Corporate governance in the presence of active and passive delegated investment

Adrian Aycan Corum   Andrey Malenko   Nadya Malenko

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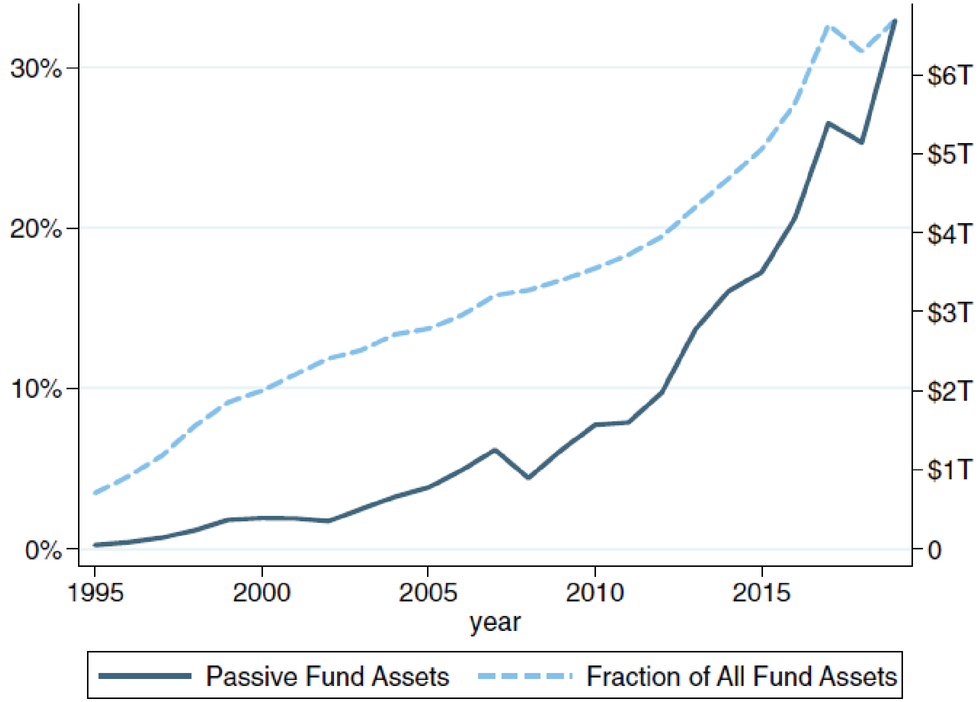
Growth of passive funds



Source: Heath et al. 2022

- Passive fund share has grown from 5% in 1995 to more than 30% in recent years
- BlackRock, Vanguard, and State Street cast ~25% of votes in S&P 500 firms (Bebchuk and Hirst 2019)

Debate on the governance role of passive funds

"what desperately needs to be discussed [in the context of index fund growth] ... is corporate governance." (Senator Phil Gramm; 2018 SEC roundtable)

Passive funds give managers less power:

- Associated with more independent directors, fewer antitakeover defenses, greater success of activists (Appel, Gormley, and Keim 2016, 2019)
- Promote the passage of value-increasing proposals (Filali Adib 2019)

Passive funds give managers more power:

- Associated with less board independence, longer director terms, more CEO titles (Schmidt and Fahlenbrach 2017; Heath et al. 2022)
- Vote pro-management more than active (Brav et al. 2022; Heath et al. 2022; Boone et al. 2020)

Debate on passive funds’ incentives to engage

- Bebchuk and Hirst (2019), Lund (2018), Fisch et al. (2019), Kahan and Rock (2020)

Opponents: Passive funds **“lack a financial incentive”** to engage

- Passive funds “*seek only to match the performance of an index*”
- Engagement “*will benefit all funds that track the index*” (Lund 2018)
- Low fund fees (Bebchuk and Hirst 2019)

Proponents

- *“significant incentives ... to play their current roles in corporate governance responsibly”* (Kahan and Rock 2020)
- *“Existing critiques of passive investors are unfounded”* (Fisch et al. 2019)

This paper

Objective:

- Develop a theoretical framework to analyze the governance role of asset managers
    - which factors determine funds' incentives to engage

- Use it to study:
    - Does passive fund growth improve or harm governance?
    - How does competition among funds affect their incentives to engage?

Key forces and implications

What determines fund managers' incentives to engage?

- Consider a fund that has invested in a firm
- Fund manager's payoff is **Value of AUM** $\times$ **Fee**

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- **Lewellen and Lewellen** (2022)
  - For top-5 index fund managers
    - if a typical holding $\nearrow$ 1% in value, annual fee $\nearrow$ by \$133,000
  - For activist investors (13D): \$520,400

Key features of the model

1. Fund investors choose between active and passive funds, and private savings
2. Funds make investment and governance decisions

⇒ AUM, fund fees, asset prices, and ownership are endogenously determined

Industry equilibrium model allows to analyze many aspects and their effects on funds' incentives to engage simultaneously

⇒ combined effects of the pros and cons discussed in the literature

Broad implications

- Passive fund growth can improve governance despite increasingly low fees and tracking the index
  - Whether governance improvements occur depends on competition between funds and the sizes of active and passive fund sectors
  - May come at the expense of fund investors’ well-being

Model

Model setup: Players

1. **Fund investors** (infinitesimal, combined wealth W)
   - allocate wealth between passive funds, active funds, and private savings
   - incur a search cost to find an active/passive fund (Garleanu and Pedersen 2018)
     - $\psi_A > \psi_P$: higher return but at a higher cost
     - **decreasing $\boldsymbol{\psi_P}$**: investor awareness; 401(k); better disclosure ⇒ easier search for fees

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2. **Fund managers** (active and passive)
   - bargain with investors over fees: fund keeps fraction f_i of AUM value
   - invest capital on behalf of investors
     - passive fund is restricted to hold the market
     - active fund chooses its portfolio to exploit mispricing
   - exert effort e_{ij} to increase value of firm i at cost $\frac{c_i}{2} e_{ij}^2$ (e.g., informed voting, engagement)

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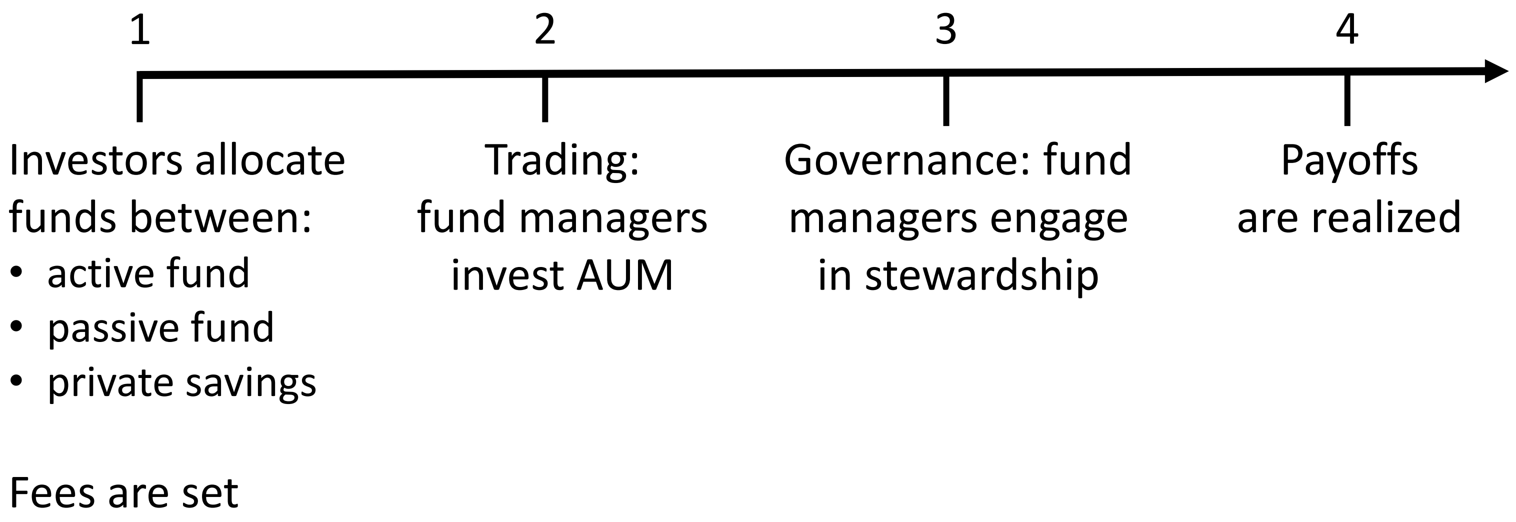
3. **Competitive liquidity (noise) investors**
   - value stock j at $Payoff_j - Z_j$ (sentiment)
   - rational in their anticipation of $Payoff_j = R_0 + e_{Aj} + e_{Pj}$
   - *L*- and *H*-stocks: "cheap" and "expensive" ($Z_L > Z_H$)

Model setup: Timeline



Analysis: Governance

1. Investors allocate funds between:
   - active fund
   - passive fund
   - private savings

   Fees are set
2. Trading: fund managers invest AUM
3. Governance: fund managers engage in stewardship
4. Payoffs are realized

Fund manager receives: (fee) x ($ value of stake)

$\Rightarrow \quad e_{ij} = \frac{f_i x_{ij}}{c_i}.$ Fund monitors more if:

- it holds a larger stake

  e.g., Iliev-Lowry 2015; Iliev et al. 2021; Lakkis 2021

- it charges a higher fee

  Heath et al. 2022; Lewellen-Lewellen 2022

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- **Passive fund**: value-weighted market portfolio
  - $x_{Pj} = \frac{AUM_{passive}}{P_M}$; $P_M = \frac{P_L + P_H}{2}$
- **Active fund**: holds L-stocks; does not invest in H-stocks
  - $x_{Aj} = \frac{AUM_{active}}{P_L \cdot 1/2}$ for L-stocks

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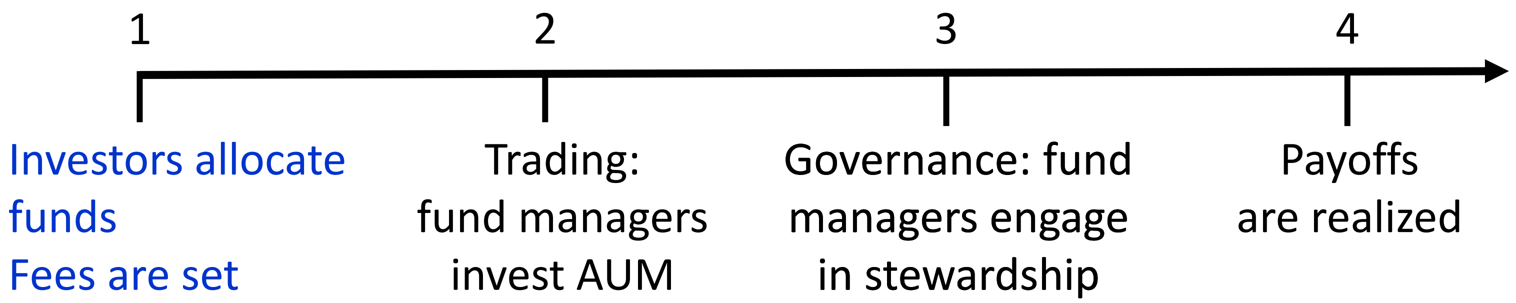
- Initial owners sell; funds + liquidity investors hold 100%

$$Price_j = Payoff_j - Z_j = R_0 + \frac{f_A x_{ij}}{c_A} + \frac{f_P x_{Pj}}{c_P} - Z_j$$

Investors rationally anticipate funds' monitoring

Analysis: Investors' capital allocation and fund fees



Investor chooses between:

- Active fund: $(1 - f_A)\frac{R_L}{P_L} - \psi_A$
- Passive fund: $(1 - f_P)\frac{R_M}{P_M} - \psi_P$
- Private savings: 1

Fund manager and each fund investor bilaterally negotiate fee via Nash bargaining (Garleanu-Pedersen 2018)

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- Denote $\lambda \equiv (1 - f_A)\frac{R_L}{P_L} - \psi_A$ equilibrium net return of investors
  - $\lambda = 1$ (if search costs are high; passive fund primarily crowds out private savings)
  - $\lambda > 1$ (if search costs are low; passive fund crowds out allocations to active fund)

Implications for governance

The governance role of passive funds

How does easier access to passive funds (lower search costs ψ_P) **affect governance?**

The governance role of passive funds

Easier access to passive funds:

- **improves** governance at first
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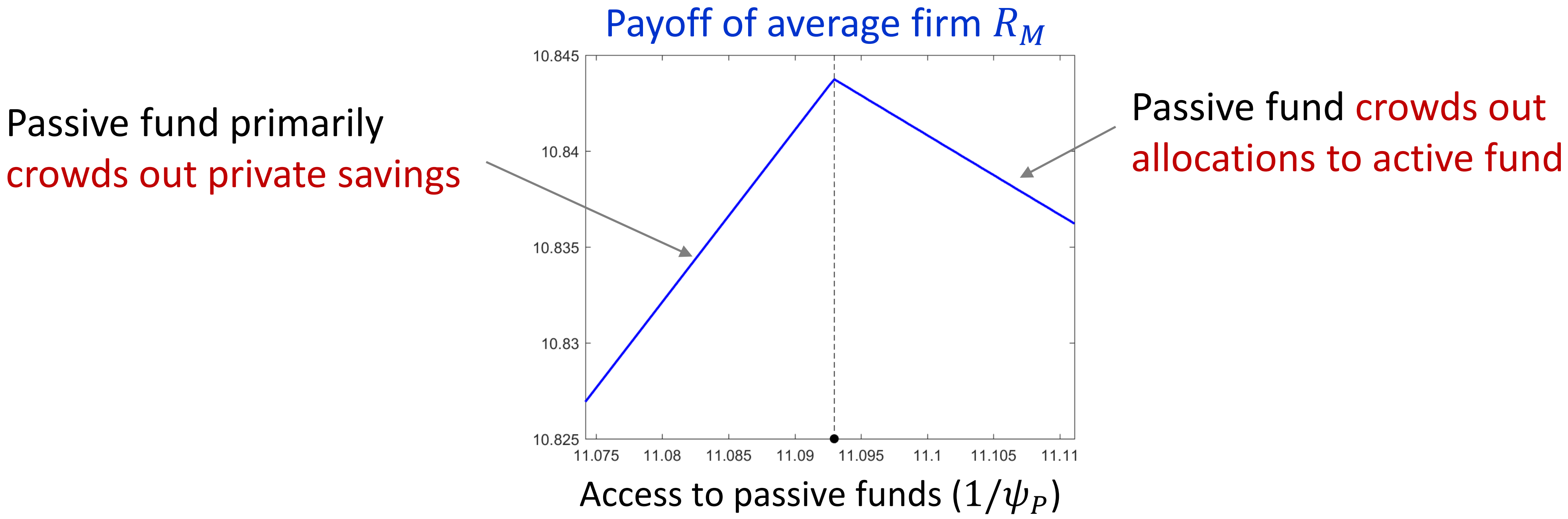

Key pros of passive fund growth

Replace retail shareholders, who do not engage

Key cons of passive fund growth

1. Replace active funds, who engage more due to higher fees (and weakly lower costs)
2. Competition ⇒ fees ↘ ⇒ incentives to engage ↘

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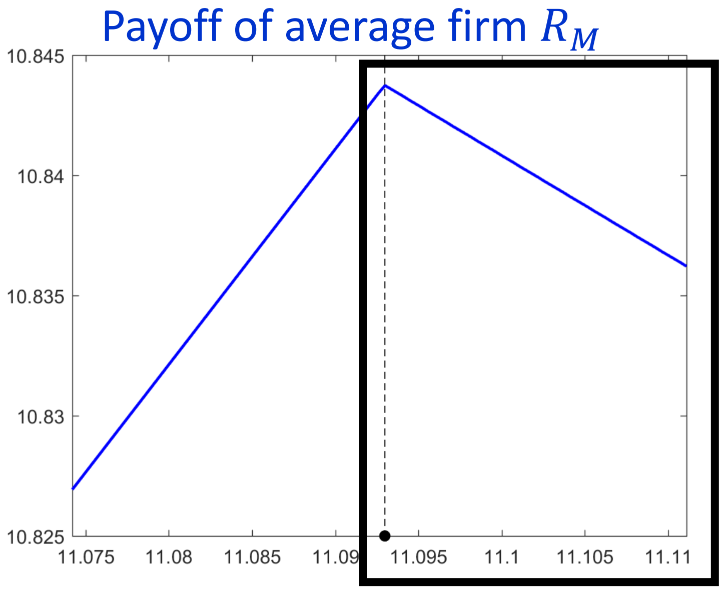

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$$AUM_{passive} + AUM_{active} = W$$

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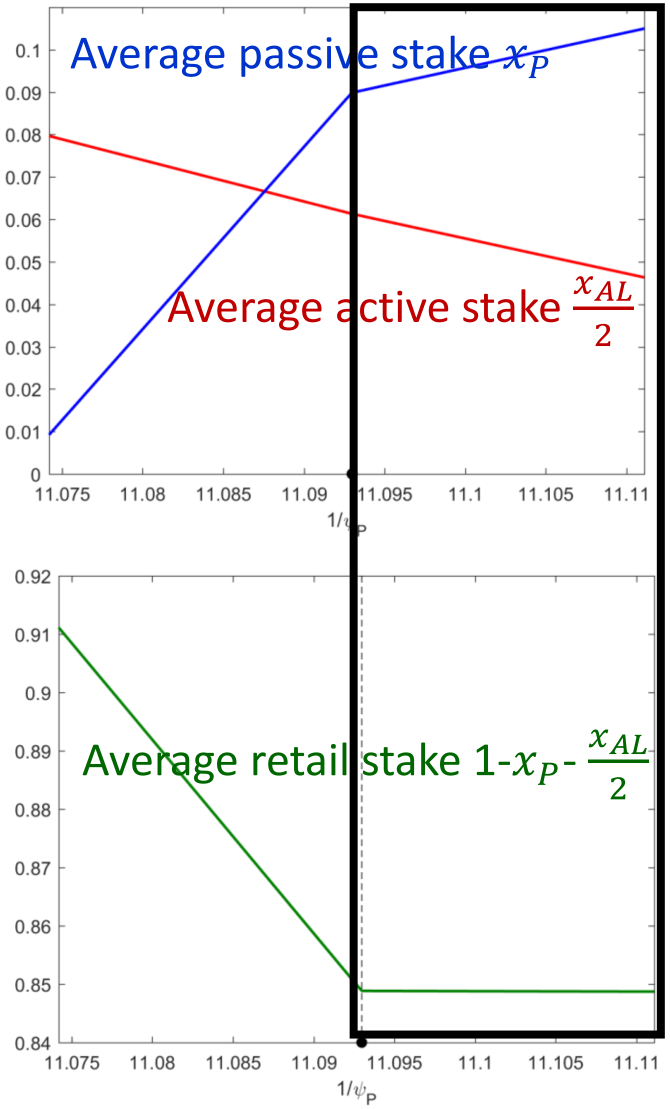

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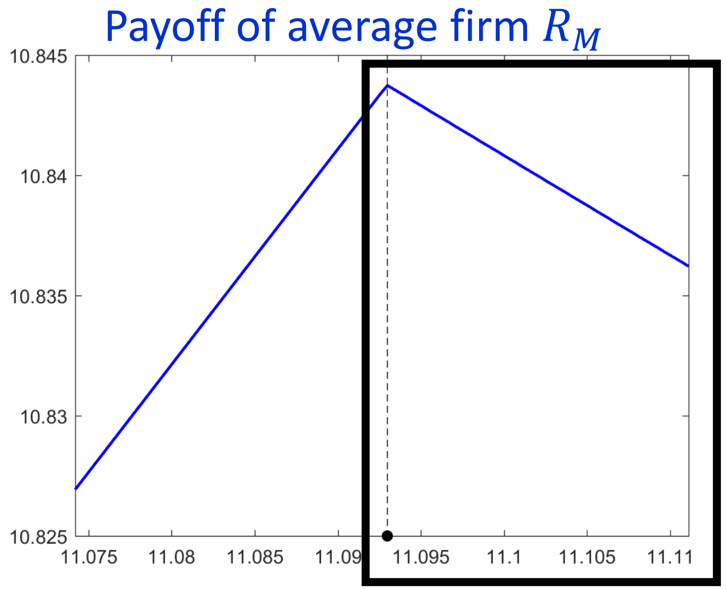

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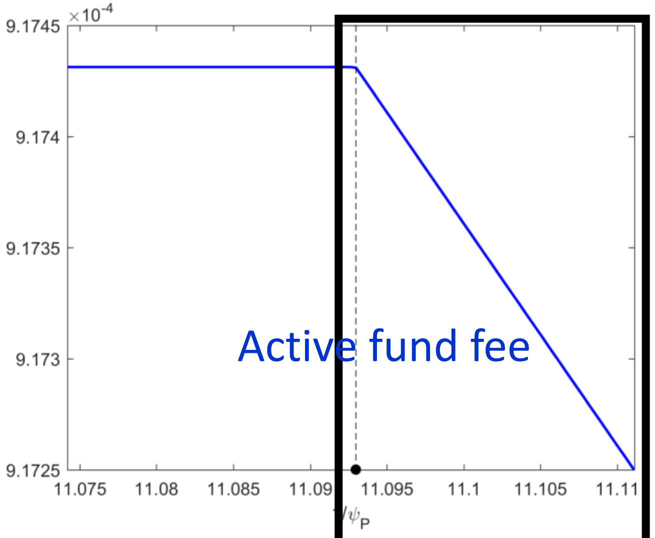

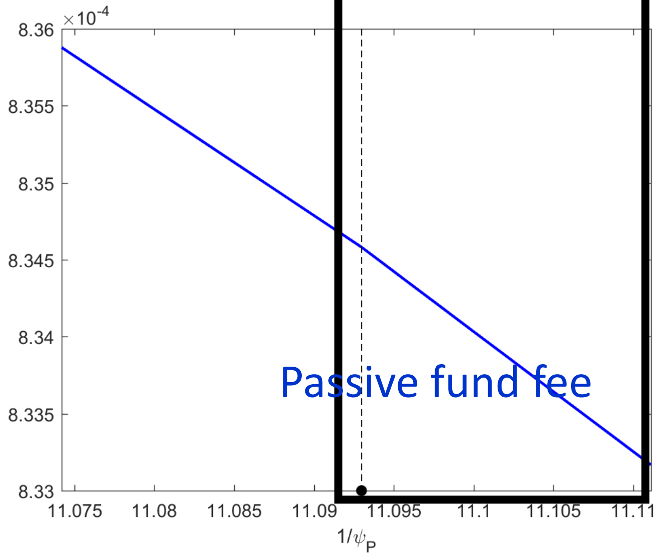

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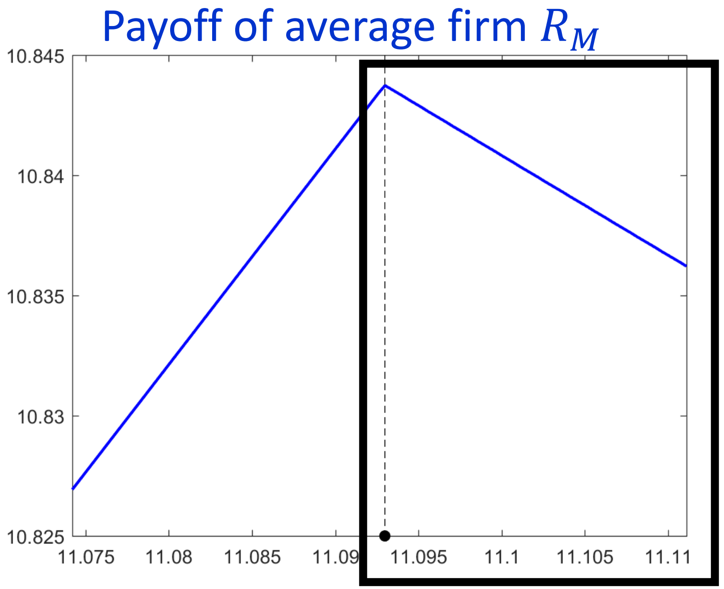

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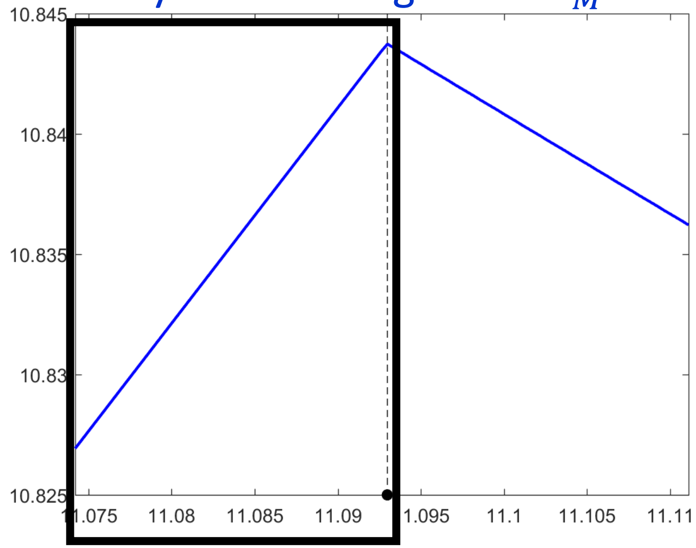
Payoff of average firm R_M



Passive fund primarily **crowds out private savings**

$AUM_{passive} + AUM_{active} \nearrow$

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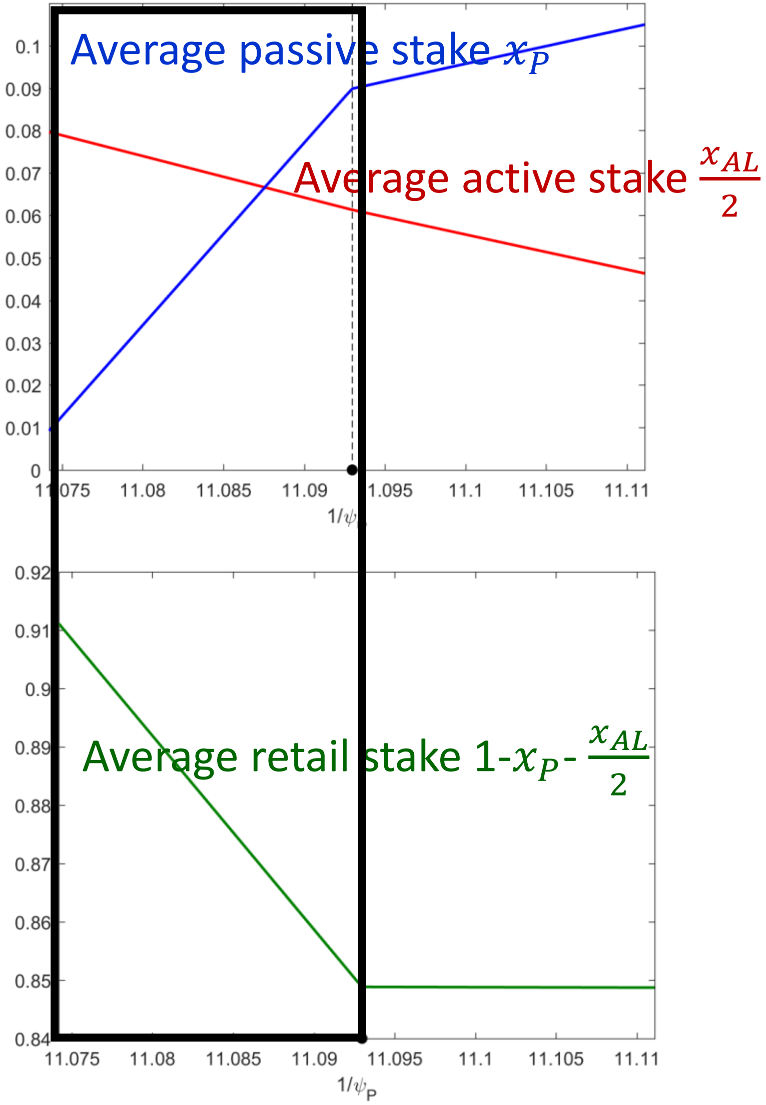

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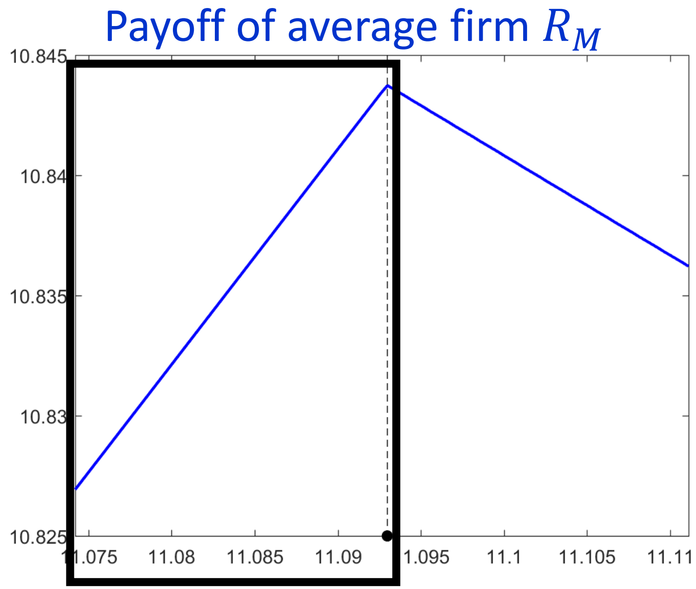

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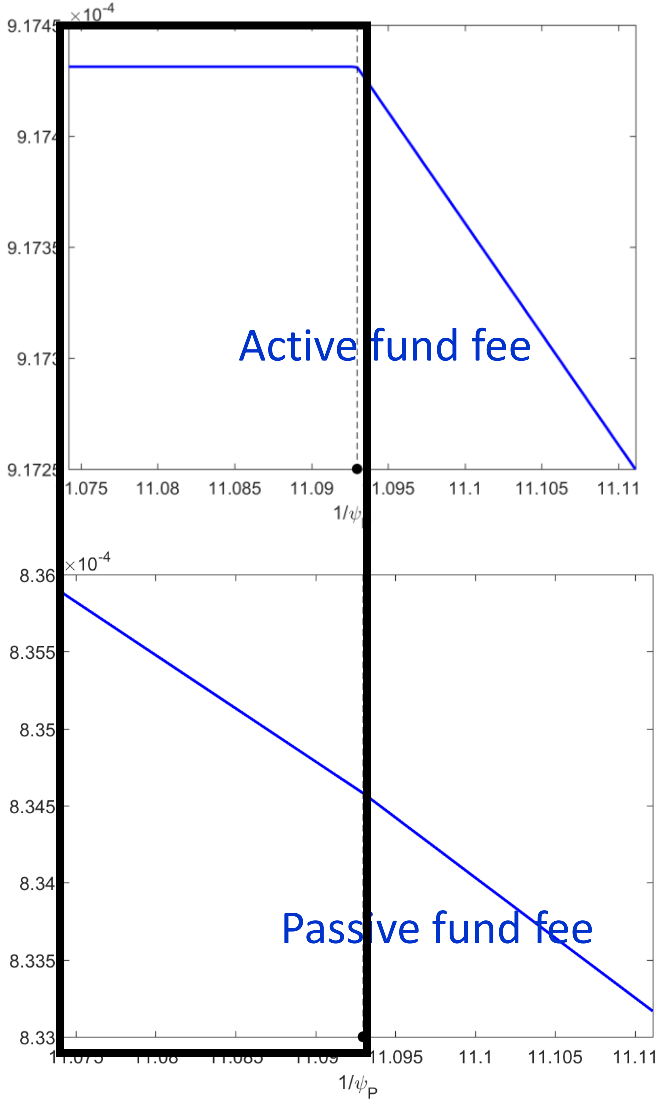

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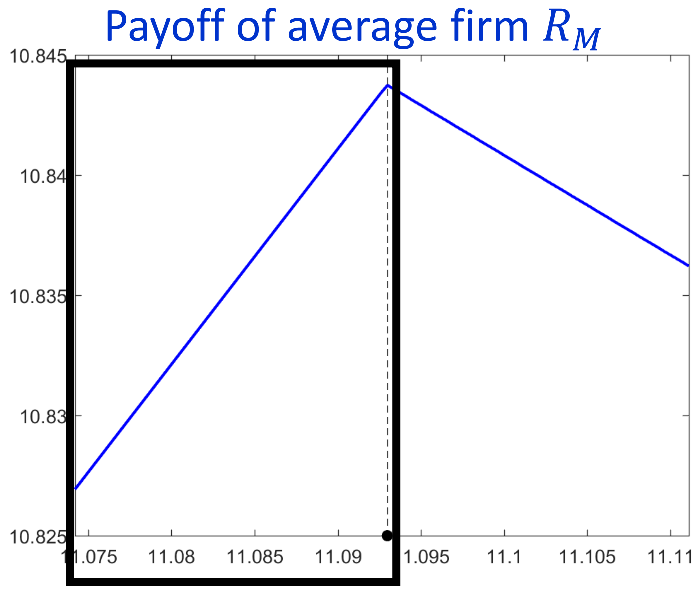

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Reconciling the empirical evidence

Conflicting empirical evidence about the effects of passive funds

- Positive: Appel, Gormley, and Keim 2016, 2019; Filali Adib 2019
- Negative: Schmidt and Fahlenbrach 2017; Heath et al. 2022; Bennett, Stulz, and Wang 2020

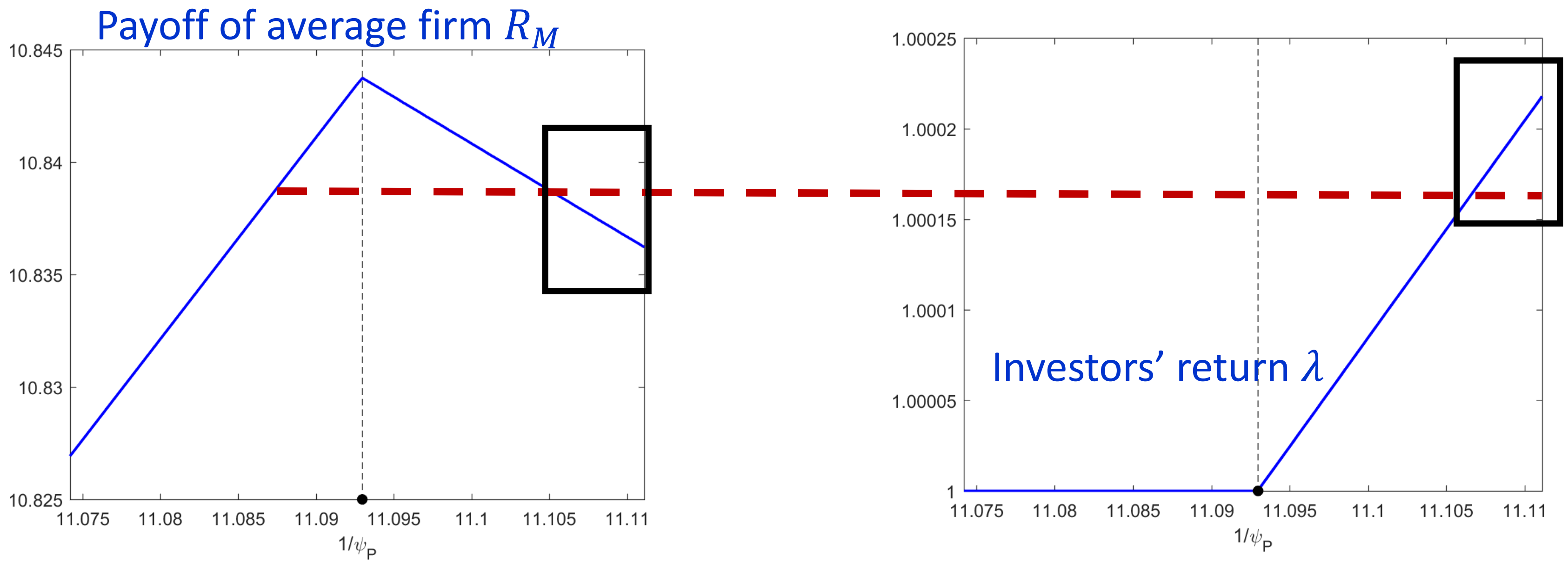
Current debate focuses on differences in methodologies

Our paper suggests a different (complementary) explanation

- In different empirical designs, passive funds crowd out different investors
- In studies that find a **positive** effect, passive funds **do not crowd out active** funds
- In studies that find a **negative** effect, passive funds **crowd out active** funds

Trade-off between governance and fund investors' returns

Governance vs. Fund investors' returns



Easier access to passive funds improves governance only if it does not increase fund investor returns too much

- Engagement requires fund managers to earn sufficient rents (i.e., charge high fees)

⇒ **Trade-off** between governance and fund investors' well-being

Fund fees and governance

Do lower fees of passive funds mean worse governance?

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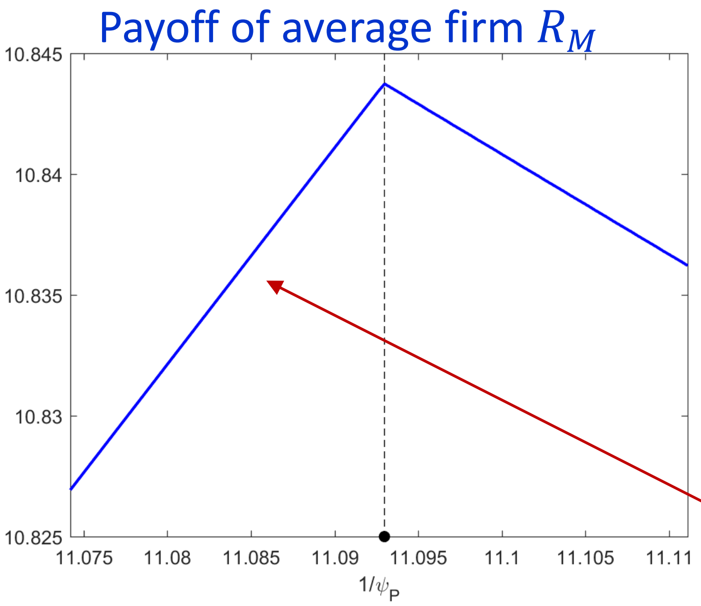

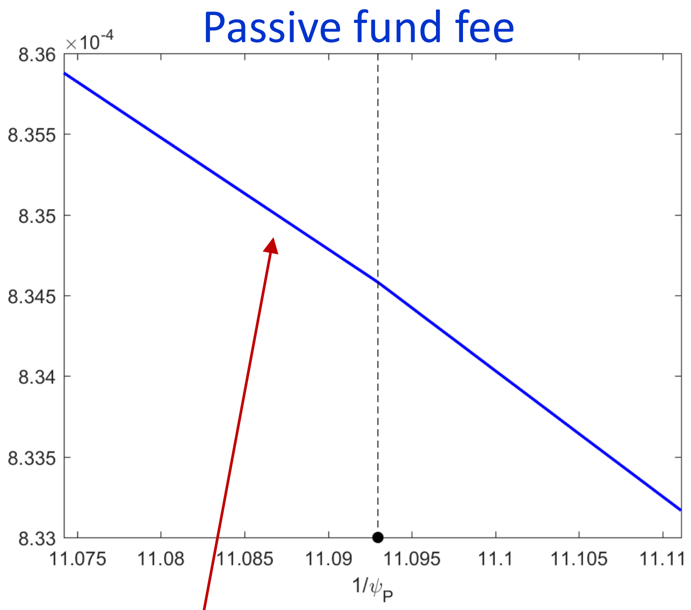

Easier access to passive funds reduces fees, but improves governance

- lower fees ⇒ incentives to engage ↘
- higher AUM ⇒ equity stakes ↗ ⇒ incentives to engage ↗
- combined effect is positive if $\lambda = 1$

Other implications and extensions

1. Governance regulations that strengthen shareholder rights (decrease c)

- Improve governance, but may hurt fund investors and fund managers
- Direct and indirect (through fund flows) effects on funds' incentives to engage

2. Extensions:

- Multiple active and passive funds
- General compensation contracts
- Heterogeneous valuations of liquidity investors
- Mispricing depends on firm value/governance

Conclusion

Contribution

- Tractable theoretical framework to evaluate governance effects of delegated asset managers

Implications

- Whether passive funds crowd out investors’ allocations to active funds is crucial
- There can be a trade-off between governance and fund investors' well-being
- Lower fund fees do not imply worse governance