FTfm Passive Investing

US index funds less likely to hold companies to account, study finds

Report says rise of index investing shifts power from investors to corporate managers

The research was done by academics at Utah and Geneva universities © Rick Bowmer/AP

Jennifer Thompson AUGUST 4, 2019

US index funds vote against management at investee companies less frequently than their actively

executive pay, research has found.

The difference suggests passive managers are not as likely to hold companies to account, say academics at Utah and Geneva universities.

When it came to contentious proposals at annual meetings — defined as those in which proxy adviser Institutional Shareholder Services recommended voting against the preference of the company — index funds sided with management 55.5 per cent of the time compared with 46.2 per cent for their active counterparts.

Index funds "potentially challenge the way corporate governance occurs", said Matthew Ringgenberg, associate professor of finance at Utah and one of the study authors.

The analysis challenges accusations that passive managers blindly follow the recommendations ofproxy advisers such as ISS at a time of greater scrutiny on how the voting advice industry operates.

The research, which examined US equity mutual funds between 2004 and 2017, said index funds were overall 12.5 percentage points less likely to vote against company executives when compared with active funds.

The study also found that index funds exited companies in their benchmark index less frequently than active funds.

While this might seem unsurprising for products that are compelled to track an index, passive managers do not necessarily hold all the stocks in their benchmark and do have some room to manoeuvre.

The report said index funds were far less likely to file a Schedule 13D, a filing used to indicate that investors are seeking significant changes at a company, and found that increased passive

meetings.

"The rise of index investing is shifting power from investors to corporate managers," the study said.

There is growing scrutiny over the stewardship record of providers of products such as index cap-weighted funds and exchange traded funds, which have scooped up trillions of dollars in assets. In 1990, less than 1 per cent of all mutual fund assets in the US were held by passively managed index funds but by 2017 this was 29 per cent, representing more than $6tn.

A recent study by consultancy Create-Research revealed that many pension schemes were concerned that passive fund managers failed to fulfil stewardship duties, partly because of the sheer number of companies in the indices their products tracked.

Rosanna Landis Weaver, programme manager of executive compensation at Californian non-profit As You Sow, described investment managers voting too closely in line with management's wishes as "a recipe for risk". "I have some serious concerns," she said.

The Big Three in passive investment — BlackRock, Vanguard and State Street Global Advisors, which collectively oversee more than $15tn — have beefed up their stewardship teams in recent years and argue that they do hold companies to account. BlackRock has 43 people working in stewardship, Vanguard 35 and SSGA a dozen.

The researchers, which said that index funds with low expense ratios were more likely to vote with management than those with higher fees, suggested that the low cost of index investing may be a barrier to them monitoring investee companies more effectively.

"The upside of index funds is that they're cheap. The downside is that they're cheap," said Ms Landis Weaver.

Another academic study examining engagement at large British companies found that for some

management more often than active managers.

However, the paper by Suren Gomtsian, lecturer in business law at the University of Leeds, found that the differences were not statistically significant.

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