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The Potential Benefits of a Public Asset Manager

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Introduction: The Importance of a Public Option in Asset Management

Asset managers—financial institutions like BlackRock, State Street, and Vanguard—manage trillions of dollars for US households and workers; as of the fourth quarter of 2020, US pension funds held $23.3 trillion in total financial assets, while mutual fund assets were $14.5 trillion (Board of Governors of the Federal Reserve 2020a). However, these private asset managers focus on their own profits and on increasing the financial value of assets under management, instead of prioritizing the true interests of those whose financial savings they manage—such as interests in a healthy environment and sustainable economy. To provide an option for asset owners that enables asset management to better serve the public interest and to increase competition in the asset management industry, which is extremely concentrated, we propose establishing a public asset manager, which would be a public financial institution, serving the public interest. This issue brief explores the evolution of the asset management industry and explains how establishing a public asset manager would be one solution to shift the financial system toward serving the actual interests of the people and social systems on which it depends.

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Asset managers take on the responsibility of managing funds, such as pension and mutual funds, into which individuals and families place money—whether on their own or through their employer. In theory, these funds are meant to serve the interests of those who part with income or savings to purchase financial assets—though "interests" has been incorrectly defined as simply financial interests, rather than the broader interests households have in a healthy planet and sustainable economy.[1] Asset managers choose how to direct the financial assets in their care, engage in corporate governance with the companies where they direct assets, and earn fees by increasing their assets under management (AUM). These assets are traditionally viewed as resources available to companies pursuing innovation

[1] For more on the interests of households holding financial assets, see Palladino and Alexander (2021), "Responsible Asset Managers: New Fiduciary Rules for the Asset Management Industry."

in the goods and services economy, even though they are mainly traded amongst asset holders, meaning that funds do not actually flow to companies. The asset management industry has grown rapidly over the last several decades, and asset management leaders like Larry Fink are key voices in economic policymaking. Yet asset owners—households and workers saving for retirement with their employer or individually—do not have a choice in whether or not their assets are managed by a private asset manager, nor do they have a voice in the corporate governance decisions that asset managers make. Establishing a public option for asset management is therefore critical.

This brief illustrates the potential of a public asset manager to assert the public's voice in issues of corporate governance, for example by voting for asset allocation toward decarbonization and divestment from fossil fuels. It examines the current framework that guides how household financial assets are invested, the reasons why today's financial system fails US households, and the benefits that a public asset manager would provide to households across the country. Specifically, we first describe the current focus on shareholder primacy in corporate governance and the workings of the "financial intermediation chain"—that is, how household capital moves through the financial system and is invested in corporate equity. We then discuss the growth of private asset managers over the last few decades, demonstrating the control they currently have over both household capital and corporations. Finally, we summarize two primary benefits of a public asset manager: one, as an entity with the ability to redirect household investments in a manner that is aligned with their overall economic interest in a healthy planet and equitable economy; and two, as a public option that changes the incentives for private asset managers and reduces their ability to extract household wealth for themselves.

The Current State of Household Asset Allocation

Most non-wealthy US households save for retirement and other financial lifecycle goals by purchasing financial assets—usually corporate stocks and bonds. The notion that middle-class households save for retirement by holding corporate stock justifies the dominant corporate governance ideology of

"shareholder primacy," which claims that the purpose of corporate production is to increase the wealth of shareholders. However, shareholder primacy is a flawed conception of the corporation that is used to justify manager and corporate board decisions to increase share prices by squeezing labor costs or using pollutants in production processes, or by choosing to spend corporate profits on stock buybacks, which enrich share sellers at the expense of shareholders. This framework is also flawed because while about half of US households do own some corporate stock, the wealthiest 10 percent of US households own 85 percent of corporate stock in terms of its dollar value. These wealthy, almost entirely white households are the main beneficiaries of corporate shareholder primacy (Palladino 2021).

As households have shifted from owning stock directly (as they did in the early and mid-20th century) to placing their savings in pooled funds, which are then managed by asset manager companies, non-wealthy households generally have no sense of actual ownership of specific corporate stocks—nor do they engage in corporate governance. As we discuss in detail below, a few asset managers have become dominant in the 21st century, greatly influencing what corporations do and how long-term projects are privately funded. Concentrated power exercised by a few financial institutions has historically contributed to economic challenges and prompted public policy responses (Kotz 1979; Steele 2020). To avoid a concentration of decision-making power over key corporate decisions and to shift away from shareholder primacy, a public policy response is needed. One path forward is establishing a public option for asset management, which has the potential to change both the kinds of economic projects for which household financial assets are used, as well as where the benefits from asset appreciation flow.

The Distribution of Corporate Equity & Retirement Accounts

It is important to recognize the stark wealth inequality and systemic racial wealth gap in the US (Board of Governors of the Federal Reserve 2021)—which are even more pronounced when it comes to

corporate equity ownership. As of the third quarter of 2020, the top 10 percent of US households by wealth held 70 percent of wealth, and white households (which constituted 65 percent of households) held 85 percent of wealth. This extreme concentration is critical to understanding the dynamics of the financial intermediation chain, and it is important to recognize the reality that the benefits of corporate shareholder primacy flow mainly to wealthy, white households. Nevertheless, the scale of current household financial assets under management means that ignoring this pool of resources, the distribution of its returns, and how asset managers vote their shares on behalf of beneficiaries is not an option. Transforming how corporate equity is invested must be paired with new duties for asset managers pushing them to consider the impacts of their investment choices on all of society, not just on those who hold corporate equity.

Financial asset ownership is even more concentrated than other major asset classes: The top 10 percent of US households by wealth own 88 percent of non-pension corporate equity and 50 percent of pension entitlements. When viewed by income percentile, the bottom 40 percent of US households by income hold just five percent of pension entitlements and the bottom 80 percent hold just 13 percent of non-pension corporate equity and mutual funds. White households hold 90 percent of corporate equities and mutual funds, Black households hold 1 percent, and Hispanic households hold 0.4 percent (while the rest is held by an “other” category). White households hold 80 percent of pension entitlements, while Black households hold 8 percent and Hispanic households hold 3 percent (Board of Governors of the Federal Reserve 2021).

The share of households with retirement accounts is broader: 35 percent of Black households have a retirement account, as do 25 percent of Hispanic households. By contrast, 57 percent of white households have retirement accounts (Board of Governors of the Federal Reserve 2020b). Over half of households in the middle of the income distribution (between 40 and 60 percent) have a retirement account (Board of Governors of the Federal Reserve 2020b). However, actual dollar holdings are very different at the median for Black, Latinx, and white households, as can be seen in Figure 1 below:

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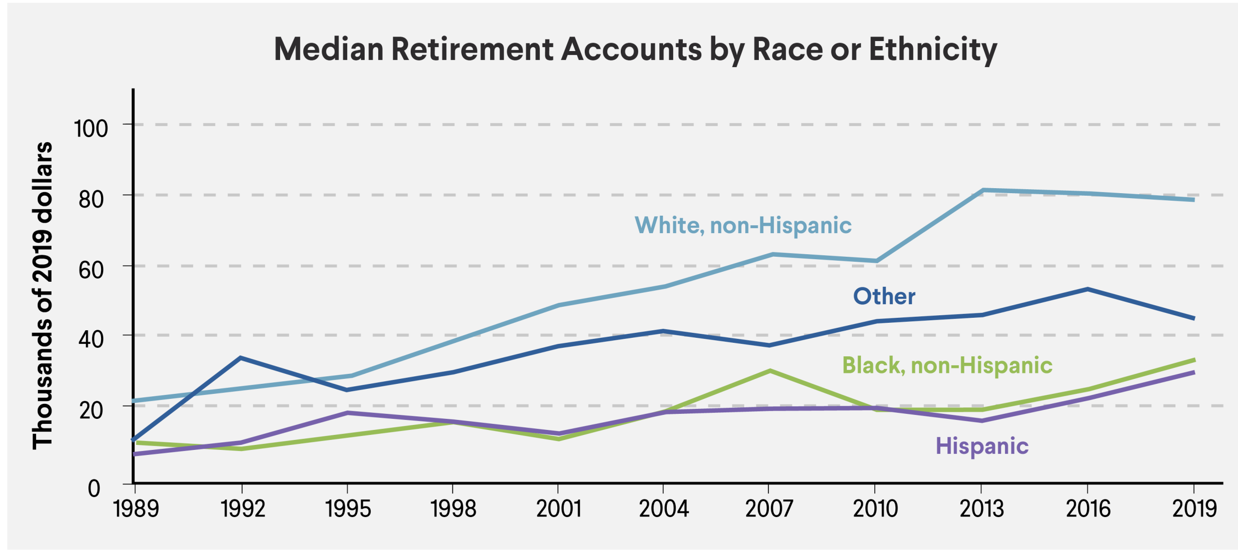
Figure 1



Source: Survey of Consumer Finances.

The main financial asset of non-wealthy households is a retirement account. Retirement assets include IRAs; DC plans; private-sector, state and local government, and federal DB plans; and Annuities. While there has been an overall growth of retirement assets in the last 10 years, both IRAs and DC plans have seen significant increases. In 2007, IRAs and DC plans made up over 50 percent of the total value of retirement assets; by 2019, that number had risen to 60 percent. The implications of this distribution of assets are that while most financial wealth is concentrated among wealthy, white households, a far larger set of households are impacted by the decisions made within the financial system. For the majority of households, the economic benefits they earn from their investments are based on allocation decisions made by asset managers and decisions regarding production and innovation made by companies producing goods and services.

How Household Savings Are Allocated: The "Financial Intermediation Chain" and the Rise of Asset Manager Capitalism

The "financial intermediation chain" refers to the way most household financial assets move through multiple institutions to become invested in corporate stock, bonds, or other financial instruments. Of

course, wealthy households often invest directly either by buying specific corporate stocks on the national stock exchanges, or by investing through wealth managers in private funds that are only available to wealthy households.[2] The recent proliferation of "retail investing" using apps like Robinhood has drawn attention to individual investing, but the reality is that most household financial assets that are invested are still channeled through multiple institutions—a pension or mutual fund, which delegates decision-making to an asset manager and which then may invest in its own funds, hold equity that is traded on the stock exchanges, or hold bonds and other financial instruments.

To understand the impact of this financial intermediation chain on households, it is important to first distinguish between "beneficial" (or economic) and "legal" ownership of corporate equity in the financial intermediation chain (Strine 2007). Typical employees can open a 401(k) account through their employer. The employer organizes the assets held by all employee 401(k)s in a mutual fund. If the employee is at a company that offers a pension plan, or works for the public sector, where pensions are more common, the employee pays into the pension fund and is either guaranteed a certain amount of money at retirement (called a "defined benefit" pension), or simply gets back what has been earned in the plan (a "defined contribution" pension). When an employee changes jobs, if they've had an individual 401(k), they generally can transfer the funds into an individual account that they hold directly at a financial company, usually referred to as an IRA (Individual Retirement Account). All of these types of funds are household financial assets.

However, fund management does not stop there—these pooled funds then delegate responsibility for the decisions of what financial assets to buy to an "asset manager." The asset management industry helps to relieve individual investors of the responsibility of deciding what funds to invest in and places it on asset managers instead. These asset managers ultimately decide how to direct the money that households have passed along to them, and, in turn, are the main actors interacting with corporate

[2] For more details about accredited investors, see (SEC 2021).

leaders in the governance process. Because household funds have been pooled, asset managers have the option to direct them to companies whose stocks are publicly traded, to mixed stocks and bonds, or to private funds that would otherwise be off-limits to the non-wealthy, such as private equity funds and hedge funds.

The stated goal for asset managers is to increase the dollar value of the assets under their management. But distinguishing the actual incentives of asset managers and household savers is critical, as is understanding the laws that currently govern asset manager behavior, and the structure of the asset manager industry in the 21st century. In legal terms, the funds are the "legal" owners of corporate equities, while households are the "beneficial" owners—the economic actors who are ultimately supposed to get the economic gain in exchange for entrusting their assets to the funds, and who empower the asset manager to make decisions and pay them a fee. In other words, the gains—and losses—from the increase in the economic value of stocks flow to the beneficial investor (the employee or household) while asset managers are compensated in fees based on the size of the pool of assets that they manage, which incentivizes them to try to capture market share and increase the amount of money under management as much as possible.

Over the past few decades, the asset management industry has grown significantly and has become increasingly concentrated, which means that households and pooled funds, such as pension and mutual funds, do not have many options when it comes to asset management. There are three major asset managers, which have come to be known as "The Giant Three"—State Street Global Advisors (SSGA), Vanguard, and BlackRock. As the percentage of corporate equity held by asset managers generally has grown, SSGA, Vanguard, and BlackRock have increased the percentage of ownership held just between the three of them. In 1998, the three combined held only 5 percent of the total ownership of corporate equity, but by 2017, the three held 20.5 percent—demonstrating just how concentrated the ownership of corporate equity is within these three asset managers alone (Bebchuk

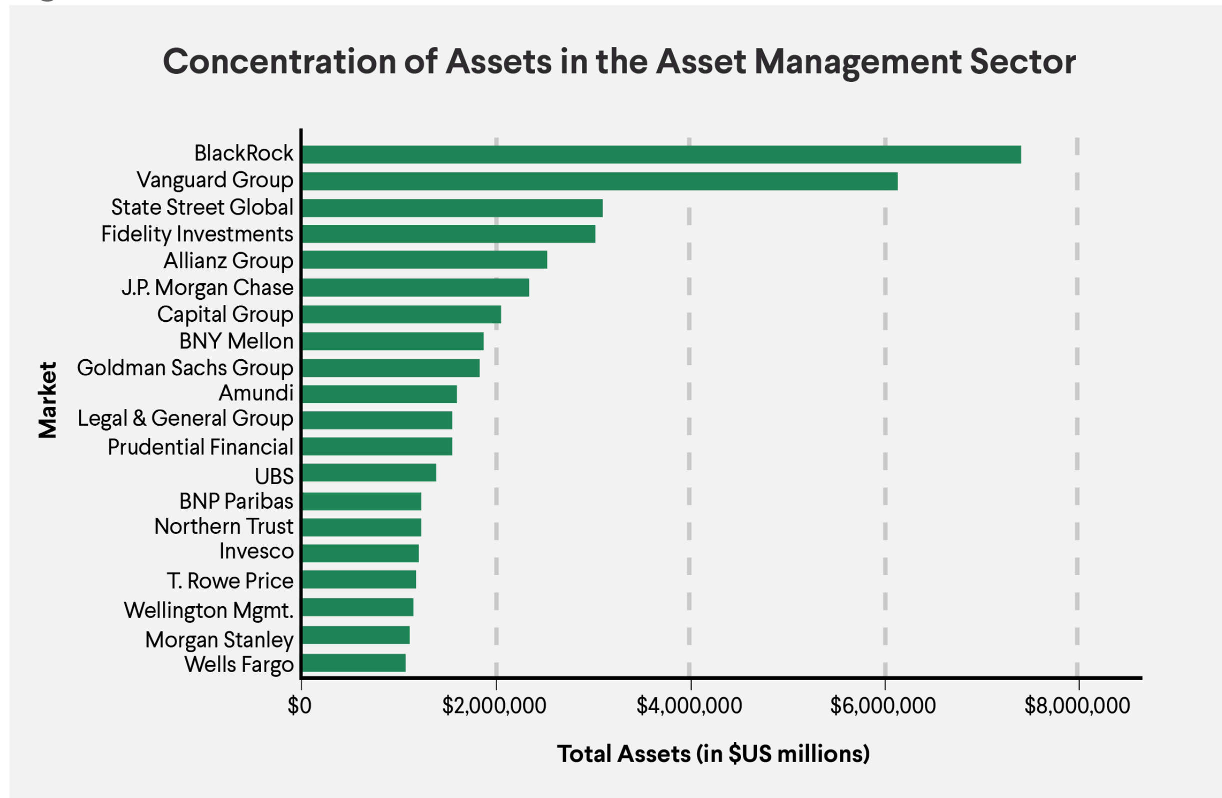
and Hirst 2019).[3] This increased concentration of ownership has also increased the ability of asset managers and their index providers to alter what counts as an acceptable, safe, or otherwise promising investment (Petry, Fichtner, and Heemskerk 2019). The federal government recognizes the outsized power that these companies have, but rather than regulate them, it has hired them: In 2009 and 2020, in the midst of financial crises, the Federal Reserve outsourced management of corporate bond buying programs to BlackRock (Steele 2020). This resulted in BlackRock's own Exchange Traded Funds (ETFs) becoming much more valuable, and BlackRock CEO Larry Fink having a major voice in economic policy (Smialek 2021).

Asset managers participate directly in corporate governance *on behalf of* their economic beneficiaries, and thus vote as shareholders. Asset management stewardship teams therefore have a lot of power to decide how to vote on critical issues, with few meaningful avenues available for their beneficiaries to voice objections if a decision is taken against their collective wishes. According to a 2019 analysis, the "Big Three" coal, oil, and gas reserve holdings grew by 34.8 percent from 2016 to 2019; asset managers could have used this increase in fossil fuel holdings as a chance to take aggressive action to curb climate change on behalf of household beneficiaries, such as through accelerating the deactivation of coal-powered generation, limiting further pipeline development, or pushing the industry to consider transitioning away from selling fossil fuels for energy consumption. Yet a recent report by Majority Action found that BlackRock and Vanguard voted against nearly all shareholder resolutions calling on fossil fuel and other companies to take aggressive action on climate (Majority Action 2020). Though BlackRock has taken some climate-related actions to improve public relations, like joining the coalition Climate Action 100+, it has not followed through with substantial efforts to truly address climate change, voting against the coalition's own proposals to take on climate change risk. Without

[3] To further add to the picture of the growth of the asset manager industry, it is important to note where most of these holdings are located geographically. Most asset manager holdings are concentrated within North America, and this has remained the same over the past decade. In 2007, North America had the greatest portion of holdings, at $24 trillion. As of 2018, North America continues to hold the most, with $35.2 trillion. North America has also seen the largest increase in asset manager holdings in the past decade, though other regions have seen an increase as well. Between 2007 and 2018, Europe went from $13.7 to $20.5 trillion, Japan and Australia together from $4.3 to $6 trillion, Asia from $2.3 to $7.2 trillion, and the Middle East and Africa from $0.9 to $1.3 trillion.

regulatory changes to asset manager fiduciary duties, and a public asset manager to transform market incentives, the Big Three asset managers will likely continue to block corporate governance actions meant to reduce the threat of climate change, thus directly hurting the actual interests of households whose assets they manage.

Figure 2



Source: Boston Consulting Group, https://www.bcg.com/publications/2020/global-asset-management-protect-adapt-innovate.

The stated goal of the financial intermediation system is to enable households to benefit from the expertise of asset managers and the supposed cost savings from pooling their funds. However, it is increasingly common for new employees to have their assets invested in an index fund, which means that the asset manager does not actively decide which stocks to hold in the portfolio, but instead simply allocates all of the pooled assets using an externally defined index meant to mimic the entire stock market.

Another problem for workers has been when their pension funds (i.e., their retirement savings) are invested in private equity companies, which operate separately from the publicly traded financial markets.[4] Private equity companies focus on either loading up financially healthy companies with debt or taking over distressed goods and services companies, before selling them for a profit. When a company that has been purchased by private equity goes bankrupt or restructures, its workforce bears the burden (Stewart 2019) as they are laid off and often lose pensions built up over time. Institutional investment in hedge funds, another form of a private financial fund, has also captured high fees from public and private pension funds, while not increasing financial returns (some major funds, however, such as New York City's public pension funds, have taken notice and withdrawn from hedge funds).

A Public Option for Household Financial Asset Management

"Public option" institutions are government economic actors that provide goods and services to the public in a market where private-sector firms also provide the same goods and services. This increases competition among businesses providing the goods and services, while also increasing public benefits, as a public institution does not have the same incentives for profit maximization. Public options can be found in the goods and services sectors and in the financial sector and have been effective in asset markets. In the words of Levitin and Wachter (2013), public option financial institutions serve as "functional regulation," though unless the public purpose of the institutions is protected, they can become re-privatized and contribute to the very market failures they were meant to solve. Still, the development of public options such as the "American Mortgage" by governmental housing finance agencies have shaped the entire market for housing finance; as described by Levitin and Wachter (2013, 1115), "by having the government as a market participant with substantial market presence, the government has been able to set the terms on which much of the market functions." Government participation in financial markets backstops deposits at commercial banks with the Federal Deposit

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[4] Institutional investors that pool individual workers' funds are able to invest as "accredited investors" in private equity funds, even though the same individuals could not invest in the funds directly unless they are wealthy and therefore permitted to invest in private companies under the securities laws.

Insurance Corporation (FDIC) and pensions through the Pension Benefit Guaranty Corporation. As another example, the proposed "public option" in health insurance would go beyond Obamacare to provide a *public* source of health insurance for all Americans rather than limiting the public option to low-income and elderly Americans.

Currently, there is not a public option for asset management, meaning that pools of household financial assets cannot choose a public institution when it comes to determining who will manage their funds. Creating a public option for asset management will incentivize private asset managers to improve their products and services while also reducing the fees charged to workers and retirees. To be clear, households will still save funds for their individual accounts through their employer retirement funds or a private fund, such as a mutual fund. But a public option for pension funds, 401K funds, and IRAs would reduce the ability of private asset managers to extract value from households and ensure that asset management actually serves the interests of households who are handing over control of their financial assets. A public asset manager would hold legal title to household financial assets in private funds as a fiduciary, just as private asset managers do, meaning that the public institution would have control over deciding what corporate stocks or other financial instruments to purchase with the funds that it holds. For funds that choose to be "universal owners," meaning they invest in index funds that broadly track the market, a public asset manager could provide a low-cost way to access the index and ensure that the economic benefits of holding financial assets flow directly to the economic beneficiaries (i.e., those whose money it is).

A public option for asset management would have several positive benefits. For one, it would be able to direct funds into investment vehicles that have public benefit purposes—such as decarbonization—taking into account the actual interests of households and not just the short-term fluctuations of the stock market or short-run returns. For example, one proposal for a public asset manager, developed by Cornell Law School Professor Saule Omarova, would enable a public asset manager to develop funds for decarbonization projects that are available to a broad range of asset owners (Omarova 2020). A

public option for asset management would also be able to act in the public interest in its corporate governance engagement with the companies or investment vehicles in which it invests. A public asset manager can view its "stewardship" responsibilities as a shareholder of corporations as a means to encourage broad-based prosperity and innovation, rather than engaging in short-term extractive practices.

There are several core features of our financial intermediation system that contribute to the need for a public asset manager. The first is that the high fees captured by private asset managers are paid ultimately by households. A public asset manager, on the other hand, would not charge the same exorbitant fees as private asset managers. The public option would therefore increase competition in the asset management sector and provide a baseline set of asset management services accessible to all, such that private asset managers would have to improve their quality of services in order to continue to attract a customer base.

The second feature of the financial intermediation system is that fund and asset managers are currently bound to consider only what will raise the financial value of the fund as they make their investment decisions. These fund "fiduciaries" have a duty to protect the interests of their beneficiaries, which has been interpreted as requiring them to focus all their effort to encourage higher asset prices, even if, for example, they are investing workers' retirement funds in a company that is trying to outsource the jobs of those very same workers (Webber 2018). This narrow focus on financial interests means that the negative consequences of corporate behavior, continuing carbon dioxide emissions, and failing to prepare for an eventual transition of workers out of fossil fuel industries do not matter to the fund manager, as long as share prices continue to go up.

If we recognize that households investing through the financial intermediation chain live on the same planet that companies are putting at risk through their contributions to climate change, we see clearly that household interests are best served when their investments are directed in ways that advance

decarbonization and reduce economic inequality. A public option would allow households and fund managers to channel their funds toward investments that serve their actual interests as human beings and members of society (as long as institutional reform is paired with reforms to the fiduciary duties of private and public asset managers alike).[5]

A public asset manager would also fundamentally change the options available to large pools of household capital. The business model of asset managers claims, in essence, that through their management, funds will grow more quickly through smart investing, making households better off. They argue that their investment services are worth the fees that households pay indirectly. However, not only do households face the general negative consequences of private equity's impact on job losses and avoidance of steps to mitigate climate harm, there is also increasing evidence that such funds lose out financially as well. In other words, funds would be better off simply investing in an index fund that tracks publicly traded stock than investing through private actors. A public asset manager would allow households to have their assets managed by an institution that keeps the public interest in mind, an option that has not been available to date. This same asset manager could create specialized indexes to leave out the most pernicious activity—including fossil fuel investment—while reducing fees and other participation costs currently heaped on households. Additional specialized investment funds could be created under the public umbrella to seek out promising sources of long-term investment and provide them with (public) equity capital. The public assets created by a government decarbonization program—including those by a green bank or National Investment Authority—could be held in trust for the public by the public asset manager, further boosting the investment authority's ability to continue decarbonization investment (Omarova 2020). The returns from these stakes would ensure public, long-term returns without the extractive excesses of current private equity.

A public asset manager would enable the public to have a crucial voice in corporate governance decisions *and* on the kinds of assets viewed as acceptable investments. Private asset managers are

[5] For further details on potential reforms, see Palladino and Alexander (2021).

supposed to participate in corporate governance vis-a-vis goods and services companies, theoretically holding them accountable to the interests of their beneficiaries. On the other hand, these same companies are themselves competing to manage the employee retirement funds of the companies in question. Research has found that these conflicts of interest for asset managers do prompt pro-management voting when the asset manager also holds the assets of that company (Taub 2009). This perverse set of incentives is reminiscent of the problems in the credit rating agency industry that led to the 2007 financial crisis and prompted calls for a public credit rating agency (Diomande, Heintz, and Pollin 2009).

In designing a public option for asset management, it is important to consider how a public financial institution would be governed and what rules would determine the responsibility of its decision-makers. A key policy reform necessary for its success would be a clarification of what true asset manager fiduciary duty means—in other words, how do the decision-makers understand their responsibilities to the households who entrust them with their financial assets. Thus far, fiduciary duty has been understood too narrowly, as simply the duty to increase asset values in the short-term as much as possible, rather than taking into account the reality that some assets go up in value by creating costs that the rest of society has to bear. This is clearly the case with climate change, as the costs of pollution and resource extraction have been externalized from energy companies and businesses generally and shouldered by the broader society. Thus, requiring trustees to see their duty as being responsible to the *actual* interests of households means investing and engaging in corporate governance so as to mitigate societal harms, including climate change and economic inequality, because the households whose capital is being invested ultimately bear the costs of such harms (Kassoy et al. 2020).

Conclusion

The concentration and power of the asset management industry has been recognized as a threat to financial stability, as leading to anti-competitive behavior by goods and services companies, and as causing a misalignment between the actions of asset managers and the underlying beneficiaries whose financial assets they hold in trust. This concentration of financial institutional power has recurred throughout the last century, each time prompting a reckoning when crises hit. With the existential threat of climate change and ongoing economic inequality, it is time yet again for policymakers to take steps to curb the power of the largest asset managers that allows them to act against the interests of US households and workers. Antitrust enforcement and taking steps to reduce the impact of asset managers on systemic financial risk are important. But it is also crucial to establish a *public* asset manager, which would change the incentives in the market and create an option for asset owners to vest their assets with a manager who has only the public interest in mind. Public asset management would more equitably distribute the financial benefits of asset ownership and is a democratic means to redirect portfolio investment away from fossil fuels and toward a decarbonized future.

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