HOW ACTIVE IS PASSIVE INVESTMENT?

On shareholder engagement among the largest index fund providers

An explanation with the visual article

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Introduction

"The stock market started off like a rocket in 2019."[1] Sounds great. But what does it mean? Not much for most people – unless this is reflecting an upward trend in the long run. Most people are not really affected by daily market fluctuations. Not only because they have a relatively very small stake in the stock market[2], but also because an increasing amount of people invests through passive funds that thrive with long-term growth, rather than short-lasting spikes.[3]

The relationship that people have with the stock market has drastically changed over the last decades. In the past, retail investors – individuals as opposed to institutions – owned a majority of the shares in companies that were publicly listed. Companies like Ford or General Electric had private individuals as owners. Changes in the value of those companies had a direct impact on the assets of the retail investors holding those companies in their portfolio. Today, retail investors make up about 10 or 20% of the U.S. stock market. Institutions own about 78% of the market value of the Russell 3000 index (small- to mid-size public companies), and 80% of the S&P 500 index (largest companies).[4] Individuals have massively moved to passive investing. More than 100 million individuals, accounting for nearly 45% of the American households, own open-end funds.[5] As a result, funds own a third of the shares of outstanding stock issued in the U.S., a number that is growing.[6] This shift from investing in individual stocks towards diversified funds has fundamental consequences on the architecture and power dynamics of capital markets. It crucially alters the position of shareholders in scrutinizing the management of a company. In a world with large funds, it is asset managers who can represent trillions of dollars in shareholder scrutiny – which is fundamentally different than an individual owner holding a few stocks here and there.

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[1] Kleibnikov, (March 20, 2019) 'The Stock Market Is Having Its Strongest Start in 21 Years. Here's What It Could Mean for the Rest of 2019', *Money.com*. http://money.com/money/5639032/stock-market-strong-start/

[2] In the US, about 84 percent of stocks belongs to the wealthiest 10 percent of households, which takes in account the ownership of common retirement and schemes. See: Edward N. Wolff (2017) 'Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?' *NBER Working Paper* (24085).

[3] See for example: Anadu et al. (2018) 'The Shift from Active to Passive Investing: Potential Risks to Financial Stability?', Boston Fed Working Papers. https://www.bostonfed.org/-/media/Documents/Workingpapers/PDF/2018/rpa1804.pdf; Fisch et al. (March 2019), 'The New Titans of Wall Street: A Theoretical Framework for Passive Investors', ECGI Law Working Paper. https://poseidon01.ssrn.com/delivery.php?ID=287114112074117090094080071094020028127035061037007087028124064125100069075086097105101029122061103047118075117013006065019069013074027021053113117096005025082081100077037000066117090001105120104017023125089089022076006117026099030028076001078103100115&EXT=pdf

[4] Charles McGrath (April 2017), '80% of equity market cap held by institutions', *P&I* https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions

[5] Investing in an open-end fund is an investment in a collection of stocks and bonds that comprise the entire fund. More explanation will follow in the subsequent paragraphs.

[6] 2018 Investment Company Fact Book (58th ed. 2018), p. 39 and Figure 7.2 https://www.ici.org/pdf/2018_factbook.pdf
Robin Wigglesworth (December 2018), 'The Passive Attack: the story of a Wall Street Revolution', FT https://www.ft.com/content/807909e2-0322-11e9-9d01-cd4d49afbbe3

This data visualization project is a first look in how this translates in the changing role of fund managers vis-a-vis the companies during companies' shareholder meetings.

> Based on voting records from these shareholder meetings, how can we understand the shareholder engagement by large asset managers in how they represent millions of Americans?

To address this question, I will look at publicly available data that funds are legally obliged to file with the securities market regulator, the Securities and Exchange Commission ("SEC"). The general objective of this analysis is to get a better idea of the influence of funds – or lack thereof - on the way that corporates are run in America today. This paper intends to provide a contextual background of the visual analysis, and explain the methodology and limitations of the analysis. Again, this project is a first look: as is clear from the graphs in this essay, more data visualization is welcome on this topic.

1. The role of shareholders

The rise of investment funds, accessible to the "masses", affects the relationship between a company and its shareholders. This relationship touches upon the core of the functioning of our capitalist system: the shareholders, by holding the ownership of the company, bear the profits as well as the losses. Shareholders have an immediate interest in the success of a company. They are owning the company, but not leading it. That is because different shareholders can have diverging views on the appropriate corporate strategy – especially when there are thousands of them. Even if they agree, shareholders often have limited capacity to manage the company.

The corporate model therefore delegates the leadership of the company – to maximize shareholder value - to the management and the board of directors. However, this separation of ownership and control is not always harmonious: the interests of company's leadership (control) do not always align with the shareholders' interests (owners). An example of this is the compensation that managers receive, which is to some extent determined by the leadership itself but paid by the owners. That is why the discretionary power of the board and management to control the company is subjected to checks and balances that seek to protect shareholders' interests. Shareholders can play an active role in the strategy and structure of the company they invest in – as investors benefit from a company's net profitability, they act as a counter balance against a company's management.

One key feature of this, is the ability of shareholders to participate in shareholder meetings such as the annual meetings at which the major issues concerning the company's future are addressed and put to vote. Shareholders are entitled to receive information in the form of the company's annual report, proxy statement and voting instructions to facilitate their voting. Shareholders will vote, proportionate to the size of their ownership and their voting rights, upon the issues at the annual meeting that are proposed by management. Besides these proposals, shareholders can submit proposals themselves to have them voted upon, in which case shareholders become "activists". Under US regulation, shareholders holding $2,000 worth of shares, or 1% of the shares entitled to vote, for at least one year, may file shareholder proposals. Once filed, shareholder proposals mostly have three possible outcomes:

- appear on the ballot and be voted upon;
- be withdrawn by the shareholder activist following successful negotiations with the company; or
- left out from the ballot if the company receives a "no-action relief" by the SEC.[7]

Many shareholder proposals are non-binding: the company's management do not have to act on the proposals that succeed. However, proxy advisory firms (advising investors on how they should vote) and investors track this. They tend to reprimand a company that fails to address proposals that passed the year before. Most impactful, by pushing for the removal of "controversial" board directors. BlackRock explains: "We vote against management (including re-election of directors) if the company is consistently unresponsive or seems not to be acting in the long-term interests of shareholders. Often we vote against individual directors due to poor attendance records and/or over-boarding."[8] Even though the majority of shareholder proposals fail, shareholder proposals are a tool for shareholders to raise concerns about emerging issues or as a catalyst for engagement in a company. Funds are inclined to go against companies' management when these companies are insufficiently responsive to engagement efforts or fail to make progress on issues previously approved. These cases are rare, but serious for a company. Typical activists are asset owners (e.g. pension funds, insurance companies, sovereign wealth funds), NGOs, and active asset managers (notably hedge funds). Regardless of industry, size or performance, hedge fund activists target all sorts of companies. Activists established new records in 2018 by targeting about 300 companies, investing more capital and winning a larger number of board seats (161) than in all previous years.[9]

Often shareholders are not physically present to vote at the meeting. A system of *proxy voting* allows for the ballot to be cast by someone else than the shareholder. Registered asset managers that offer the funds cast proxy votes on behalf of the funds, representing the clients whose money is pooled with the fund. As a result, by participating in a fund, clients are not actively picking their individual stocks, nor actively voting at the shareholder meetings of the companies in their fund portfolio. A passive form of investing: in selecting and voting.

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[7] Under Securities and Exchange Act Rule 14a-8, companies can seek a 'no action relief' from the SEC to exclude certain proposals brought by shareholders. The most common cases in which the SEC to grant this relief is when the proposal is directly in conflict with a management proposal, or if the company already implemented what the proposal stands for.

[8] Barbara Novick (July 2018), The Investment Stewardship Ecosystem, *HLS Corporate Governance and Financial Regulation Blog* https://corpgov.law.harvard.edu/2018/07/24/the-investment-stewardship-ecosystem/

[9] Martin Lipton, Steven A. Rosenblum, Karessa L. Cain and Sabastian V. Niles, 'Wachtell Lipton on Dealing with Activist Hedge Funds and Other Activist Investors', *Columbia Blue Sky Blog* http://clsbluesky.law.columbia.edu/2019/02/04/wachtell-lipton-on-dealing-with-activist-hedge-funds-and-other-activist-investors/

2. The rise of passive investing

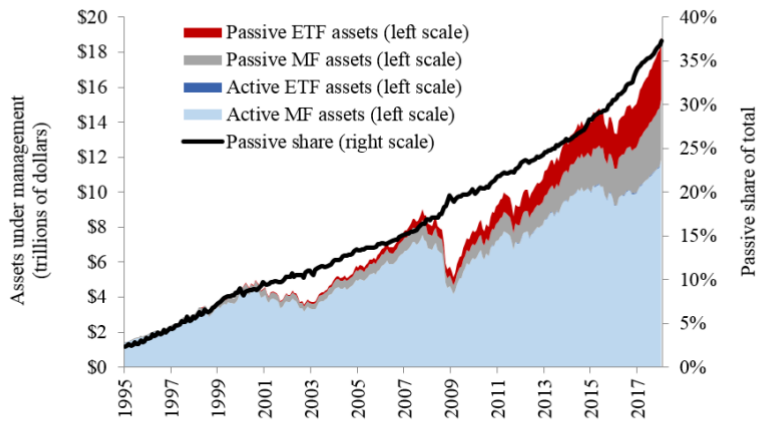
There are several forms of pooling investors into funds, but the most interesting development has been the significant rise of passive fund ownership. More and more people have a passive rather than active investment approach. People do not only rely on professional asset managers, but also increasingly invest with a more passive, long-term strategy regarding stock performance. Active investing implies a hands-on approach towards stock picking, when someone is acting in the role of portfolio manager.

Passive investing is a long-term approach, with a limited amount of trading and less immediate exposure to market movements. The typical example of passive investments are index funds, allowing people to ride (a part of) the market as reflected by stock indices like the Dow Jones, Nasdaq Composite or S&P 500. A market index is a hypothetical portfolio of investments in companies, based on certain selection criteria, which together represent a segment of the financial market. The performance of an index depends on the cumulative share price of the companies underlying the index: it tells something about how that market segment is doing in terms of stock price. These hypothetical portfolios are broadly used as benchmarks or for developing index funds. Index funds replicate the constituents of these indices into investment vehicles. Index funds are a pooling of money collected from a large number of investors in order to buy the stocks in the index, overseen by professional asset managers.

The total value of the fund depends on the performance of the securities purchased by the fund. The investors that collectively invested in the index fund each participate from gains and losses of the companies in the index, relative to their contribution in the fund. Individual investors cannot invest in an index without buying shares from each of the individual constituent companies, which is generally too expensive. Because index funds consist of a replication of the companies in the index, trading and management costs are relatively low. There is not much creativity needed to build an investment portfolio that is a copy of the S&P 500 companies. As such, index funds are an affordable way for people to participate in the market. Furthermore, active investment approaches require an active monitoring of how companies are doing in terms of finances, governance, exposure to sector risks, macro-economic trends etc. which is not only difficult (and often unsuccessful) but also time-consuming and of little interest to many people. Passive investing comes with little overhead to investors, allowing people to benefit from capital markets without much investment in terms of time, energy and financial knowledge.

Why passive investing works

Amazing isn't it? Many people think so. Around the world, more than $13 trillion is invested in index or passively-run mutual and exchange-traded funds.[10] Passive funds had the most traction in U.S. equities. In the US, passive funds represented about $4 trillion in 2017, accounting for about 43 to 45% of total US *equity* fund assets[11] and about 35% of total assets under management. Indeed, also the assets of more than 100 million Americans.[12]



Source: Morningstar (2018) link

Ok, but what if you are smarter than average (which a little less than 50% of the people are). What if we can pick the active asset managers with the best historical returns? Why would it make sense to be a passive participant in the markets rather than a potential winner? Why would you just follow the market instead of selecting the best companies and beating the market average?

Market efficiency contributes to price discovery so that securities trade closer to their "fair value". In more efficient markets it is harder for investors to consistently outperform "the market" based on economic research or financial analysis related to the asset. However, on the *level of individual actors*, even though market efficiency contributes to price discovery, some actors are more capable of digesting uncertainty and risk. More efficient markets enhance investors' ability to – in theory - know fair asset value. But efficiency does not necessarily solve *information asymmetries* during the investors' decision-making involved with investing. Even if – again in theory - retail investors are at par with the overall market in asset valuation based on the relevant information, their ability to oversee alternatives, understand uncertainty and risks on a portfolio (or multi-asset) level is significantly less than professionals.

That is why, on the level of individual market players, it is relevant to look at parties' *locus operandi* within the intermediation chains that characterize capital markets. Over the past decades, the academic idea of market efficiency has drastically altered the nature of retail investing. In 1976,

[10] Braham (February 19, 2019) 'How Jack Bogle Changed Investing', https://www.barrons.com/articles/yield-curve-inversion-51553272263

[11] Sushko, Vladyslav, and Grant Turner (2018), 'The implications of passive investing for securities markets' *BIS Quarterly Review*. https://www.bis.org/publ/qtrpdf/r_qt1803j.pdf; see also: Amy Whyte, "Passive Investing Rises Still Higher, Morningstar Says", *Institutional Investor* https://www.institutionalinvestor.com/article/b189f5r8g9xvhc/passive-investing-rises-still-higher,-morningstar-says

[12] 2018 Investment Company Fact Book (58th ed. 2018), p. 39 and Figure 7.2. https://www.ici.org/pdf/2018_factbook.pdf

John C. Bogle introduced the first index fund inspired by Burton Markiel's popular book *A Random Walk Down Wall Street* (1973). A year later, Nobel Prize winner Paul Samuelson argued in the article 'Challenge to Judgment' that there was no proof of fund managers being able to *systematically* outperform the S&P 500 on a *sustained* basis.[13] Based on the efficient market theory, this work showed that actively picking stocks will probably render mediocre result in the long term because - on average - markets are pretty accurate. And actually this theory is often confirmed by empirical data. Morningstar notes that for the year 2018, only 38% of active U.S. stock funds survived and outperformed comparable average passive funds, showing a down wards trend with 46% in 2017. Among the active funds, active value investment funds ("stock picking") had the most trouble, only 26% of them were able to beat the average passive fund in their categories.[14] Outflows from active funds are to the benefit of passive index-based funds. Meantime, the costs of indexing are declining rapidly – to the point that there are more zero-fee funds.[15] With these patterns, the rise of index-based investing no surprise. Mutual funds and exchange traded funds (ETFs) drastically changed the investment landscape for retail investors.

The passive landscape is concentrated

Passive investing works because of the low costs to investors to mitigate investment risks through cheap diversification, whereby the potential returns are not that much compromised. Jack Bogle (1929-2019), the actionable mind behind passive investing, is seen as the hero of "normal people".

However, while disruptive innovations have a massive success in solving existing problems, new problems are created along the way. Passive investing means a concentration of investors and their assets with the fund managed by the asset manager.

As scale allows for cheaper funds, which attracts more clients interested in low-fee investing, passive investing became concentrated. Research found that the ownership of the three largest fund managers in the U.S. together, are the largest shareholder in 88% of the companies in the S&P 500.[16] In other words, as largest owners, the three largest asset managers yield significant power over a fast majority of the large companies in the US. This power resonates in the voting at shareholder meetings.

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[13] Paul Samuelson (1974), 'Challenge to judgment', *The Journal of Portfolio Management*. https://jpm.iijournals.com/content/1/1/17

[14] Ben Johnson (February 2019), 'Actively vs. Passively Managed Funds Performance', *Morningstar research services* https://www.morningstar.com/blog/2019/02/12/active-passive-funds.html

[15] Elliot Smith (May 17, 2019), 'Investors will soon pay zero fees for market trackers, new research suggests', CNBC https://www.cnbc.com/2019/05/17/etfs-investors-will-soon-pay-zero-fees-research-suggests.html

[16] Fichtner et al. (2017), Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk. *Business and Politics* 19(2): 298-236.

Largest asset managers in the U.S. (in trillion $, as of September 2018)

Source: Statistica link

As a reference, the U.S. has a GDP of about $19.39 trillion. BlackRock, the largest asset manager, has clients that are governments, pension funds, sovereign wealth funds and endowments – they make up about 75% of BlackRock's business. The importance of these asset managers is twofold, as BlackRock is the largest manager *and* investor of the world. It is within the three largest shareholders in companies such as ExxonMobil, Apple, the four large U.S. banks. Index fund investing at BlackRock is significant: index investment mandates represent approximately 90% of equity assets under management.

Why concentrated ownership matters

In contrast to active investors, index funds do not imply active buying and selling based on the companies' expected returns or overall future prospects. They mostly follow the indices to set the composition of their fund portfolios. The sheer size of these large asset managers, and the fact that these funds do actively buy and sell, makes them recurrent players at shareholders meetings. However, unlike active investors, they do not need to assess the financial fundamentals and business of the company as they pick stocks based on what is in the index rather than their own judgement. In plain terms: index fund managers do not have to know what is going on with a company in order to invest in it. That stands in contrast with the informed mind-set that shareholders need in order to be critical of a company's leadership at shareholder meetings. Passive fund managers do not have the amount of equity analysts and researchers that characterizes active investment. The question arises, as these three large asset managers represent passive ownership in their trading strategy, are they equally passive in their engagement at shareholder meetings?

3. Active engagement by passive funds

When looking at the voting of funds, we talk about proxy voting since the voting is often not done by a physical presence at the shareholder meeting but by "proxy". What is involved in the voting of funds?

A mutual fund is a legal entity distinguished from the investment advisor (often referred to as asset manager) that manages it. The fund is the beneficial owner of the securities in its portfolio. This means that the board of directors of the fund, acting on the fund's behalf, has the right and obligation to vote at shareholder meetings for the companies in the fund's portfolio. In practice, the board typically delegates this function to the fund's investment adviser (such as BlackRock, Vanguard or State Street). The advisor is responsible for the general management of assets in the fund, subject to the board's continuing oversight: voting is part of that "general management" of the fund. These responsibilities come with a fiduciary duty that asset managers have towards their clients' whose money they manage. More specific, when asset managers must vote proxies, they should do so in a way that is in the sole interests of their clients.

Voting is a significant responsibility for the largest asset managers. There is a large amount of shareholder meetings and issues these asset managers have to vote upon. Asset managers oversee many funds, and the average mutual fund voted on 1,504 separate proxy proposals, during shareholder meetings for the 2017 season.[17] The largest manager, BlackRock votes at more than 18,000 shareholder meetings globally each year, on over 160,000 ballot items.[18] Vanguard's Investment Stewardship team voted at more than 18,000 company meetings.[19]

Each company has its own unique issues, ownership structure and strategic challenges that are relevant when deciding upon the vote. However, active monitoring of portfolio companies is not in the business model of index fund managers, who per definition follow indices rather than the fundamentals of companies. Asset managers therefore rely on proxy advisors. As a service, proxy advisors assist institutional shareholders with company research and the logistics around voting, including the vote execution.

The influence of funds

Large asset managers represent a powerful vote during shareholder meetings due to their relative size. This influence indirectly reflects the voices of millions of people that invested in the passive funds. This invites scrutiny, and a call for transparency.

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[17] SEC Commissioner Elad Roisman (March 2019) 'Keynote Remarks: ICI Mutual Funds and Investment Management Conference', https://www.sec.gov/news/speech/speech-roisman-031819#_ftn8

[18] Barbara Novick (July 2018), The Investment Stewardship Ecosystem, *HLS Corporate Governance and Financial Regulation Blog* https://corpgov.law.harvard.edu/2018/07/24/the-investment-stewardship-ecosystem/

[19] Vanguard, https://about.vanguard.com/investment-stewardship/portfolio-company-resources/

As part of being a *fiduciary* to the fund, an asset manager owes the fund a duty of "utmost good faith, and full and fair disclosure".[20] Following the SEC rule from 2003, funds that are registered under the Investment Company Act of 1940 (officially called "management investment companies") are required to disclose in their registration statement their voting policies and procedures; and asset managers must disclose the way they vote for their funds.[21] Asset managers disclose how they voted for each proposal during the shareholder meetings, including the amount of times they voted differently than management.

Another form of shareholder stewardship, in addition to voting at shareholder meetings, is the more implicit "shareholder engagement". Engagement can include in-person or written conversations with companies. Companies can approach asset managers to discuss proposals that have been brought by activist shareholders to gauge the support among other shareholders (like large asset managers) for the activist proposals. Through these conversations, the outcome of proposals can be reached in advance of the vote at a shareholders meeting. Companies or shareholders can be pressured by other shareholders, including the large asset managers. Large asset managers play a crucial role in these pre-meeting negotiations, and possible withdrawals if the proposal is accepted by a company beforehand. Withdrawals of shareholder proposals occur in about 11% of the cases in 2018, up from 8% in 2017.[22] BlackRock states it is taking an "engagement-first approach" in which proxy voting is one of the means for their stewardship as shareholders. "While we are generally supportive management, we believe board directors are elected to represent shareholder interests, among other things. As such, much of the focus of our proxy voting is on director accountability."[23]

Ongoing communication between the funds as "eternal" shareholders and the portfolio companies might lead to constructive consensus between large asset managers and portfolio companies.[24] However, even though asset managers publicize the amount of engagements they have, voting records are far more clear and transparent as regards to the way in which asset managers vote for their funds. In that sense voting records help fund investors to hold their asset managers accountable for their overall stewardship.

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[20] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940). *Cf*. Section 36(b) of the Investment Company Act [15 U.S.C. 80a-35]

[21] Form N-PX is used for open-end funds and Form N-CSR for close-end funds. https://www.sec.gov/rules/final/33-8188.htm#P52_9791

[22] Kosmas Papadopoulos, 'The Long View: The Role of Shareholder Proposals in Shaping U.S. Corporate Governance (2000-2018)', ISS. https://corpgov.law.harvard.edu/2019/02/06/the-long-view-the-role-of-shareholder-proposals-in-shaping-u-s-corporate-governance-2000-2018/

[23] Barbara Novick (July 2018), The Investment Stewardship Ecosystem, *HLS Corporate Governance and Financial Regulation Blog* https://corpgov.law.harvard.edu/2018/07/24/the-investment-stewardship-ecosystem/

[24] See for example, the idea behind the *New Paradigm.* Martin Lipton (February 11, 2019) 'It's Time to Adopt the New Paradigm', *HLS Corporate Governance and Financial Regulation Blog* https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm/

Public evidence on stewardship role: voting records

Based on the filings by funds on how they voted, form N-PX data, the ballot contains about 13 proposals on average per shareholder meeting. The majority of the proposals are brought bay management and routine matters such as the reappointment of auditors or reelection of directors. Asset owners and asset managers mostly agree with the management on such routine issues.

For the largest listed US companies, the 2 largest asset managers (Vanguard and BlackRock) are alike in that they supported about 99% of the management proposals, whereas they supported only about 9% of the shareholder proposals. State Street supported 24.2% of the shareholder proposals but voted on a relatively smaller amount.[25]

However, an analysis of fund voting records, should account for the tens of thousands of routine and non-controversial votes by disregarding those. The number of times funds agree with management on routine issues, skews the data towards funds voting the same. However, as I will analyze, funds not necessarily vote the same with respect to more controversial votes, like shareholder proposals.

4. Stewardship

Asset managers on their stewardship role

How do asset managers appreciate their responsibility to be long-term stewards? The largest fund providers are not activist – as that approach contrasts with their business model - but they are supposed to fulfill a "stewardship" role, - or at least aim to do so. The SEC stipulates that all mutual funds and ETFs funds disclose their proxy voting guidelines.

State Street (number three in terms of assets under management) says its "Built for impact: Proactively using our voice and our vote to make a measurable difference around the globe".[26]

Number two, Vanguard states that "Public attention often focuses on difficult issues such as environmental concerns, gun violence, and the opioid crisis. Such topics elicit strong emotions and a desire for action. Vanguard is constantly thinking about the role we play as a long-term investor representing the best interests of those who have entrusted us with their savings."[27]

For the largest player, BlackRock's CEO, Larry Fink, famously addresses companies' leadership: "Companies that fulfill their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail."[28]

[25] https://www.fundvotes.com/fundvotingdata/

[26] https://www.ssga.com/na/us/institutional-investor/en/about-us/asset-stewardship.html

[27] https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/voice-on-societal-risks.html

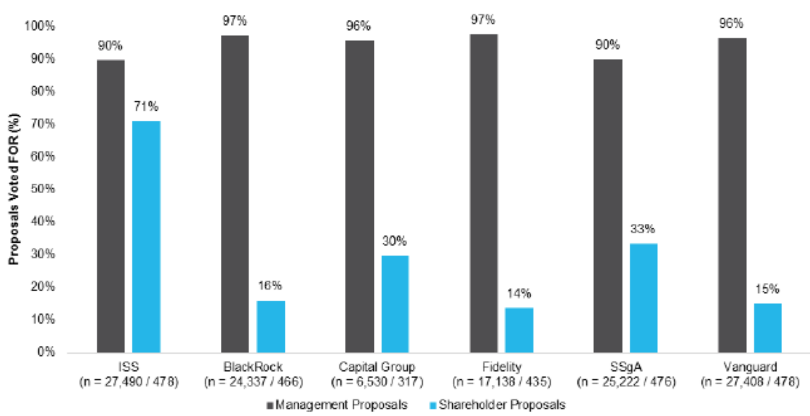
[28] Larry Fink Annual Letter to CEOs (2019). https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

Concentration and voting patterns

Given the ongoing increase of assets under passive management, as well as the concentration of investment firms managing these assets, the question arises: *How do asset managers actually put their aforementioned commitments in practice when they go out and vote?*

As said, voting on thousands of companies, each with several issues on the ballot, is time-consuming and costly. ***A recent concern therefore is that firms managing passive money become passive shareholders***.

They would rely too much on proxy advisors, which is – like the asset management industry - a heavily concentrated market. Institutional Shareholder Services (ISS), and Glass, Lewis & Co. control approximately 97% of the U.S. market for proxy advisory services.[29]
This duopoly of proxy advisory firms, and a select few asset managers who control a growing sum of passive money, the control of shareholder meeting outcomes seems extremely concentrated. Irrespective of proxy advisors' role, if the three largest asset managers are not caring too much (or unable to care) about each issue on the ballot – they might support management more often than they should as fiduciaries. Indeed, data shows that proxy advisors as well as the largest asset managers tend to vote *in favor* of management.



Indeed, looking at SEC Form N-PX filing data from 2014-2018, management can count on loyal support from these large voting blocks. Shareholder activists receive significantly less support.

Source: BlackRock (showing 2017 Form N-PX data) [link]

Is this strong support for management bad practice? Triggering a need for regulatory reform?

A closer look at the data shows that every ballot has far more proposals from management than from shareholders. Management proposals often relate to routine matters, such as the ratification of auditors or reappointment of un-contested board directors. Shareholder proposals however are contentious by nature – if management agreed or assumed all other shareholders would commonly support it, the issue would likely have been settled. Given the proportionate number

[29] Copland et al. (May 2018), 'Proxy Advisory Firms: Empirical Evidence and the Case for Reform', *Manhattan Institute,* https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf

of proposals from shareholders versus management, and the different nature of those, it is valid that asset managers usually vote in support of management. An analysis of voting records should therefore take account of thousands of non-controversial and routine matters – zoom in on the relevant votes. Asset managers can have significantly different proxy voting approaches, and investment stewardship more generally, but that is only reflected in non-routine votes. The previous graph (page 12) shows indeed that shareholder proposals do receive different levels of support among these players.

Why passive investment advisors should be active owners

That said, because of the concentration of this industry, the case for active ownership by asset managers becomes stronger on non-routine and shareholder issues. That is where large asset managers can make a difference. Zooming in on these non-routine and shareholder issues, social and environmental issues stand out. More environmental shareholders proposals received support.[30] But, having looked at the Form N-PX filing data with the specific proposals, this support can be more.

As long-term investors (investors as long as a company is in some tracked index), large asset managers have the ability to move corporate conduct in a more social and sustainable direction – beneficent to non-executive employees, and society at large.

A fiduciary should "*pursue the interest stakeholders*" in the interest of society, a responsibility that is implied by its size. One can disagree with this idea. But if we follow the more Milton Friedman-like "*maximization of shareholder value"* as the single purpose of assert managers as fiduciaries, active shareholdership still makes sense.[31] In short, not only social, but also financial reasons justify active engagement by passive managers:

1. An asset managers' active stewardship approach can be a potentially valuable part of an asset manager's brand. The largest asset managers are almost uniform in their low fees and passive investment strategies: the managers' different interpretations of "the sole interest of clients" comes to expression in how their engage with portfolio companies.
2. The largest asset managers offer an increasingly wide variety of index-based products. They are tracking indices that cover all corners of the public markets, all over the world. This means that the largest index asset managers are exposed to risks they cannot diversify – not even over time. Environmental risks – such as rising sea level, pollution and natural disasters – have negative economic consequences.
3. With large enough stakes in portfolio companies, active asset managers can less so rely (or "free ride") on other shareholders' efforts to hold companies' management

[30]Jackie Cook (March 2019), 'A Closer Look at Shareholder Democracy and the Proxy Process', *Morningstar* https://www.morningstar.com/blog/2019/03/06/proxy-process.html

[31] Not everyone thinks so. See: Lydia DePillis (January 2019), 'Shareholder activism is on the rise, but companies are fighting back', *American Council for Capital Formation*, http://accf.org/2019/01/31/shareholder-activism-is-on-the-rise-but-companies-are-fighting-back/

accountable. And if their shareholder stewardship is successful, they will capture a greater share of value from long-term value creation that follows from corporate governance improvements.

To start, it is therefore important that we, society and potential index fund investors, **have better understanding of the voting patterns of asset managers on the issues that matter to us** as it represents the voting power of our money. The information from Form N-PX filings, showing the voting patterns, is not easily accessible. SEC Commissioner Robert Jackson raised this issue, urging the SEC to improve the filing: "That's why I'm urging my colleagues at the SEC to pursue new rules requiring clearer, summary disclosure of the voting behavior of institutional investors relative to other voters' views on corporate elections."[32] Indeed, the data capturing done for the visualization was complicated by the data format that impedes further analysis.

Conclusion

The point of this research is to compare these funds' ambitions (their voting guidelines) to the raw data of how they voted (Form N-PX filings). As was mentioned, voting is not the only form of shareholder stewardship: funds do also "engage" with companies through ongoing conversations. However, this shareholder engagement is not visible in the way that voting records show exactly on what topics a fund supports or counters the company's management. It is this transparency is that is crucial. The only disclosed data is not transparent as it is too buried in an overwhelming amount of information of which only a little is relevant to investors – all presented in user-unfriendly data formats. That is where visualization can play an important role. This research is a first attempt.

[32] Robert Jackson (December 2018), 'Common Ownership: The Investor Protection Challenge of the 21st Century', *Testimony Before the Federal Trade Commission Hearing on Competition and Consumer Protection,* *https://www.sec.gov/news/testimony/jackson-testimony-ftc-120618#_ftnref13*