Why would passive funds invest in corporate governance?

Ownership by passively managed funds has increased over the last 20 years. They are called passive because they hold stock in proportion to the company's weight on a published index, such as the FTSE100 or the Dow Jones Industrial Average. Being tied to indexes means they cannot modify the weight of a specific company in their portfolio. ***Henry Friedman and Lucas Mahieux*** *explore passive funds' incentives to monitor the firms they invest in and present a nuanced view of the role that these funds play in firms' corporate governance.*

The Big Three passive fund managers (BlackRock, State Street, and Vanguard) have roughly quadrupled their collective ownership stake in S&P 500 companies over the past two decades (Hirst and Bebchuk, 2019). This enormous increase in ownership by passively managed funds raises questions regarding the corporate governance of firms because it is unclear to what extent passively managed funds have the incentives to monitor their portfolio firms. Reduced monitoring and oversight in aggregate can open the door to executive entrenchment, inefficient corporate investments, and inattention to long-term risks.

Passive funds primarily compete on both price and performance with other investment options to attract fund flows and retain assets under management (AUM). On the one hand, competition can reduce passive funds' incentives to engage in monitoring, as monitoring also benefits competing funds and investors who take direct positions. Indeed, unlike actively managed funds, which can modify the weight of a portfolio company based on its expected performance, passive funds hold stock in proportion to the company's weight on a published index. A passive fund that invests in value-increasing governance, therefore, would improve the performance of competing funds in equal measure. Active funds can overweight companies that passive funds monitor, further reducing passive funds' incentives to invest in corporate governance.

On the other hand, competition may provide passive funds with a variety of incentives to engage with the companies in their portfolios. Engagement allows for differentiation that reduces direct competition between passive and active funds. Furthermore, the size of the major passive funds and the breadth of their holdings affords them economies of scale that not only justify engagement economically but also enable them to engage effectively. Rock and Kahan (2019) argue that both active and passive funds have incentives to improve performance when they compete.

In a recent working paper, we shed light on this debate by analysing the monitoring incentives of passive and active funds when they compete both with each other and with direct and risk-free investment options. To that end, we develop an economic model in which passive and active fund managers can choose which firms to monitor, and active fund managers have pre-investment information about firm performance. In the model, active funds invest in firms with higher expected performance and attract investors with relatively high risk-tolerance. Investors with intermediate risk-tolerance invest in passive funds to gain diversification benefits, and the most risk-averse investors hold risk-free securities. The implications we derive for monitoring depend on additional features of the environment.

First, we show that taking the active fund monitoring as given, competition between active funds and passive funds that invest in the same firms decreases the incentives of passive funds to monitor those firms. Active monitoring and passive monitoring are then substitutes. This first insight is in line with arguments that competition reduces the incentives of passive funds to engage in monitoring activities, as monitoring will also benefit the other competing funds.

Second, taking into account the impact of passive fund monitoring on active fund monitoring, we highlight a complementarity effect, which implies that passive funds may have incentives to monitor the same firms as active funds. Active monitoring and passive monitoring are more likely to be complements than substitutes when the impact of passive monitoring on active monitoring is large.

Our research delivers several other corporate governance implications. Some academics have made the case against passive shareholder voting, whereas others have proposed arrangements in which long-term shareholders receive more votes per share than short-term shareholders. Our results provide insights into the consequences of restricting fund managers' voting rights. We show that removing the voting rights of passive funds may increase or decrease the active funds' incentives to engage in monitoring. Similarly, restricting voting rights of active funds may decrease or increase monitoring by passive funds. The overall effects on total monitoring are therefore ambiguous and depend on the complementarity between the funds' monitoring choices.

Additionally, our results contribute to an ongoing debate on whether activist investors should publicly disclose their portfolios. In order to reduce "unnecessary burdens" on smaller fund managers, the SEC has proposed that only investors with assets of more than $3.5bn will have to submit quarterly 13F filings, raising the threshold from its current value of $100m. Hundreds of US-listed companies have come out against this proposal. We show that disclosure or non-disclosure of active fund portfolios also has implications for the monitoring activities that fund managers find optimal. In particular, a lack of disclosure can make it more difficult for passive funds to target their monitoring efforts, which in turn has spillover effects on active fund monitoring. We show that reduced disclosure leads to less monitoring in aggregate if the active fund manager's monitoring cost is very high or very low, but more aggregate monitoring if this cost is intermediate. This result highlights the importance of considering the monitoring context when evaluating the costs and benefits of the SEC's proposed disclosure reduction.

Overall, our research shows that even passive funds find monitoring portfolio firms optimal, because such monitoring helps attract and retain (retail) investors. We further demonstrate that passive and active fund monitoring may be strategic complements, leading to monitoring of the same firms, or strategic substitutes, leading to monitoring of different firms. Our research therefore provides a more nuanced view of the role that passive funds play in firms' corporate governance.

Notes:

- *This blog post expresses the views of its author(s), not the position of LSE Business Review or the London School of Economics.*
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