Index Fund Stewardship

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In an article published in the American Economic Association's *Journal of Economic Perspectives*, The Agency Problems of Institutional Investors (Bebchuk, Cohen and Hirst (2017) or "BCH"), we put forward and applied an analytical framework for understanding the monitoring and engagement decisions made by index funds. (Our article also extend the framework to actively managed funds). In light of the current policy discussions regarding the rise of index investing, this post discusses some of the implications of our article's results and conclusions for this discussion.

A significant body of recent work has expressed serious concerns that the rise of indexing leads to increase in "common ownership" that produces anti-competitive effects (e.g., Azar, Schmalz & Tecu (2018), Elhauge (2016); Posner, Scott Morton & Weyl (2017)). These writers worry that index funds, which have substantial ownership in many companies that operate in a given industry, can induce corporate managers to act in a more anti-competitive fashion than they would do without such institutional owners. We show that this line of work fails to take into account the incentives of index fund managers that we analyze. As a result, it makes implausible assumptions regarding the extent to which index fund managers influence the business decisions of their portfolio companies. Our incentive analysis should temper the concerns of index-fund-alarmists.

At the same time, our incentive analysis should also temper the enthusiasm of those who expect large governance benefits to flow from the rise of index investment. On the view of index-fund-enthusiasts, because index funds do not have the option of exit, they have a strong incentive to improve governance and thereby improve value, and their substantial stakes in companies enable them to do so. Indeed, the leaders of the largest index fund managers have made public announcements stressing their commitment to stewardship and improving corporate governance, and these fund managers have been expanding the number of staff that are dedicated to voting and engagement.

Such governance commitments by index fund managers are encouraging, and we recognize that well-meaning index fund managers may make stewardship decisions that are superior to those predicted by an incentive calculus. However, a key premise in the fields of corporate governance and financial economics is that incentives matter. Our analysis sheds light on the structural incentive problems that impede the ability of index funds to produce governance benefits.

To give readers a sense of these problems we discuss below two structural factors that sharply limit the benefits to index fund managers from bringing about value-enhancing changes. (Among other things, our article also analyzed private costs that index fund managers bear that discourage them from seeking governance changes that the managers of portfolio companies resist; *see* BCH, pp. 101-104.) Our discussion below proceeds in three steps:

- We first identify an analytical benchmark, the actions that would be optimal from the perspective of the beneficial investors in index funds;
- We then analyze how the tiny fraction of governance-generated gains captured by index fund managers provides incentives to under-invest significantly compared to this benchmark; and
- Finally, we analyze how the competition for investment assets among rival index fund managers provides *no* incentives to seek value gains.

The Benchmark Scenario: Stewardship Decisions that Maximize Portfolio Value

Our focus is on the stewardship decisions of index fund managers. Such stewardship can take various forms, including monitoring the managers of portfolio companies, obtaining information relevant for assessing the governance of portfolio companies, as well as proposals coming for a vote, and engaging directly with company managers.

Let us consider an index fund in a hypothetical scenario where there are no agency problems in the management of the fund. For instance, suppose that the index fund manager owned all the beneficial investments in the fund. In this case, the index fund manager would have an incentive to make stewardship decisions that would maximize the total wealth of the index fund's owners. Formally, suppose that some stewardship activity would cost C and increase the value of the index fund's portfolio by ΔV. Then, in the benchmark no-agency-problems scenario, the stewardship activity would be undertaken if $C < \Delta V$.

For large equity positions — like those that index fund managers hold in many companies — this no-agency-problems scenario would often predict meaningful investments in stewardship activities. FactSet data that we reviewed indicates that each of the Big Three – BlackRock, Vanguard, and State Street Global Advisors – holds positions exceeding $1 billion in value in a large number of public companies. Consider an index fund that owns a $1 billion investment in a given portfolio company, and suppose that investment in certain stewardship activities would increase the value of the company by 0.1 percent. In the no-agency-problems scenario, the index fund would have an incentive to spend up to $1 million on stewardship to bring about this change.

Capturing Only a Small Fraction of the Benefit

We now turn to the decisions that index fund managers can be expected to find privately optimal in such a situation. We initially take as given the level of fees charged by investment managers and the size of the portfolio managed; we then relax these assumptions below.

One key source of agency problems is that index fund managers bear the costs of stewardship activities, but capture only a small fraction of the benefits that they create. For example, under their existing arrangements, if an index fund manager were to employ staff fully dedicated to stewardship of a small number of companies, or if an investment manager were to conduct a proxy fight in opposition to incumbent managers, the index fund manager would have to cover those expenses itself, out of the fee income it receives from investors.

At the same time, the benefits from stewardship flow to the portfolio. Index fund managers do not receive incentive fees on increases in the value of their portfolio but only charge fees that are calculated as a percentage of assets under management. Let α be the fraction of assets under management that an investment manager charges as fees. Therefore, α is also fraction of the increase in the value of a portfolio company that the index fund manager would be able to capture, in present value terms, from additional fees.

The value of α is likely to be small for index fund managers, as the asset-weighted average net expense ratio for US equity index funds is on the order of 10 basis points (see, e.g., Oey and West, 2016). It would not be in the interests of the investment manager to spend an amount C that would produce a gain of ΔV to the portfolio if C is larger than $\alpha \times \Delta V$. Thus, agency problems would lead to underspending on stewardship, precluding efficient expenditure, whenever:

$$\alpha \times \Delta V < C < \Delta V$$

To illustrate this wedge, reconsider the example above of an index fund that holds a $1 billion investment in a portfolio company whose value would increase by $1 million if certain stewardship activities are undertaken. Assume that the index fund manager would expect additional fees with a present value of 0.5 percent from the $1 million increase in the value of the investment. In this case, the index fund manager would be willing to undertake these stewardship activities only if their cost were below $5,000. The expected private benefit to the index fund manager, and correspondingly the maximum that the fund manager would be willing to spend end on the stewardship activities, is tiny compared with the $1 million in the no-agency-costs scenario.

The Limits of Competition

Thus far our analysis has assumed that index fund managers take their fees and their assets under management as given. We now relax this assumption. This enables us to consider whether the desire to attract additional funds might counter the distortions identified above – and thereby lead index fund managers to make additional investments in stewardship that would enhance the portfolio value.

Investors wishing to invest in index funds can choose among options offered by different index fund managers. It is therefore crucial to understand how such competition affects the incentives of index fund managers.

If an index fund manager were to increase its spending on stewardship at a particular portfolio company and thereby increase the value of its investment in that company, the manager would also increase the value of the index. As a result, the expenditure would not lead to any increase in the performance of the index fund relative to the performance of rivals of the index fund manager that follow the same index. Any increase in the value of the corporation would also be captured by all other index funds investing according to the index, even though they had not made any additional expenditure on stewardship.

Thus, if the index fund manager were to take actions that increase the value of the portfolio company, and therefore also the value of the portfolio that tracks the index, doing so would not result in a superior performance that would enable the manager to attract funds currently invested with rival index fund managers. Such decisions would also not enable the index fund manager to increase fees relative to rivals tracking the same index, as such rivals would offer the same gross return without the increased fees. Accordingly, for index fund managers, a desire to improve relative performance would not provide *any* incentives that could counter tendencies that the manager might otherwise have to underspend on stewardship.

It might be argued that the inability of index funds to attract additional investors by increasing stewardship spending implies that the existing equilibrium is optimal. However, this argument is incorrect. Our analysis indicates that this equilibrium exists due to a collective action problem.

The beneficial investors of an index fund would be better served by having the fund increase stewardship spending up to the level that would maximize the portfolio value, even if the fund were to increase its fees to fund this spending. However, if the index fund were to raise its fees and improve its stewardship, each individual investor in the fund would have an incentive to switch to rival index funds. That is, a move by any given index fund manager to improve stewardship and raise fees would unravel: the fund's investors would prefer to free-ride on the manager's efforts by switching to another investment fund that offers the same indexed portfolio but without stewardship or higher fees.

Taking Incentives Seriously

The above analysis suggests that index fund managers have incentives to under-invest substantially in stewardship relative to what is optimal for their beneficial investors. Our article also showed that index fund managers have excessive incentives to go along with the preferences of corporate managers (BCH, pp. 101-104), as do active fund managers. Both factors are impediments to the ability of index fund managers to bring about governance gains.

As our article explained, while index fund managers are in the process of expanding the resources they dedicate to stewardship, their current expenditures are consistent with our incentives analysis (BCH, p. 100). According to Krouse, Benoit, and McGinty (2016), 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; and State Street Global Advisors employed fewer than 10 staff for voting and stewardship at its 9,000 portfolio companies.

These figures imply that the amount of personnel time that each of these major index funds devoted to each portfolio company was, on average, *less than one person-workday per year*. This seems to be very little investment of personnel time for the tasks involved in monitoring and engaging with portfolio companies, which include (a) reviewing and assessing (i) the company's annual report and proxy statement, (ii) the performance of the directors and the performance of the company with respect to the long-term plans whose importance index fund stress, (iii) the company's executive pay arrangements, (iv) all management proposals, including proposals regarding option plans, and all shareholder proposals that go to a vote, as well as (b) reviewing proxy advisor assessment on these matters, and (c) all engagements that the manager undertakes with the company during the year.

The effects of incentives on behavior are rich and complex, and depend on a number of dimensions. In our current work we explore ways of improving the stewardship activities of index fund managers so they contribute to governance significantly more than they do currently. In the meantime, we hope that the framework of incentive analysis that our article provided will be useful for helping both index-fund-alarmists and the index-fund-enthusiasts to re-examine their positions.

The complete article is available here.