The New Titans of Wall Street: A Theoretical Framework for Passive Investors

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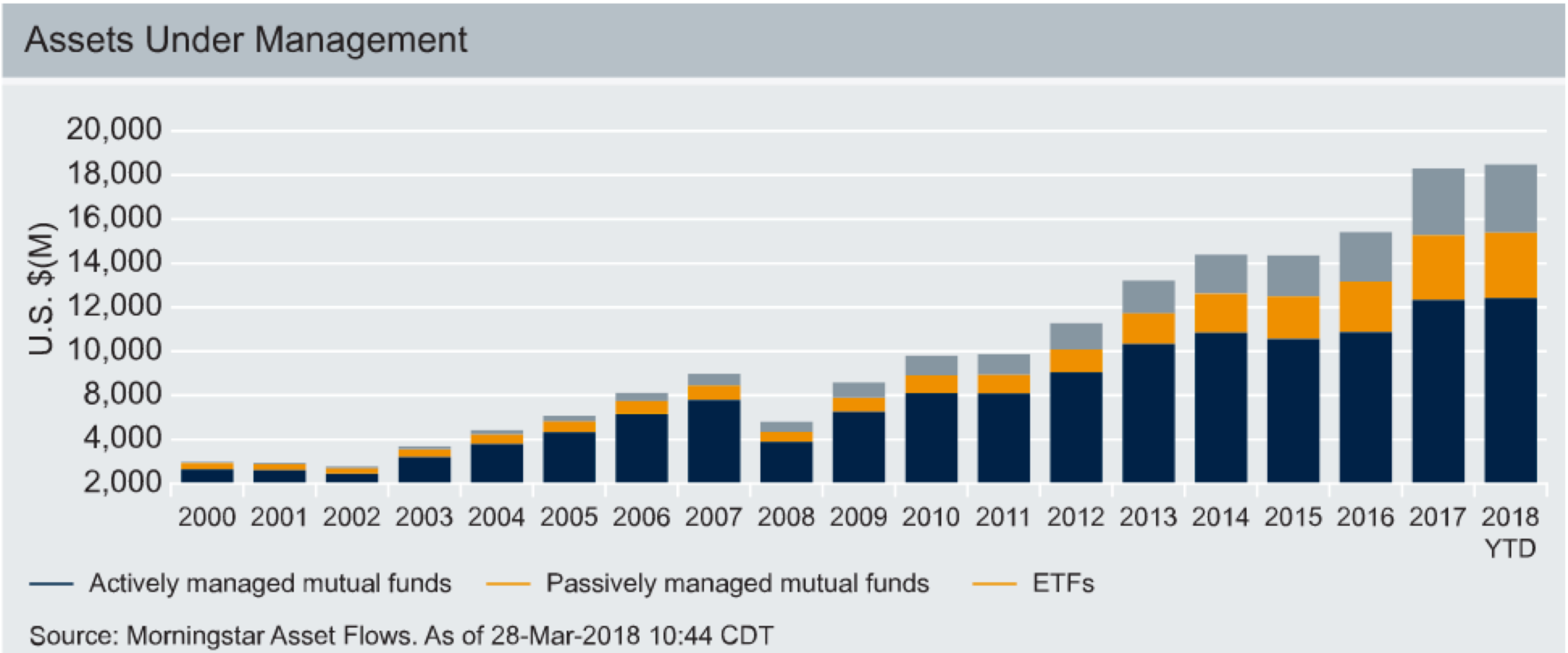
Overview

- 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

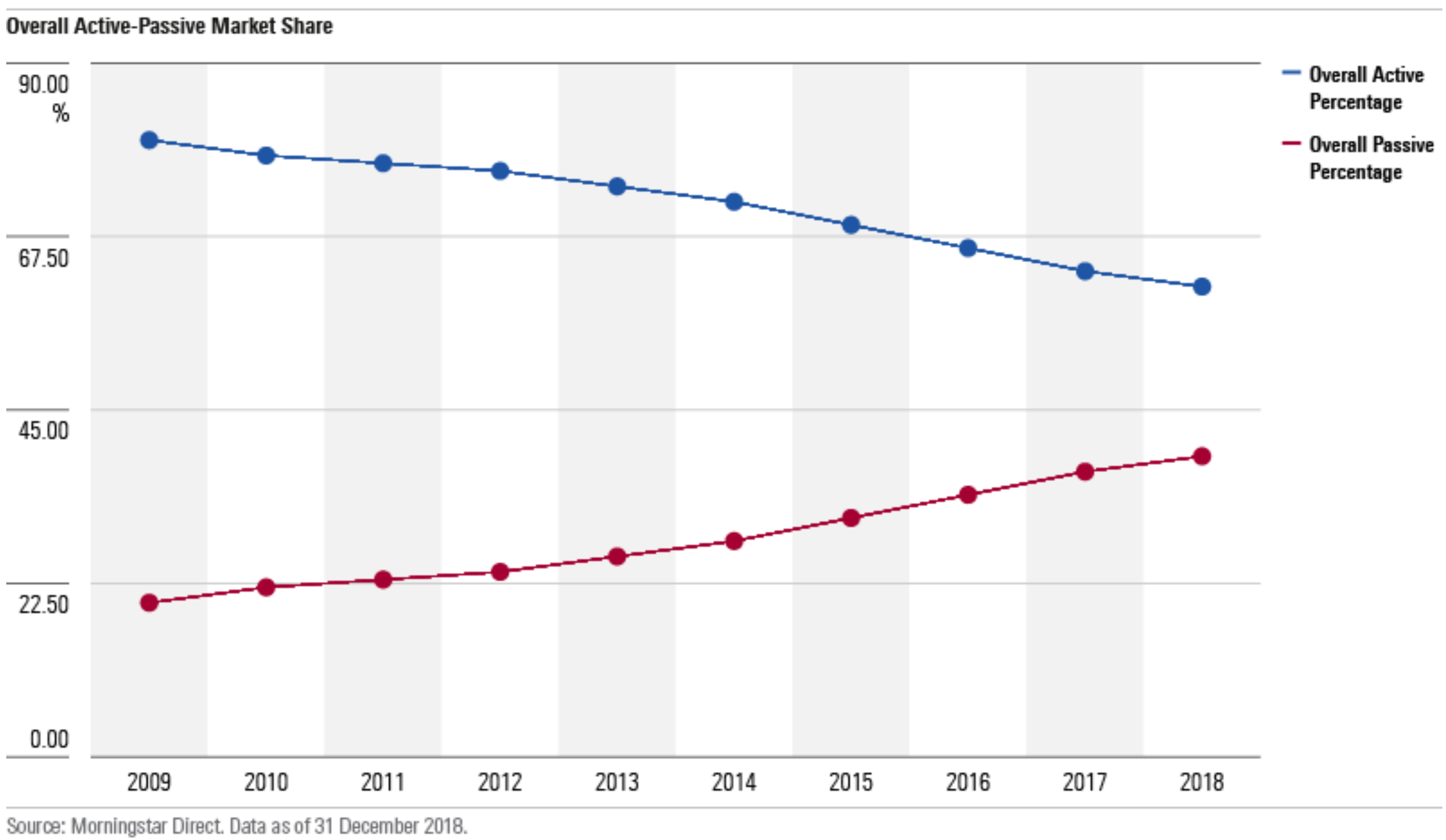
Size of Mutual Fund Market



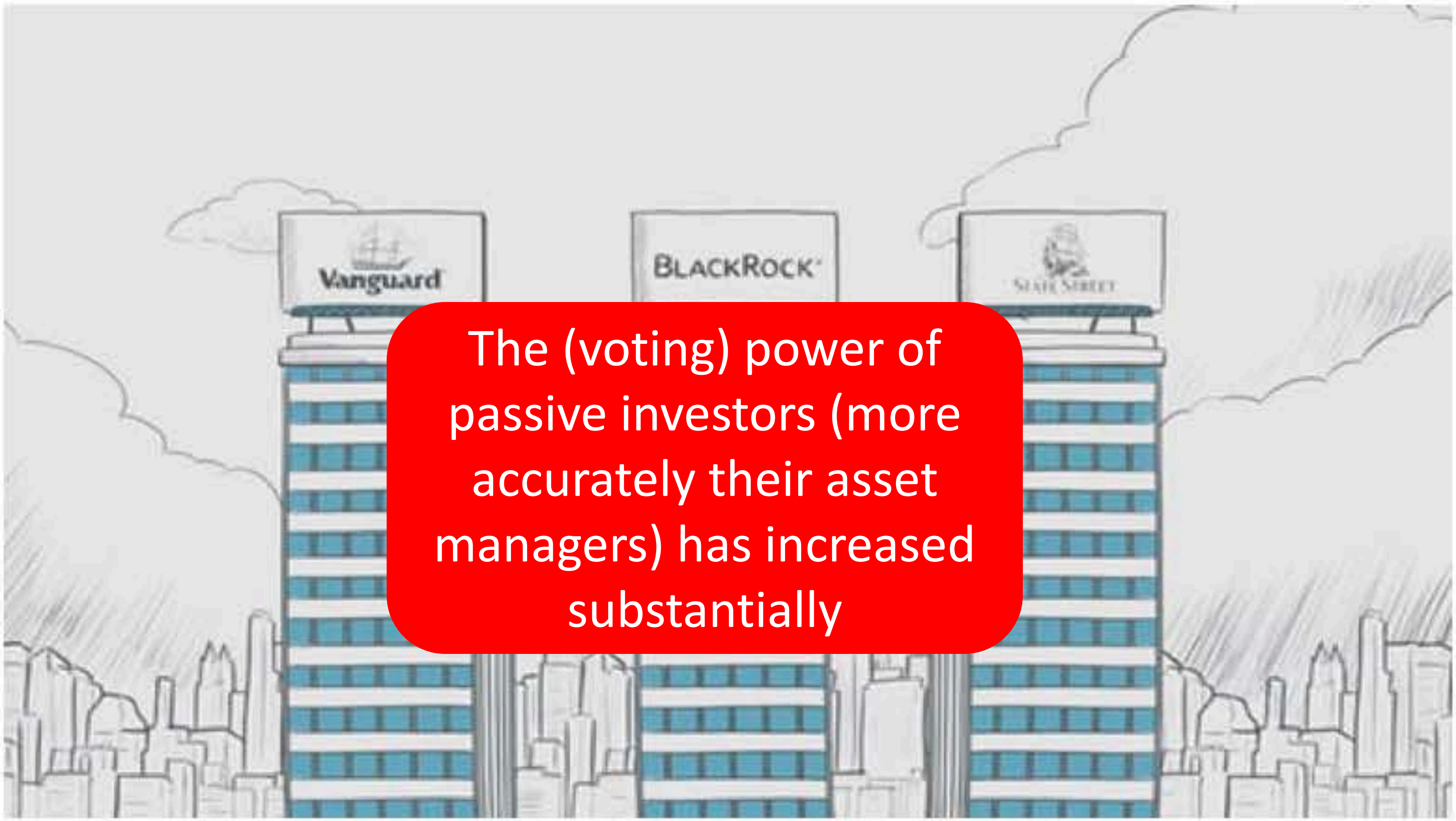
The passive fund market has grown in both size and concentration

Blackrock alone has $6.3 trillion in assets under management!

Actives vs. Passives



The Big Three



The (voting) power of passive investors (more accurately their asset managers) has increased substantially

The Big Three.

What is Passive Investing?

- **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%**

The Passive Investor Critique

- Passive Investors don’t engage enough
- Passive Investors don’t challenge management enough (perhaps because of conflicts of interest)
- Passive Investors don’t have the incentive or resources to engage intelligently
- Passive Investors don’t act in the interests of their beneficiaries
- Passive Investors don’t act in the interests of society

Problems with these Critiques

- The definition of passive investing
- Decisions are made at the level of sponsors and advisers, not funds
- Fiduciary duties and the uncertain relevance of the “fund’s” interests
- The challenge of looking to the interests of fund beneficiaries
- The Nirvana fallacy – what is the relevant comparison?

The Business Model of Asset Managers

- 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
  - The potential for competition over values and engagement

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

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
- Synergies between 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

Potential Concerns

- Reduction in market discipline
  - But relatively little active ownership is required to maintain price efficiency
- Ownership concentration
  - But asset managers do not all vote the same way and
  - Substantial improvement over dispersed retail investors
  - Role of other shareholders (hedge funds)
- Agency costs and conflicts of interest

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
  - Uniform voting policy when “fund” interests differ
- Agency costs of fund managers

Larry Fink letters to CEOs

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

The Complexity of the Agency Problem

- Funds are intermediaries
- At the fund level, it is difficult to identify “interests” or preferences – what are the interests of a pool of assets?
- The interests of the fund sponsor, different funds it sponsors, the individual fund advisers, and the fund beneficiaries may differ
- And people invest in multiple funds

The distinctive challenge of ESG engagement

- Broadening the scope of engagement to non-economic considerations increases agency costs for index funds
- What societal issues are properly the subject of stewardship?
- How does a fund trade off economic and non-economic considerations?
- Who decides?

The potential value of empowering fund beneficiaries

- Passing through voting decisions to fund beneficiaries can reduce agency costs
- But pass-through voting raises additional issues
  - Manageability of the process and the likely dominance of "one-size-fits-all"
  - Voter turn-out
  - The knowledge and sophistication of Mom and Pop 401(k)
  - Heterogeneous investor preferences
  - Reducing the power of mutual funds to advocate for change

The market continues to evolve

- We are still in the early stages of market differentiation based on engagement policies
- Funds can advertise their voting and engagement policies
- Funds can retain or delegate discretion over engagement decisions
- Will investors be willing to pay more for greater engagement by passive investors?

Conclusion

- Current governance critiques of passive investors are misguided
- Our theory shows that passive investor engagement is continuing to increase and improve
- Regulatory intervention is not warranted at this time
- Market developments warrant continued attention