Passive Investors are Passive Monitors

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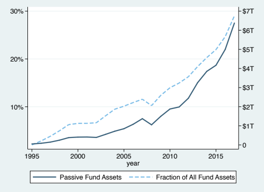
The rise of passive investing



- Index funds are now the largest shareholders of most large U.S. corporations
- **Implications for corporate governance**
  - Long term investors with large positions have strong incentives to monitor (principal-agent theory)
  - But the economics of index investing suggests that index funds may have weak incentives to monitor

Economics of index investing

1. Index fund managers focus on tracking error, not alpha
2. If an index fund monitors $\rightarrow$ firm's value increases
   - But this does not improve fund performance relative to:
     - The index
     - Other funds that follow the same index
3. If monitoring is costly, an index fund that monitors might *underperform* its competitors (Bebchuk et al. 2017)

Debate in the empirical literature

1. Boone & White (2015), Appel, Gormley & Keim (2016), Crane, Michenaud & Weston (2016), Appel, Gormley & Keim (forthcoming):
    - More passive ownership $\rightarrow$ better governance
2. Schmidt & Fahlenbrach (2017), Azar, Schmalz & Tecu (2018):
    - More passive ownership $\rightarrow$ worse governance

- **How do these effects occur?**

This Paper

Do index funds monitor?

1. We directly examine fund monitoring behavior:
    - Voting
    - Exit
    - Engagement

2. We look at the universe of fund votes and in a new research design using post-2006 Russell reconstitutions

Fund Voting: Summary Statistics

Management	ISS	Index funds				Active Funds				Difference	
Recommend	Recommend	Yes	No	Abstain	DNV	Yes	No	Abstain	DNV	PctYes	N
All		91.3%	4.8%	3.6%	0.3%	90.4%	5.8%	3.3%	0.4%	0.9%	22,393,982
Consensus											
Yes	Yes	96.8%	1.6%	1.5%	0.1%	97.1%	1.4%	1.3%	0.3%	-0.3%	19,875,577
No	No	4.5%	80.3%	12.3%	2.8%	5.3%	81.8%	11.2%	1.6%	-0.8%	344,402
Contentious											
Yes	No	51.6%	19.8%	26.7%	1.9%	44.6%	23.6%	29.5%	2.3%	7.0%	1,451,657
No	Yes	43.2%	50.1%	6.6%	0.1%	48.1%	45.3%	6.4%	0.3%	-4.9%	722,346

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Summary statistics $\Longrightarrow$ Voting differences

- On consensus items, no difference in voting
- On contentious items, index funds vote with management 52.7% of the time, active funds 47.4% ($t =$75.0)
- From a principal-agent perspective this means index funds cede power to management

Vanguard index funds prospectus, 2018:

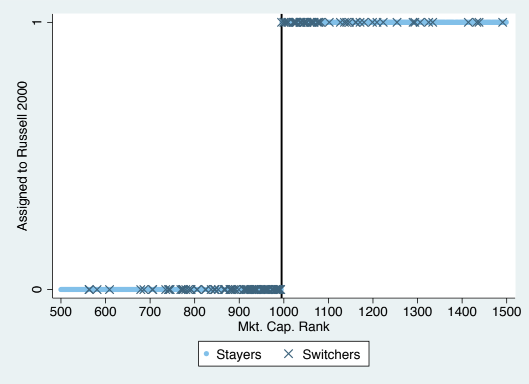
"We will give substantial weight to the recommendations of the company's board absent guidelines or other specific facts that would support a vote against management."

Summary statistics $\neq$ Voting differences?

Problem: Fund voting is endogenous

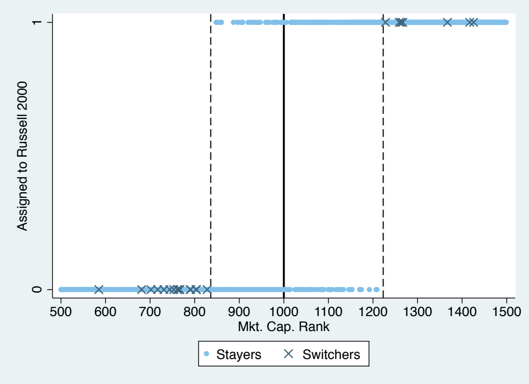
1. Firm characteristics jointly affect ownership and governance (*omitted variable*)
2. Different firm policies attract different types of investors (*reverse causality*)
3. We don't observe voting if a fund chooses *not* to hold a firm (*selection bias*)

Russell reconstitution pre-banding



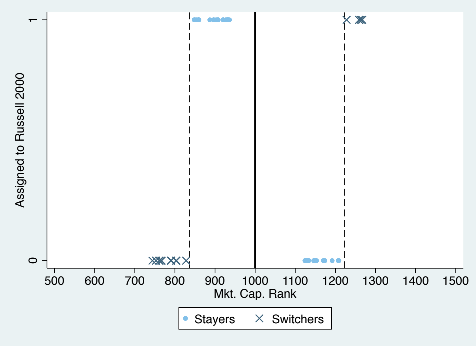
June 2006

Russell reconstitution post-banding



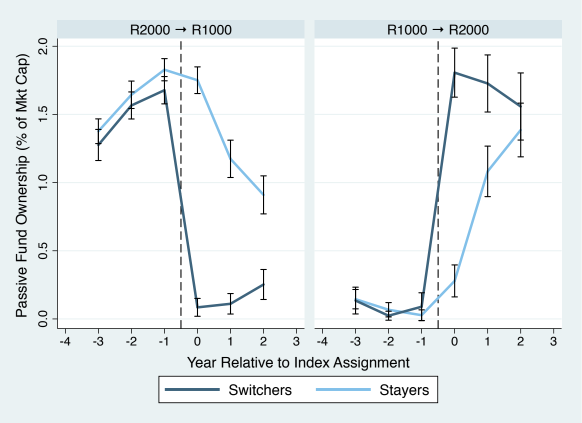
June 2007

Russell research design



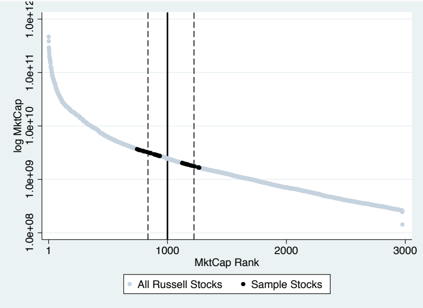
- Stocks above make up the 2007 *cohort*
  - Firm-years from 2004-2009, firm fixed effects
  - More RCT than RDD

Passive fund ownership relative to treatment year



- Parallel trends, symmetric treatments

A clean comparison



1. Balance tests ✓: firms look identical *ex ante*
    - Addresses endogeneity
2. Index switching quasirandomly shocks fund *i* to hold firm *j*
    - Addresses selection bias

Index funds vote with management

- Index funds are 10.1% more likely to vote with management
  - Higher-fee index funds vote with management *less*
- Across different agenda item types:
  - Board of directors, compensation, disclosure, entrenchment
- On management and shareholder proposals
- Index funds abstain less on contentious votes
- Results similar at the fund-family level
  - Here the ind. variable is fraction of AUM that's passive

Index funds exit less

- We find that index funds exit 25% less than active funds
    - Though they do exit and omit firms
    - The average Russell 2000 fund-year voluntarily exits 253 (15%) of its 1734 positions
- Active funds, but not index funds, are more likely to exit if they previously lost a vote
    - Active funds use exit as a strategic substitute with voting
    - Index funds don't

Engagement

- A third channel: Index funds could engage with management
- If engagement changes firm behavior, then voting and exit might not be needed
- Hard to rule out... how to measure engagement?
- We look at funds' blockholding disclosures:
    - Schedule 13D: "activist" disclosure
    - Schedule 13G: "passive" disclosure

Index funds don't engage

- Index funds are less likely to file 13D, more likely to file 13G
- Also, when index funds enter or exit, no change in the *types* of proposals put forward
- These findings, plus Bebchuk and Hirst (WP) on meetings and Iliev et al (WP) on EDGAR searches, are inconsistent with engagement

Passive voting hurts firm value

- So what?
  - Maybe voting, exit, engagement don't matter
- Voting-day abnormal returns:
  - **Active** fund, **lost** the vote: -7 bp
  - **Active** fund, **won** the vote: -5 bp
  - **Index** fund, **lost** the vote: +21 bp
  - **Index** fund, **won** the vote: -17 bp

Conclusion: Passive Funds are Passive Monitors

- Index funds cede power to firm management:
  1. More likely to vote with management
  2. Less likely to exit
  3. More likely to file Schedule 13G
  4. Passive voting hurts firm value
- Index funds are (relatively) **weaker monitors**
- The rise of index investing shifts the balance of power from investors to firm managers