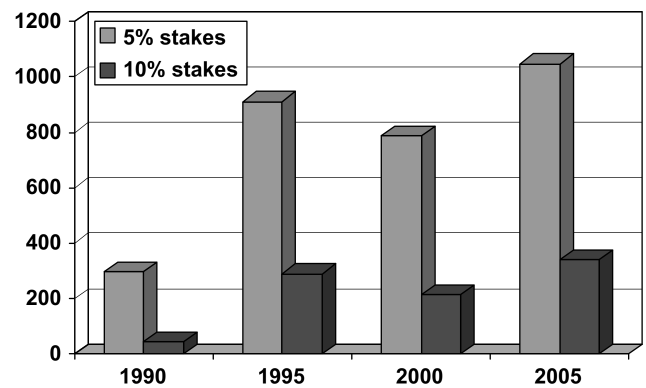

Figure 3 Number of companies traded on Nasdaq and the New York Stock Exchange in which Fidelity owns 5% or 10% of shares outstanding (compiled from Spectrum 13D and 13G databases).

shareholder of roughly 100 companies, out of the nearly 4000 US corporations traded on Nasdaq and the New York Stock Exchange. Five years later, the number of companies traded on these markets had increased to over 5000, while Fidelity's 10% stakes had increased to 290, and it was the largest blockholder in almost 400 US corporations. By 2005, the number of traded companies had declined to roughly 4400 (from a high of over 5800 5 years previously, before the Nasdaq bubble burst). Fidelity was the largest shareholder in 420 of them, holding 10% stakes in 341.

It is worth pointing out that Fidelity accumulates these large stakes through a relatively undirected process. A 10% stake held by Fidelity in the aggregate typically consists of smaller stakes held in several funds. The Fidelity family currently contains over 300 different funds with diverse management objectives and investment styles, and it is their managers that generally make buy and sell decisions. That is, unlike its rival Vanguard, which consists primarily of index funds, Fidelity's funds are primarily actively managed by separate fund managers. But, of course, it is not coincidental when several of them make similar choices, as all of them draw on guidance from the same internal research analysts. Thus, when Fidelity research analysts say 'buy airlines', dozens of fund managers do, leaving Fidelity with large stakes in the aggregate.

Although Fidelity's stakes arise 'spontaneously', however, the firm is coordinated in its ability to exercise control. All shares held by Fidelity are voted as a bloc according to a firm-wide policy (see Rothberg and Lilien (2006) and Davis and Kim (2007) for discussion of proxy voting guidelines by the largest mutual funds). Thus, it is neither the funds' shareholders nor their managers that determine Fidelity's votes on corporate proxy elections, but a firm-level body. This is what gives Fidelity great potential power: as the largest single shareholder in hundreds of companies, it has the ability to adopt voting policies that can change the outcomes of corporate elections.

More importantly, it seemingly has strong incentives to vote in ways that maximize shareholder value. Shareholder activists offer similarly worded propopsals at dozens of corporate annual elections in the United States each year, and therefore the effort required to parse proposals can be amortized over many elections. If it is good practice for corporations to have annual elections for all directors, rather than having one-third elected each year, then a fund can choose to vote the same way on every proposal to require annual elections. Moreover, Black (1990: 585) shows that in addition to economies of scale in voting on such 'generic' issues, large shareholdings increase the incentives for informed voting exponentially, not linearly: 'A shareholder who owns 100 shares has an incentive to become informed 10,000 times greater than a shareholder who owns a single share'. According to this model, Fidelity has a far greater incentive to vote in favor of corporate governance reform than any other shareholder in history.

Thanks to new regulations by the Securities and Exchange Commission in 2003, it became possible to examine the proxy votes of all US-based mutual funds starting in August 2004. An examination of votes by the largest mutual fund families by Davis and Kim (2007) revealed several regularities. First, according to its voting record, Fidelity was by far the most management-friendly large fund. Examining six shareholder proposals on corporate governance issues that were opposed by management (requiring an independent board chair, repealing poison pills and golden parachutes, expensing stock options, requiring annual election of directors, and allowing cumulative voting), Fidelity voted in favor of the proposals 33% of the time, compared to 51% for Vanguard, 62% for TIAA-CREF (the private pension fund for college professors), 70% for American Funds, and 86% for CalPERS (Davis and Kim, 2007: Table 3). No other fund came close to Fidelity for its pro-management stance on governance issues. This is in notable contrast to in Europe, where the *Wall Street Journal* reports that Fidelity 'has taken a leading, and public, role in some high-profile disputes between shareholders and management both in the United Kingdom and on the Continent. That willingness to pursue battles openly is in contrast to Fidelity's approach in the US, where the firm traditionally prefers to work behind the scenes' (*Wall Street Journal*, 28 October 2003).

Second, across all mutual funds studied, the degree to which a fund voted with management (i.e., against shareholder proposals for governance reform) was highly correlated with the amount of business a fund's parent did with corporate clients, which in turn is highly correlated with the size of the fund. Specifically, the more pension management business a fund did with large corporations, the less likely it was to vote against management (Davis and Kim, 2007). This was true regardless of the size of the ownership position the funds held: Fidelity tended to vote with management whether its stake was large or small, in clients and non-clients alike. Thus, even in a situation where 'activism' bore no direct cost at all, Fidelity failed to adopt an activist stance with respect to corporate governance.

If Fidelity amasses large stakes with relatively little fanfare, what about the other direction, when the fund seeks to liquidate its holdings? It has long been thought that concentrated ownership implied a relatively long-term connection, as some ownership positions would seem to be too big to sell. In 1994, Davis and Thompson wrote:

> The increased size of institutional investors' holdings limited their ability to divest from firms with which they were dissatisfied. Previously, institutions that were dissatisfied with management would typically do the Wall Street Walk and sell their stake rather than confront management. When one's stake is large enough, however, selling out depresses the share price and harms the seller; in addition, for the largest funds, the number of alternative investments is limited. Faced with such a high cost of exit, voice – shareholder activism – became more appealing (Davis and Thompson, 1994: 154).

Yet this is false – or at least not entirely true. Examination of Fidelity's large shareholdings demonstrates that Fidelity routinely liquidates very large ownership positions – not overnight, but over time. Of the 13 firms in which Fidelity held a 10% or greater stake in 1990, it was still a large shareholder in only 18% 5 years later; 10 years later it held none of the same large positions. Among its 1995 large (10%) stakes, it held 13% of them 5 years later, and 9% of them 10 years later.

Figure 4 provides a more fine-grained analysis of this process. Drawing on the same data reported in Table 1, this figure shows the number of years that Fidelity and the American Funds continued to hold a 5% or greater stake in a company in which it reported such a stake at the end of 1999. For Fidelity, nearly one-quarter of its large stakes were dropped the subsequent year, and two-thirds were gone at the end of five years. American Funds had a slightly smaller 1-year dropoff, but less than one-third of its large holdings in 1999 were still there at the end of 2004. This is not to say that all companies have an equal chance of being deleted, of course: Fidelity maintained large stakes in

Figure 4 Length of holding period for New York Stock Exchange firms in which Fidelity or American Funds held a 5% stake at the end of 1999 (compiled from Spectrum 13D and 13G databases).

approximately 80 NYSE-traded companies from 1995 to 2005 inclusive. But the average large portfolio firm has a relatively brief life in the Fidelity network.

Thus, the new system of institutional ownership entails a surprising combination of concentration and liquidity. Fidelity may own large blocks of vast networks of portfolio companies, but these networks are evanescent. In contrast to the German corporate network (e.g., Kogut and Walker, 2001), the nodes in the American corporate network may not realize that they are part of Fidelity's network until after it is done, and they may not know they have lost their membership until some time later. Moreover, even corporations that employ Fidelity to operate their pension plans – a major source of revenues for the fund company – are not immune, as Fidelity is no more likely to maintain long-term ownership relations with their clients than with other firms. (Data on corporate pension fund client relationships compiled from Department of Labor Form 5500 filings by Judy Diamond Associates; author's analysis.)

Why Fidelity opts for exit, not voice

Expectations of scholars at the dawn of this new era of institutional ownership were that large owners would be compelled to exercise voice, not exit (e.g., Davis and Thompson, 1994; Useem, 1996). Yet by most accounts, Fidelity is almost relentlessly passive. If they are powerful, why don't they use their power to influence corporate governance or corporate strategy? Indeed, part of the reason that Fidelity has evaded much scrutiny may be because of its passivity. According to a review of research on large blockholders, 'Studies infrequently address the stock ownership of outside blockholders who do not serve on the board of directors…large-block shareholders or their representatives *almost always* serve as directors or officers' (Holderness, 2003; emphasis added). This is clearly false: to my knowledge, there is *not a single instance* in which Fidelity has nominated a director for an American corporation, much less placed a 'representative' on such a board. (Peter Lynch independently served on a pair of corporate boards in the early 1990s – Morrison-Knudsen and W.R. Grace – both of which endured notable governance failures and ended up in bankruptcy.)

There are three reasons why mutual funds owning large stakes might remain passive. First, there are legal restrictions. Bernard Black (1990) documents the surprising restrictions on large shareholders, enacted over the course of decades to keep financial institutions separate from – and powerless with respect to – industrial corporations (see also Roe, 1994). In particular, funds passing a 10% ownership level are, for some purposes, treated as 'insiders' under the law, and thus efforts to exercise control can put them in a position of liability with respect to minority investors.

A second reason is conflicts of interest, as we have seen. One result of the great growth of the largest mutual fund families is that their prospects for superior performance, and thus for further investment inflows, were sharply limited. A trillion-dollar fund has difficulty remaining limber in its investments, particularly given expansive disclosure requirements. Thus, several of the largest funds, and Fidelity in particular, moved aggressively into other lines of business. The most obvious candidate is pension fund management for corporations, where Fidelity is now the largest vendor. Indeed, more than one in five of the 1000 largest US corporations hire Fidelity to do at least some pension business (Davis and Kim, 2007). Moreover, Fidelity has drawn on the investments in infrastructure it built up in its pension business to move aggressively into broader outsourcing of human resource functions. Ned Johnson, Fidelity's CEO (and son of the founder) was quoted as saying 'What mutual funds were to the first 50 years of Fidelity, benefits outsourcing will be to the next 50 years', and the firm projected that benefits administration would account for half of its revenues by 2013 (*Wall Street Journal*, 3 January 2003). As a result, the firms where Fidelity might seek to be an activist are also highly likely to be actual or potential clients. This has a clear potential for stifling even low-level activism, as the previously reported results on proxy voting demonstrate; indeed, there is a nearly perfect correlation between pension business and pro-management voting (Davis and Kim, 2007). Thus, American Funds – whose parent had about one-quarter as many pension clients among the Fortune 1000 as Fidelity – was twice as likely to vote against management as Fidelity, although it too faces growing conflicts of interest from its pension business.

Finally, the Wall Street Walk is still easier than activism. Even a 10% owner faces the dilemma of collective action: the benefits are spread among all shareholders, while the costs are borne only by the activist. Given the uncertain payoff, the prospect for liability, and the potential to alienate actual or potential clients, the cost of exerting overt control may not be worth the expected benefit.

Conclusion

The new American system of finance capitalism is still in its early stages, and it is premature to begin speculating about a general theory. After all, the original finance capitalism lasted less than two decades in the United States, and ended somewhat abruptly at the onset of the First World War. It is certainly possible that the current version will be even more short-lived, as financial crisis may end the attraction of mutual funds. And as Table 1 demonstrates, the identities of the largest blockholders can shift rather dramatically in a brief period. Owing to the massive success of its iShares exchange-traded funds, Barclay's went from essentially nothing to the second-largest shareholder on the New York Stock Exchange in under a decade. Thus, it is risky to predict what the situation will be even a decade hence.

My aim in this paper has been more modest: to explore the origins and some of the emerging features of the 'new finance capitalism', in which ownership is both concentrated and liquid, and in which active control is largely avoided. Mutual funds grew big, and a few of them grew enormous, largely due to the shift of American retirement funds from defined benefit plans (associated with particular employers) to defined contribution plans (invested in mutual funds). As Americans put their retirement and other savings into mutual funds, the funds grew into the largest blockholders, with the potential to exercise influence across a broad swath of corporate America. Yet legal rules limit their ability to exercise overt influence, and as vendors in the pension market themselves, the largest mutual funds face conflicts of interest that curtail their activism. Thus, rather than seeking control over portfolio firms, the funds maintain their liquidity, and their large holdings rarely last for more than a few years. This combination of concentration and liquidity characterized both of the largest actively managed funds, Fidelity and American Funds. Vanguard, in contrast, has 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.

On the surface, the ownership networks created by Fidelity and some of its largest competitors are far denser than those of any other nation (cf. the other papers in this volume). The large German banks, for instance, could never claim 10% ownership of 400 public corporations at any one time. Yet it is also clear that these networks are somewhat evanescent, and thus far show little sign of translating into overt control. This is historically unique: large blockholdings are generally associated with influence, if not outright control, and ownership networks imply a relatively long-lived connection among firms and owners. The new finance capitalism is thus theoretically puzzling, and its durability remains to be seen.

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