

Passive Investing and Corporate Governance

Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value

Professor Rudi Fahlenbrach,
Swiss Finance Institute at
Ecole Polytechnique Fédérale
de Lausanne (EPFL)



Overview of presentation

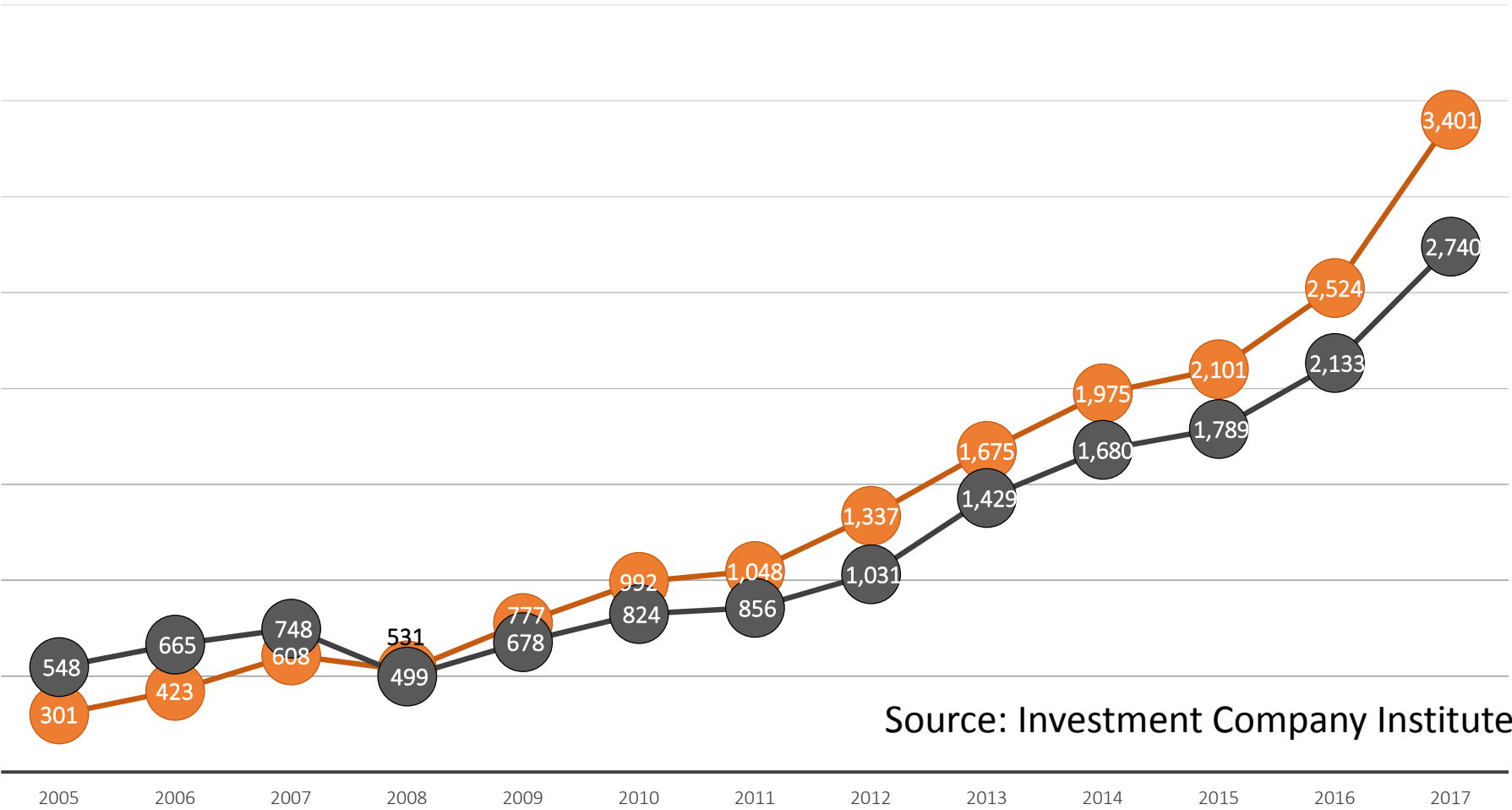
Big picture

Exogeneous changes in passive ownership as a framework for policy

An evaluation of the corporate governance activity of passive managers

Conclusion

Growth in total AuM (\$ bn) of US-based passively managed ETFs and index MFs, 2005-2017



Source: Investment Company Institute

What are the consequences of that growth for the shareholder base of corporations worldwide?



15 largest shareholders

	<u>Holder</u>	<u>% Owned</u>	<u>Mkt. Value (USD in mm)</u>
1	The Vanguard Group, Inc.	7.162	51,590.50
2	BlackRock, Inc.	6.254	45,046.40
3	Berkshire Hathaway Inc.	5.338	38,450.00
4	State Street Global Advisors, Inc.	4.071	29,320.00
5	FMR LLC	2.273	16,369.00
6	Northern Trust Global Inv.	1.238	8,920.90
7	Geode Capital Management, LLC	1.160	8,357.70
8	BNY Mellon Asset Management	1.017	7,324.90
9	Norges Bank Investment Mgmt	1.008	7,259.00
10	Invesco Capital Management LLC	0.905	6,520.10
11	Morgan Stanley, IB / Brokerage	0.806	5,807.90
12	TIAA-CREF	0.775	5,581.80
13	UBS Asset Management	0.757	5,453.70
14	J.P. Morgan Asset Management	0.706	5,086.10
15	T. Rowe Price Group	0.623	4,489.50



15 largest shareholders

	<u>Holder</u>	<u>% Owned</u>	<u>Mkt. Value (CHF in mm)</u>
1	BlackRock, Inc.	3.944	10,069.80
2	Capital Research and Management Company	3.485	8,897.20
3	The Vanguard Group, Inc.	2.820	7,200.70
4	Norges Bank Investment Management	2.367	6,044.70
5	UBS Asset Management	1.961	5,006.00
6	Massachusetts Financial Services Company	1.746	4,458.30
7	Credit Suisse Asset Management	1.050	2,680.30
8	Harris Associates L.P.	0.573	1,463.80
9	Zürcher Kantonalbank, Investment Arm	0.530	1,352.10
10	Gardner Russo & Gardner	0.504	1,286.50
11	Deutsche Asset & Wealth Management	0.491	1,254.50
12	Pictet Asset Management Limited	0.486	1,240.80
13	Flossbach von Storch AG	0.476	1,216.00
14	First Eagle Investment Management, LLC	0.447	1,141.70
15	FMR LLC	0.440	1,123.40



15 largest shareholders

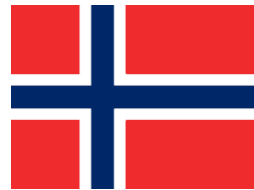
	<u>Holder</u>	<u>% Owned</u>	<u>Mkt. Value (BRL in mm)</u>
1	Litel Participações S.A.	21.480	58,117.10
2	Capital Research and Management Company	14.324	38,755.40
3	BNDES Participações S.A. - BNDESPAR	6.579	17,801.60
4	Bradespar S.A.	5.695	15,409.40
5	Mitsui & Co., Ltd.	5.549	15,013.00
6	BlackRock, Inc.	4.657	12,600.90
7	The Vanguard Group, Inc.	2.443	6,609.00
8	The Privest Group Limited Share Trust	1.687	4,563.60
9	Dimensional Fund Advisors L.P.	1.460	3,950.90
10	Standard Life Aberdeen plc	1.329	3,596.10
11	Orbis Investment Management Limited	1.264	3,419.50
12	Bradesco Asset Management S.A.	1.092	2,955.90
13	Norges Bank Investment Management	1.032	2,791.50
14	Caixa Economica Federal, Asset Mgmt	0.711	1,922.40
15	Fisher Investments	0.661	1,789.00

Largest passive investors

- BlackRock, Vanguard, State Street, the Norwegian Sovereign Wealth Fund, Capital Research and Management, and Fidelity own some 20% of world market capitalization, and they are often among the largest shareholders in a corporation



Vanguard[®]



BLACKROCK



The important role of large shareholders for corporate governance

- Corporate governance research attributes an important role to large shareholders
 - they have enough shares to get involved in the company and to **supervise management**
 - they are important enough to be able to **speak to management**
 - they can help **orchestrate a takeover** of the company if things don't go well
- However, when researchers think about large shareholders and their importance for supervising companies, they have shareholders like Warren Buffet or Daniel Loeb in mind

Daniel Loeb, Third Point Capital

- Activist investor in Nestle (since June 2017)
- Writes letters to management, intervenes, seeks board representation – often, but not (yet?) in Nestlé’s case
- If unhappy, engages more actively (www.nestlenow.com)



Third Point Capital vs an investment management company as a large shareholder

- For many reasons, unrealistic to expect that an investment management company will or can carry out the same level of activism as an activist hedge fund:
 - **Votes are aggregated** across dozens or hundreds of different funds with potentially different investment styles
 - **Conflicts of interests** with other business lines
 - **Legal issues**
- Fascinating paper by John Morley on these issues that will be presented next
- My talk: what exactly is the evidence on the corporate governance activities of passive asset managers?

The two channels of governance for institutional asset managers

- How do institutional investors protect their stake in poorly governed companies?
 - **Voice channel:** Become active and try to bring about change
 - **Exit channel:** Walk away and sell your shares: “The Wall-Street-Walk”

The two channels of governance for institutional asset managers

- How do institutional investors protect their stake in poorly governed companies?
 - **Voice channel:** Become active and try to bring about change
 - **Exit channel:** Walk away and sell your shares: “The Wall-Street-Walk”
- Both channels, however, appear at first glance ill-suited for index-tracking institutions:
 - **Voice channel:** expensive for low-cost and low-overhead passive institutional investors that cover thousands of stocks
 - **Exit channel:** not available to institutional investors who track indexes and are often paid by tracking error

Corporate governance activities of passive institutional investors

- Jill Fisch has convincingly argued in her presentation that there are significant economic incentives for passive investors to engage and to use the ‘voice channel’
- Passive institutional investors themselves also insist that they have a **fiduciary duty to exercise governance** and that it is in their interest, as they are long-term holders

A Sense of Purpose

“Globally, investors’ increasing use of index funds is driving a transformation in BlackRock’s fiduciary responsibility and the wider landscape of corporate governance. [...]

In managing our index funds, BlackRock **cannot express its disapproval by selling the company’s securities as long as that company remains in the relevant index.** As a result, our responsibility to engage and vote is more important than ever. In this sense, **index investors are the ultimate long-term investors** – providing patient capital for companies to grow and prosper. [...]

Source: <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

Overview of presentation

Big picture: Large shareholders and corporate governance

Exogeneous changes in passive ownership as a framework for policy

An evaluation of the corporate governance activity of passive managers

Conclusion

Exogeneous changes in passive ownership as a framework for policy

- We need to have causal evidence to make policy recommendations, not just document correlations
- For example, it is plausible to expect that a firm's shareholder structure is influenced by firm characteristics that also drive changes in governance
- A series of papers has used the Russell 1000/2000 index reconstitution which is based on changes in market capitalization to obtain (almost) exogeneous variation in ownership

Russell 1000 / 2000 index reconstitution

- Russell Investments **ranks all U.S. stocks according to their raw market capitalization** by the end of May each year
 - Largest 1000 firms by market cap form Russell 1000 index
 - Firms between 1,001 and 3,000 form Russell 2000 index
 - Amount of money benchmarked to the Russell 1000 and Russell 2000 are approximately of the same order of magnitude
 - Weights of lowest ranked Russell 1000 firms **are ten times smaller** than weights of the highest ranked Russell 2000 firms
- Russell index-tracking institutions increase holdings of firms that switch from the Russell 1000 to the Russell 2000 for reasons that have (almost) nothing to do with firm fundamentals

Identification – variation in passive ownership caused by Russell 1000/2000 index reconstitution

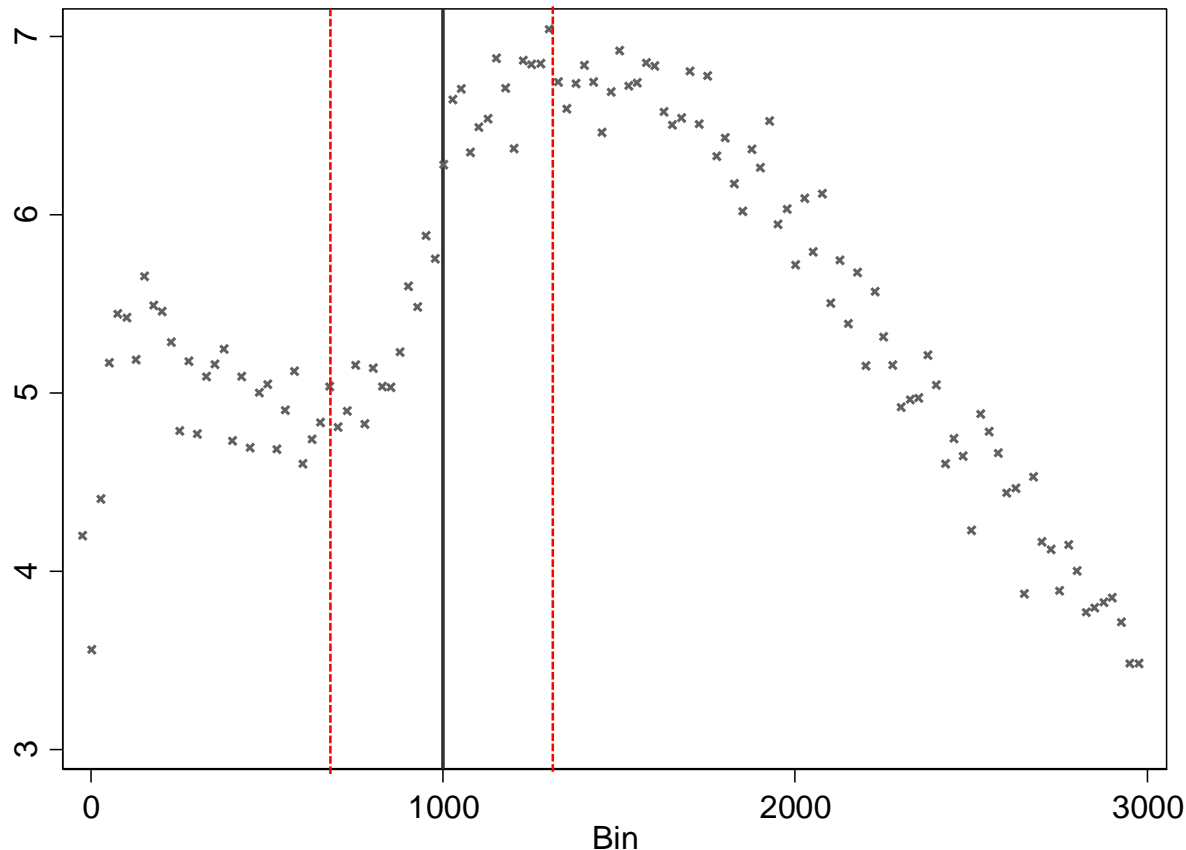


Fig. 1. Shareholdings by passive institutional investors around the index reconstitution threshold. The figure shows the level of passive institutional ownership by Russell 1000 and Russell 2000 index-tracking institutions. Each marker in the figure corresponds to the average holding of passive investors for a bin of 25 stocks. The vertical line at 1,000 indicates the index reconstitution threshold. Stocks to the left of the line are members of the Russell 1000, and stocks to the right of the line are members of the Russell 2000. Sample period is 1992 to 2010.

Five slides on the methodological debate in the literature

Reconstitution of the Russell 1000 and Russell 2000 indices - complications

- Rank day** { Last trading day in May. The one thousand largest firms comprise the Russell 1000 index and the next two thousand firms constitute the Russell 2000 index. Both indices are value weighted. Researchers do not have access to the raw market cap used by Russell
- Reconstitution** { Last Friday in June. Russell sets portfolio weights for each index. Russell computes the index weight using a proprietary float adjustment to account for shares not part of the free-float (strategic shareholders, significant inside ownership, IPO lockups)
- Banding policy** { To mitigate unnecessary turnover, beginning with its 2007 reconstitution, Russell set a banding policy around the 1000 cutoff. If an index member's market capitalization has not deviate more than a set threshold it remains in its original index

(Source: FTSE Russell j Russell U.S. Equity Indexes Construction and Methodology, v2.1, April 2016)

Index ranks vs market capitalization ranks

- Free-float adjustment can lead to important differences between raw market capitalization rank and index weights rank
- E.g., CNH Global in 2010:
 - Raw market capitalization rank of 412
 - But majority shareholder Fiat S.P.A. held 89% of the shares
 - Russell removed Fiat's stake in the free-float adjustment
 - Float-adjusted index weight rank of 973
- In a free-float-adjusted ranking
 - the lowest ranked stocks in the Russell 1000 are more likely to have strategic shareholders or significant inside ownership
 - the highest ranked stocks in the Russell 2000 will be those that are the most liquid

Index ranks vs market capitalization ranks, ctd

- Economic argument for why passive institutional ownership changes with an index reassignment is based on end-of-June index weights calculated on the basis of free-float adjusted market cap
- Actual assignment to the Russell 1000 or Russell 2000 index, where firms are close to each other and index inclusion is locally random and what is used for identification, is instead based on raw market capitalization weights at the end of May.
- Example of CNH Global indicates that a sample selection based on free-float adjusted index weights within each index are inappropriate for identification

Overview of presentation

Big picture: Large shareholders and corporate governance

Exogeneous changes in passive ownership as a framework for policy

An evaluation of the corporate governance activity of passive managers

Conclusion

Three academic papers that offer causal analysis of passive investors and corporate governance, all using the Russell 1000/2000 methodology

- Appel, Gormley, and Keim (2016) (CG activities at AGMs)
- Schmidt and Fahlenbrach (2017) (CG activities outside AGMs)
- Appel, Gormley, and Keim (2019) (interactions with activists)

Identification – variation in passive ownership caused by Russell 1000/2000 index reconstitution

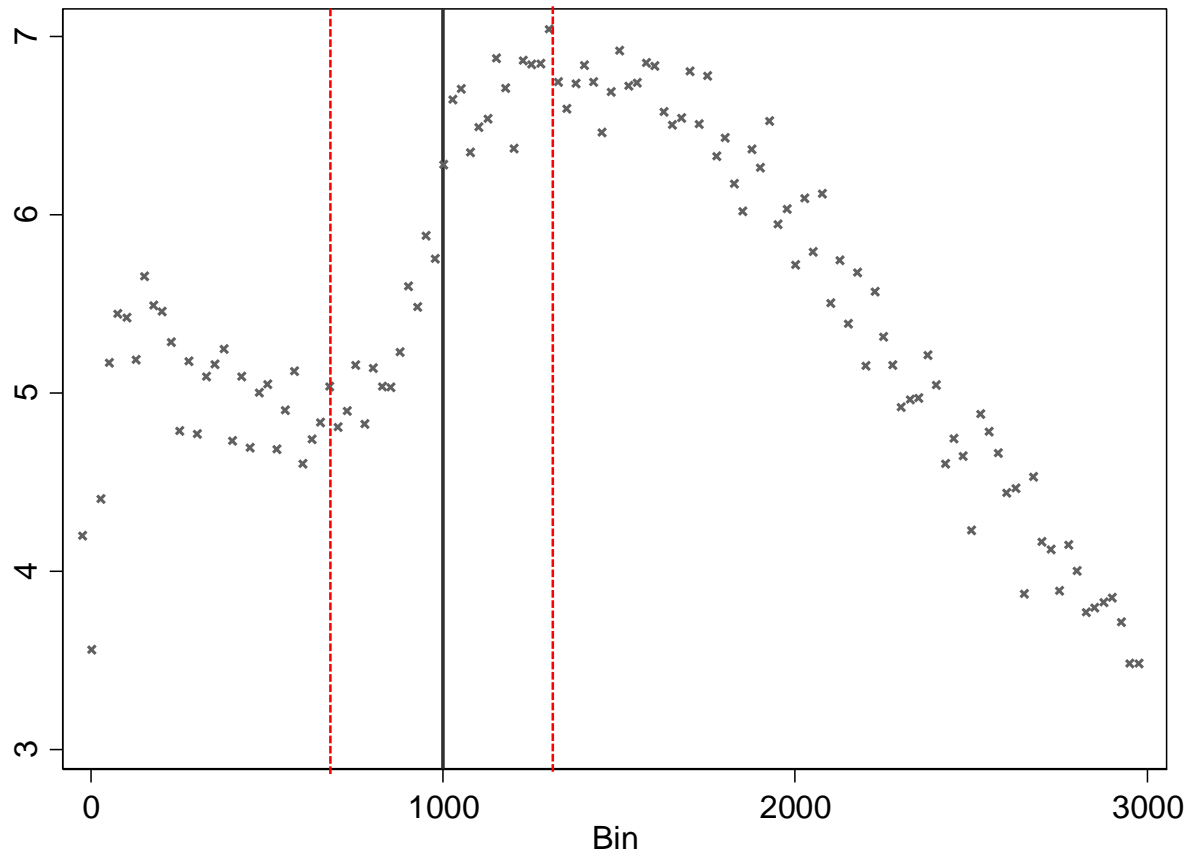


Fig. 1. Shareholdings by passive institutional investors around the index reconstitution threshold. The figure shows the level of passive institutional ownership by Russell 1000 and Russell 2000 index-tracking institutions. Each marker in the figure corresponds to the average holding of passive investors for a bin of 25 stocks. The vertical line at 1,000 indicates the index reconstitution threshold. Stocks to the left of the line are members of the Russell 1000, and stocks to the right of the line are members of the Russell 2000. Sample period is 1992 to 2010.

Appel, Gormley, and Keim (2016)

- Appel, Gormley, and Keim (2016) examine *basic* corporate governance mechanisms that the largest passive institutional investors themselves describe as relevant to them
- These mechanisms are targeted because they require a relatively low level of monitoring
- Findings suggest that passive mutual funds influence firms' governance choices through proxy voting, resulting in more independent directors, removal of takeover defenses, and more equal voting rights

Schmidt and Fahlenbrach (2017)

- Examine *high-cost* governance activities which require continuous monitoring throughout the year, and not just proxy voting
- Find that increases in passive ownership lead to
 - increases in CEO power (e.g., accumulation of titles)
 - fewer off-schedule new independent director appointments
 - lower announcement returns for those appointments, suggesting captured independent directors
 - worse mergers and acquisitions

A Sense of Purpose

“Globally, investors’ increasing use of index funds is driving a transformation in BlackRock’s fiduciary responsibility and the wider landscape of corporate governance. [...]

In managing our index funds, BlackRock cannot express its disapproval by selling the company’s securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever. In this sense, index investors are the ultimate long-term investors – providing patient capital for companies to grow and prosper. [...]

If engagement is to be meaningful and productive, then engagement needs to be a year-round conversation about improving long-term value.”

Source: <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

Appel, Gormley, and Keim (2019)



CALERES

★ 5 ★



<u>Top 3 passive holders</u>	<u>Percentage owned</u>
The Vanguard Group, Inc.	9.8%
BlackRock, Inc. (NYSE:BLK)	6.9%
State Street Global Advisors, Inc.	4.5%
	21.2%

<u>Top 3 passive holders</u>	<u>Percentage owned</u>
BlackRock, Inc. (NYSE:BLK)	12.1%
The Vanguard Group, Inc.	8.8%
State Street Global Advisors, Inc.	3.7%
	24.6%



Main Results



- Target selection:
 - no evidence that activists target more frequently firms with more passive ownership; no evidence that passive ownership impacts the type of firms that are targeted
- Conditional on having selected a target:
 - Tactics of campaign: They seek more board seats when passive ownership is high and are more willing to engage the company if it does not respond to demands (via proxy fights for board seats)
 - Campaign outcomes: More likely to win settlements; not more likely to win proxy battles that go to a vote

Overview of presentation

Big picture: Large shareholders and corporate governance

Exogeneous changes in passive ownership as a framework for policy

An evaluation of the corporate governance activity of passive managers

Conclusion

The research results seem to be in line with common wisdom...

- According to a Wall Street Journal article*, in 2016,
 - Vanguard employed about 15 staff for voting and stewardship at its 13,000 portfolio companies
 - BlackRock employed 24 staff for voting and stewardship at 14,000 portfolio companies
 - State Street Global Advisors employed fewer than 10 staff for voting and stewardship at 9,000 portfolio companies
- Implies that most governance activities restricted to proxy voting

* **Source:** Krouse, Sarah, David Benoit, and Tom McGinty. 2016. "Meet the New Corporate Power Brokers: Passive Investors." *Wall Street Journal*, October 24.

... and insights from passive investors themselves

From Larry Fink's (BlackRock) 2018 letter

“We also intend to **double the size of the investment stewardship team over the next three years**. The growth of our team will help foster even more effective engagement with your company by **building a framework for deeper, more frequent**, and more productive **conversations.**”

Corporate governance activities of passive institutional investors – my personal view

- More passive ownership **improves governance for low-cost** governance activities
 - consistently voting according to a pre-defined program at annual general meetings
 - E.g., endorsing removal of poison pills and staggered boards
- More passive ownership **reduces governance for high-cost** governance activities
 - monitoring and assessing value creation of M&A
 - monitoring other events that happen outside of annual general meetings and require continuous oversight
- **It is unreasonable to expect an activist approach** to governance by passive institutional investors