# Gross, greed, and ETFs: The case for a micro-founded political economy of the investment chain

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*Driven by a lust for power, greed, and a desire to improve their own financial position and reputation at the expense of investors and decency, a cabal of Pimco managing directors plotted to drive founder Bill Gross out of Pimco in order to take, without compensation, Gross's percentage ownership in the profitability of Pimco.*

Thus begins the suit that Bill Gross filed in October 2015 against the firm he had co-founded in 1971, Pacific Investment Management Company. One year earlier Gross had still been Pimco's star manager, in charge of the world's largest bond fund. What had happened? According to Gross, his former colleagues had cast their eyes on his 20 per cent, or $300 million, share in Pimco's 'profit-sharing plan' in 2013. This left $1 billion for the remaining 60 managing directors to share between them (Bloomberg 2015b). The lawsuit, which the California Superior Court of Orange County admitted earlier this year (Bloomberg 2016), is for the $200 million that Gross claims would have been the remuneration for his last two quarters at Pimco.

$1.3 billion? This question – the question of the profitability of managing other people's money – has received surprisingly little attention. While the Pimco cabal raised some eyebrows in the financial press, the broader public, politicians, and scholars of finance and financialisation took little notice. This is problematic, especially in the context of growing inequality at the top of the income distribution. The economic purpose of the capital investment channel is to intermediate between providers and users of capital. Excess profits that accrue within this 'investment chain' constitute transaction costs, which not only increase inequality but can also reduce efficiency and welfare. Despite the importance of this social institution, however, the investment chain tends to fall between the cracks of a problematic disciplinary division of labour. Economic sociologists, especially those inspired by science and technology studies, have largely concentrated on micro-level devices, practices, and narratives (Beunza and Stark 2004; MacKenzie 2006; Chong and Tuckett 2015). Although this literature has made invaluable contributions to our understanding of the micro-foundations of contemporary finance, it has been criticised for bracketing the structural features of capitalism as a historically specific institutional formation (Christophers 2014; Koddenbrock 2015). Meanwhile, their interest in precisely these structural features has prevented political economists from developing strong micro-foundations for their analysis of capitalism. Add to this the still widespread assumption that politics 'takes place where the realm of economics stops' (Murphy and Tooze 1991: 24), and the criticism that political economy 'treats the economy as a black box' remains valid (Streeck 2011: 138).

This bracketing and black-boxing has made it easy for economics to claim near-exclusive jurisdiction over the study of the economy. In increasingly economic times, this has helped to entrench the 'superiority of economists' in the 'implicit pecking order among the social sciences' (Fourcade et al. 2015: 89). Yet there is hope. Perhaps the most promising approach to wrest the economy from the grip of economics is for economic sociology and political economy to join forces to build a micro-founded analysis of capitalism (Beckert and Streeck 2008, cf. Peck 2012; Christophers 2014; Braun 2016). Using 'Bill Gross vs Pimco' as a starting point, the present article takes a closer look at the investment chain to demonstrate the value added of such an approach. The article indicates avenues for future research by highlighting how micro-level practices in the investment chain relate directly to the macro-issues of power and inequality that are at the heart of political economy. The remainder of the article consists of five sections. The first argues that the investment chain has been neglected in the financialization literature. The second section looks at the business model of asset management and asks why it has been so profitable for so long. The third section presents three elements of a potential answer to this question – psychology, power, and the late introduction of potentially

game-changing financial technology, namely exchange-traded funds (ETFs). The fourth section highlights some recent developments sparked by the ETF revolution and the final section provides a conclusion.

## Finance, financialization, and the black-boxing of the investment chain

At first glance, finance might well be the exception to the social science hierarchy identified by Fourcade et al. However, research in economic sociology and political economy on 'financialization' has arguably not brought these disciplines up to speed with economists in public debates and policy controversies. According to one critic, 'the most penetrating and critical studies' on financial practices such as securitization are found 'in the work of (much-maligned) mainstream financial economists' not in spite of but *because of* the proliferation of the notion of financialization (Christophers 2015: 231).1 For while 'financialization' promises to open the black box of finance, 'something rather peculiar and paradoxical' has happened instead: 'as attention is drawn to the ways in which the 'rise' of finance and its colonization of various social spheres reshape the social world around us, finance's ostensible impacts are placed in the foreground but finance itself recedes from view' (Christophers 2015: 230). In light of this criticism, developing a micro-foundation for political economy means to bring the market practices and devices that constitute finance back into view.

One literature which has done exactly this is the literature on the *marketization* of financial intermediation. However, this work has largely concentrated on one channel of intermediation only, casting little light on the other. The elementary function of financial systems in capitalist economies is to intermediate between providers of capital (mostly households) and users of capital (firms, governments, and again households). There are two basic channels, the credit intermediation channel and the capital investment channel (or investment chain) (Jackson and Deeg 2006: 13). The first operates via the banking system, which extends long-term loans on the asset side of its balance sheet that are financed by short-term liabilities. A number of penetrating analyses have studied the marketization of such bank-based credit intermediation, which generally involves securitized lending and collateralized borrowing (Hardie et al. 2013; Thiemann 2014; Gabor and Ban 2016). The second channel connects savers and firms via capital markets. Here, the picture is less fine-grained. Comparing it to the bank-centered credit intermediation chain, the literature tends to conceptualize the investment chain as operating via an intermediation-free capital market that enables 'a direct transfer from savers to borrowers' (Jackson and Deeg 2006: 13). While this view of the investment chain was never particularly accurate, it has become less so as the number and variety of asset managers and other intermediaries within the investment chain have proliferated (Kay 2012). Two main categories of asset managers can be distinguished – alternative investment firms and mutual fund firms. The former – hedge, private equity, and venture capital funds – are more visible and have received considerable attention (Goyer 2006; Froud and Williams 2007; Erturk et al. 2010). However, alternatives account for only a relatively small share of the market. The vast majority of financial assets are under management with 'plain vanilla' mutual fund firms. BlackRock alone manages far more capital than the entire hedge fund sector ($4.7 trillion vs. $3 trillion at the end of 2014). These firms compete to attract money mostly from institutional investors, such as pension funds and insurers, but also from retail investors. And when it comes to bond investing, the biggest name on the street is Pimco. Which brings us back to the all-important question: If what Pimco does is to collect pensioners' savings and invest them in government and corporate bonds, then why is it that a $1.3 billion bonus pool exists for managing directors to fight over?

## Follow the money: The astonishing profitability of managing other people's money

One key lesson from the US securitization bonanza of the mid-2000s is that a research strategy that 'follows the money' and focuses on the most profitable financial activities likewise has a high expected return. Today, the most profitable sector in finance is asset management. In 2014, the operating margin of listed fund managers was 33 per cent, just one percentage point shy of the pre-crisis peak reached in 2007 (Financial Times 2015e). The sector has also seen rapid growth as it 'has filled a void left by banks' in the aftermath of the bank-centered crisis of 2008 (Financial Times 2015d). Global banks such as UBS and Goldman Sachs have significantly increased their asset management operations, which in the case of UBS now account for two thirds of pre-tax profits (Financial Times 2015b). While pay at investment banks has been falling, fund manager pay has continued to increase in recent years (New Financial 2016). The profitability of fund management constitutes a classic case of elephant-in-the-room – too big not to notice, but also too intangible for economic sociologists and political economists to puzzle too much about it (however, see Godechot 2015).

Asset managers charge fees for their services. These fees are paid by investors – pension funds, insurers, retail investors – whose return 'after fees' is thereby reduced. Regarding the costs of investment, the key distinction is between actively managed funds, which aim to 'beat the market' (that is, a specific benchmark), and passively managed funds, which merely replicate and thus 'track' a specific index. The benchmark-beating returns promised by active funds are delivered by fund managers such as Bill Gross, and thus come at the price of higher fees compared to passive funds. To be sure, compared to the '2 and 20' fee model of the hedge fund industry – which refers to a management fee (2 per cent of the capital invested) and an additional performance fee (20 per cent of profits earned) – the fees charged by 'plain vanilla' asset managers look modest. Prior to recent changes aiming at making fees more transparent, the fees charged by actively managed equity funds stood at around 1.5 per cent, 'of which about half went to the fund manager' (Financial Times 2015c). In relation to the returns investors make, however, this is expensive. Between 1980 and 2006, according to one authoritative study, paying US fund managers to beat the market cost investors 10 per cent of annual returns on the market portfolio (French 2008: 1538).

As John Bogle, the founder of the low-cost investment firm Vanguard, has tirelessly pointed out, 'the elemental arithmetic of investing' is simple: 'Gross return in the financial markets, minus the costs of the system, equals the net return actually delivered to investors' (Bogle 2008: 98). The question, therefore, is whether the significantly higher costs of active management are compensated by above-average returns. Theory, measurement, and logic all tell us that they are not. According to modern financial theory, a fund manager cannot consistently outperform the market on a risk-adjusted basis (Malkiel 1973). Empirically, this was established as early as 1964 (Jensen 1968). Ultimately, the impossibility of active outperformance comes down to simple logic. 'The market' is just another way of saying 'all investment funds'. On average, funds will therefore earn the market return. But that is before fees. After fees, investors are left with a below-market return. The implication for investors is clear – own the market portfolio at the lowest available cost.**2**

## Why have high fees and profits persisted?

Index funds offer precisely this – exposure to an index at a fraction of the cost charged by actively managed funds. Index funds had been introduced already in the early 1970s, when they received strong support from leading financial theorists, including Michael Jensen, Myron Scholes, William Sharpe, Fischer Black, and Eugene Fama (Bernstein 2005: 240-52; MacKenzie 2006: 84-88). Why, then did competition and technological progress not drive down prices (i.e., fees) and erode profits for active fund managers? Why was there still, in 2013, a $1.3 billion bonus pool at Pimco? This is a major puzzle and an unanswered research question. Three potential explanations seem worth exploring – social psychology, power, and financial technology.

The social-psychological explanation rests on the assumption of a genuine belief among asset managers that they offer skills that are worth the price they command in the market. There is anecdotal evidence that would support such an interpretation. Following a presentation of Jensen's results to 'some men from the mutual fund industry', a laconic Fischer Black wrote to his parents (Mehrling 2005: 63): 'They were surprised. Indeed, one might say they didn't believe us.' Anecdotes of industry representatives reacting with surprise, disbelief, or outright hostility when confronted with academic challenges to the active investment model are legion (cf. MacKenzie 2006: 80-81). Recounting an episode in which he confronted a group of fund managers with evidence that they did not create value for their clients, Daniel Kahneman describes their reactions as a mixture of incredulity and denial (Kahneman 2011: 215-17). Social psychology certainly played an important part here, as both fund managers and their clients developed mechanisms to avoid cognitive dissonance in the face of a yawning gap between modern financial theory and market practice. Kahneman views asset management as a case in which 'a major industry appears to be built largely on an *illusion of skill*' (Kahneman 2011: 212, orig. emphasis).

However, even if fund managers believed in their ability to create value for clients, the question remains why and how the 'illusion of skill' stuck, especially with institutional investor clients. From the start, investment firms opposed the arguments put forward by the proponents of efficient-market financial theory. This is unsurprising given that, as Paul Samuelson (1974: 18) noted, it followed from these arguments 'that most portfolio decision makers should go out of business'. Here, more research is needed on the strategies employed by the asset management sector to keep the lid on ideas that threatened its business model. The commissioning, funding, and production of research is likely to have played a key role in this context. In terms of instrumental power, little is known about industry lobbying with regard to the regulation of fee structures and transparency, con-

flicts of interest among investment advisors, or investment strategies (see the discussion of 'closet indexers' in the next section). As for the question of remuneration, the protracted negotiations in the European Parliament and between EU member states about the rules for fund manager pay provide ample material. Crucially, although the final package of 2014 set some restrictive standards, a concerted lobbying effort brought a surprise victory for the fund industry – unlike the banking sector, it succeeded in averting a pay cap for senior managers (Financial Times 2014). Another telling example is provided by the case of David Godfrey who, until his ousting in 2015, had served as the head of the UK's Investment Association (IA). In that capacity he campaigned for lower fees, greater cost transparency, and a 'statement of principles' through which the association's members would commit to putting their clients' interests first. He reportedly resigned after having been told by the IA's board that if he did not he would be fired (Financial Times 2015a).

Although they go a considerable way towards explaining the puzzling persistence high fees and profits, psychology and power must be complemented by a third factor – the (non-)availability, until relatively recently, of the financial technology to perform the 'passive investor' on a mass scale (Braun 2016: 263-67). As mentioned above, thanks to the introduction of index funds, low-cost exposure to a benchmark had been available as early as the 1970s. However, it was not until the early 2000s that index-tracking funds became a mass market phenomenon. This points towards the introduction of exchange-traded funds (ETFs) in the 1990s – namely of a Nasdaq-100 fund called 'Cubes' (Deville 2008: 68-70) – as the real game changer. ETFs solved two problems related to index-tracking that had prevented low-cost index funds from living up to the promise of posing a serious competitive threat to high-fee active fund management (Braun 2016: 265-67). First, index funds face a trade-off between transaction costs and 'tracking error', which arises from the need to buy and sell securities in order to minimise the fund's deviation from the index. Second, a trade-off exists between transaction costs and liquidity, as the creation and redemption of shares also requires trading. Index funds do not allow for intra-day trading – their shares can be bought and redeemed only at the end of each trading day and at the market value of the underlying basket of securities, or net asset value (NAV). ETFs have been designed to mitigate both of these trade-offs through a dual trading structure that separates the trading of shares from the creation and redemption of shares. Investors can trade ETF shares continuously via exchanges (just like individual shares). The creation and redemption of shares, by contrast, involves third-party market makers, so-called authorized participants (APs), usually large investment banks. When the price of ETF-shares rises above the price of the underlying basket of securities, these APs can create new shares via an 'in kind' transaction with the fund company. By acquiring a portfolio of the underlying securities and handing it over to the ETF provider in exchange for new ETF shares, they make an arbitrage profit.

See appendix, figure 1

## Consequences of the ETF revolution: Price wars, smart beta, and closet-indexers

ETFs have been *the* growth story of the past decade in the asset management sector. Fees, by contrast, have decreased markedly as a result of the ETF boom. As shown in Figure 1, financial assets held in ETFs have grown rapidly, reaching almost $3 trillion in 2015 (and thus the same size as the hedge fund sector). While more than two thirds of the ETF market is controlled by only three firms (BlackRock, Vanguard, and State Street Global Advisors), a growing number of asset managers have added ETFs to their product ranges in recent years, including industry giants such as Goldman Sachs and Fidelity. These market entries and the associated increase in competition have brought ETF fees down even further, with expense ratios now as low as 0.03 per cent in some cases (Bloomberg 2015a). The notion of an ETF price war has since caught on in the financial press.

The reactions of the investment industry to these competitive pressures include both new financial innovation and fraudulent tactics. The most prominent item on the innovation agenda has been 'smart beta'. This strategy aims to combine low-cost index tracking – which aims for a portfolio that moves exactly as the market does and thus has a 'beta coefficient' of 1 – with the goal of outperforming standard benchmarks (Financial Times 2013). In order to combine these two hitherto irreconcilable notions, smart beta funds invest in formula-determined securities baskets that offer higher risk-adjusted returns than established indices. Some of these formulas are designed to exploit the very inefficiencies that are generated by herd behavior inherent to indexing, and by the overrepresentation of certain types of firms in the standard indices. They do so, for instance, by weighting high-dividend or momentum stocks, or simply by giving companies with smaller market capitalizations (small-cap) an equal weighting. Already accounting for over one fifth of US ETFs (Financial Times 2016a), smart beta can be

seen as an attempt to reconcile indexing with the traditional, alpha-centered culture of the investment industry.

The strategy of 'closet-indexing', by contrast, resorts to fraudulent means to preserve profitability. Closet indexers are high-fee investment funds that promise active management but in reality closely 'hug' a benchmark in order to minimize their risk of underperforming it. Investors, of course, would have access to that same performance at lower cost via an index fund. A recent study found that in most of the 20 countries it covered, between 30 and 50 per cent of total net assets were held in closet-indexing funds (Cremers et al. 2016). In 2014, the consumer organization Better Finance alerted the European Securities and Markets Authority (ESMA) to an investigation by the Danish financial regulator that had found closet indexing to be widespread among active funds in Denmark. According to the ensuing investigation by ESMA, 5 to 15 per cent of nominally active funds could 'potentially' be index trackers (European Securities and Markets Authority 2016). However, ESMA was immediately criticised for using an overly conservative methodology, as well as for not releasing the names of the funds it suspected of closet indexing (Financial Times 2016b). In future, tensions between fund managers, clients, and regulators will continue to surface as the cost pressure on traditional, actively managed funds is unlikely to abate.

## Conclusion

In their recent review of the financialization literature, Davis and Kim (2015: 204) have emphasized that alternative ways of organizing credit and investment intermediation have far-reaching social consequences. However, precisely because the investment chain connects micro-level practices to macro-level structures, this amorphous institution has tended to fall between the cracks of the disciplinary division of labor between economic sociology and political economy. In light of this observation, the key message of the present article is that when it comes to the political economy of the investment chain, and thus of financialized capitalism more generally, studies of micro-practices and macro-structures are complementary rather than contradictory. Starting out from the lawsuit filed by Bill Gross against Pimco, the article has focused on the question of how and why managing other people's money has continued to be so profitable. While the puzzling persistence of the high-fee, active-fund-management model calls for further research, growing ETF assets combined with falling fees point towards the possibility of transformative changes. Indeed, if these trends continue they will likely have dramatic consequences for profitability and pay in the the asset management sector. When the next bond king takes their employer to court, the sums that will be at stake may well fall one or two zeroes short of what Bill Gross is currently suing for.

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### Endnotes

1For an ongoing attempt to change this, see the contributions to the workshop *Financial Innovation, Diffusion and Institutionalization: The Case of Securitization*, recently held at the Max Planck Institute for the Study of Societies in Cologne http://www.mpifg.de/projects/financial_innovation/program_en.asp

2It should be noted that active investing does, of course, fulfil an important societal function by helping price discovery in financial markets. From this perspective, 'the cost of active investing also measures society's cost of price discovery'. The question then becomes whether 'society is buying too little or too much of this good' (French 2008: 1538).

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