PASSIVE INVESTORS

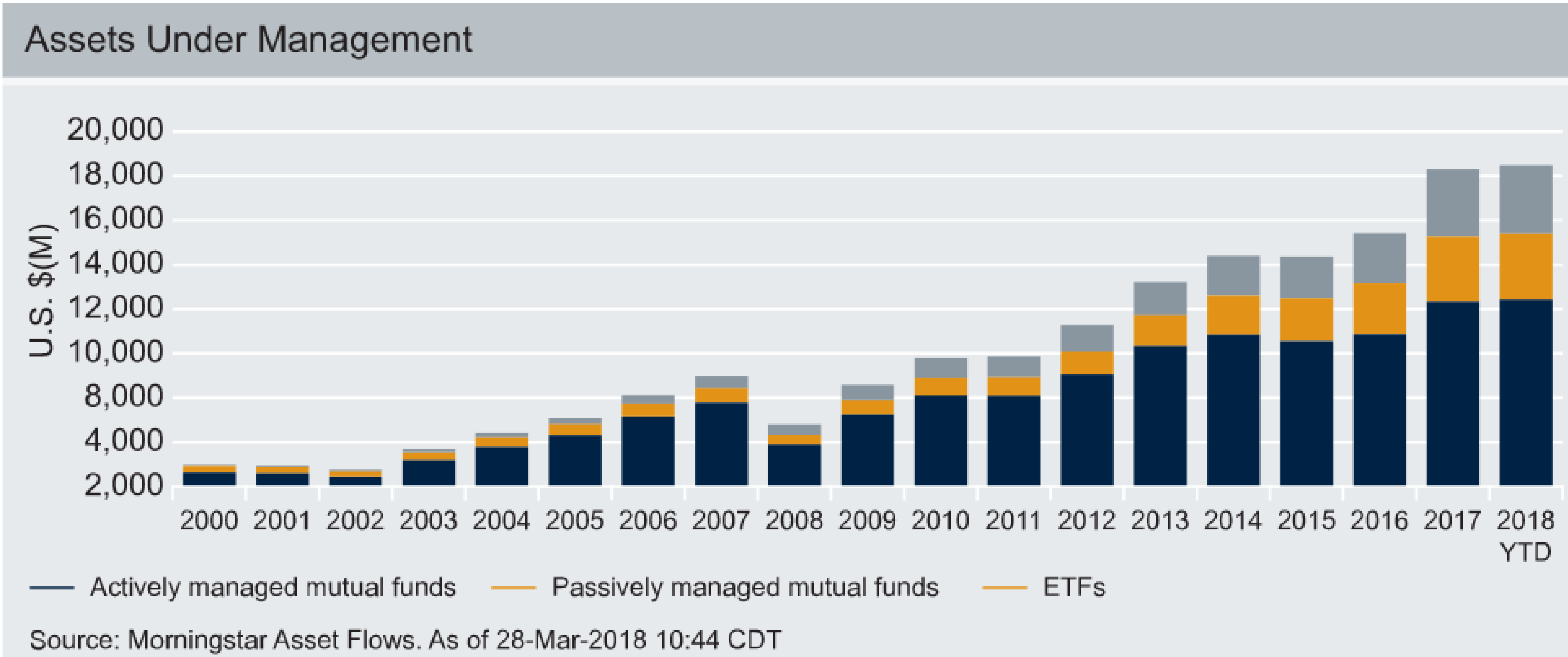
Jill E. Fisch
Assaf Hamdani
Steven Davidoff Solomon

Overview

- Investment assets have shifted dramatically into passively-managed funds
- This has generated controversy
- Much of the controversy is insensitive to the institutional context in which passive funds operate
- We examine this context and demonstrate that sponsors of passive funds have incentives to engage and can do so effectively
- We then consider potential concerns about this engagement

What is Passive Investing?

Size of Mutual Fund Market



The passive fund market has grown in both size and concentration

Blackrock alone has $6.3 trillion in assets under management!

The Big Three

The Big Three.

Passive Investing critiques

Passive investors "lack[] a financial incentive to ensure that the companies in their portfolio are well run").

Dorothy Shapiro Lund

Lucian Bebchuk & Scott Hirst

Index fund managers have "substantial incentives to under-invest in stewardship"

"[a] small group of institutions has acquired large shareholdings in horizontal competitors throughout our economy, causing them to compete less vigorously with each other

Einer Elhauge

Robert Shiller

Passive investing is a dangerous, chaotic system

The Passive Investor Critique

If passive funds simply hold the index, why should they care about corporate governance?

Passive investors' business model is about cutting costs, so they can't afford to spend money to become informed

Problems with this Critique

- What is a passive fund?

- **Fidelity's Sustainability Index Funds Provide Access to U.S. and International Markets**
- Each fund will attempt to replicate the performance of its respective index, before expenses, by normally investing at least 80% of its assets in securities included in the index.
- **Fidelity U.S. Sustainability Index Fund** will seek to provide investment results that correspond to the total return of the MSCI USA ESG Index. The MSCI USA ESG Index is a capitalization-weighted index that provides exposure to companies with high ESG performance relative to their sector peers, as rated by MSCI ESG Research. MSCI USA ESG consists of large- and mid-cap companies in the U.S. market.

BOON - NYSE Pickens Oil Response ETF

- BOON tracks an index of equally weighted US large-cap companies with significant correlation to the price of Brent crude oil.
- **BOON Factset Analytics Insight**
- BOON looks beyond the traditional energy sector for exposure to energy stocks it aims to invest in all US large-cap companies with significant correlation to the price of Brent crude oil. The index measures the sensitivity of each company's total returns to the price of Brent crude over the previous five years. Targeted companies come from across the energy supply chain, including both producers and consumers the only prerequisite is correlation to crude oil. Only companies that consistently rank within the top 40% of the correlation analysis are considered for inclusion. The final portfolio is determined by a committee, which selects companies most strongly affected by energy demand. The fund is equally weighted and rebalanced quarterly. Although BOON provides specialized exposure, its fee still seems high for an index fund of US large-cap stocks.
- **BOON Expense Ratio .85%**

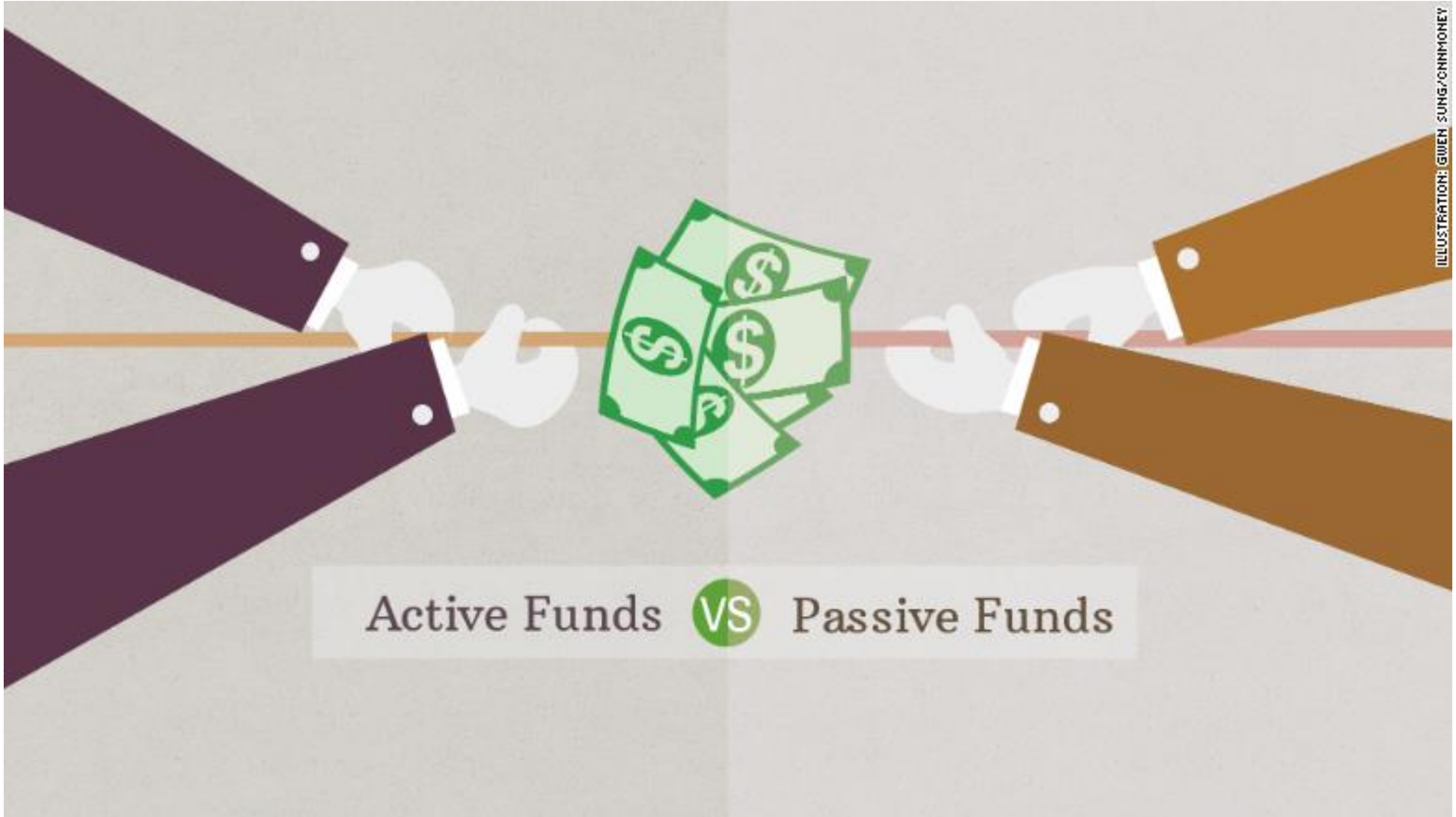
Problems with this Critique

- What is a passive fund?
- Sponsors not funds
- Customers, not shareholders
- The Nirvana fallacy – what is the relevant comparison?

Our Theory: The Business Model of Passive Investors

- Passive funds are locked into their portfolio companies, but
- Investors are NOT locked into passive funds
- Individual funds (active and passive) compete on fee-adjusted performance
- Recent data shows fee-based competition has declined
  - Zero fee funds failed to draw substantial inflows
  - Investors rated performance as important as fees

Passive Funds Compete for Assets with Actively-Managed Funds (and other passives)



Our Theory: The Business Model of Passive Investors

- The real competition occurs at the sponsor level where the goal is to
  - Gain customers and
  - Maximize fee revenue
- Sponsor level fund offerings (and thus incentives) differ

BlackRock - 2017

Passive Investors Can Engage Effectively

- Size creates economies of scale, lowering the cost of engagement
- Size also generates leverage with issuers – they are typically the pivotal voter
- Large number of holdings makes market-wide initiatives more practical and valuable than firm-specific interventions

Competition at the Sponsor Level

- Passive funds lower the cost and heighten the effectiveness of sponsor engagement
- Engagement synergies for sponsors of both active and passive funds

Passive Investor Engagement in Practice

- Passive investors devote increasing resources to analyzing governance issues
- Extensive private engagement with issuers – meetings, letter-writing
- Participation in governance organizations, standard-setting
- Growing political and regulatory influence (SEC rule-making)
- Passive investors mediate hedge fund activism

The Big Three and DuPont

- Vanguard, BlackRock and State Street were DuPont’s three largest shareholders
- All three voted for management
- Had any one of the three voted for Trian, the outcome would have been reversed

Potential Concerns

- Reduction in market discipline
- Ownership concentration
- Agency costs and conflicts of interest

Market Discipline

- The Secondary Market
  - Active funds still dominate
  - Even a much smaller active market would not reduce efficiency – Berk & van Binsbergen
  - The growth of passive funds increases the returns available to active investing
- The IPO Market
  - Passives don't generally buy at the IPO stage
  - Developments limiting inclusion of dual class in indexes

Passive Investment is Growing but Active Funds Continue to Dominate

Ownership Concentration

- The Big Three are getting pretty big
- But potential solution to Berle & Means problem (were we better off with dispersed retail investors?)
- Limited legal power of shareholders (see Morley)
- Continued role of other shareholders – actives, hedge funds, management

Conflicts and Agency Costs

- Fund level conflicts
  - Cross-ownership and voting on acquisitions
  - Cross-ownership and antitrust issues
  - Leveraging passive fund voting power in the interest of active funds
- Agency costs of fund managers

Larry Fink letters to CEOs

Society is demanding that companies, both public and private, serve a social purpose

Conclusion

- Current governance and antitrust critiques of passive investors are misguided
- Our theory shows that passive investor engagement is rational and efficient
- Regulatory intervention is not warranted at this time
- Increasing passive ownership merits continued attention