Which Firms Require More Governance? Evidence from Mutual Funds’ Revealed Preferences

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Research Question

- What drives mutual funds' voting on shareholder proposals?
  - **Economic incentives** (Iliev and Lowry, 2015)
  - **Ideology or fund-specific preferences** (Bubb and Catan, 2019; Bolton et al., 2020)
  - **Proxy advisor recommendations** (Iliev and Lowry, 2015; Malenko and Shen, 2016)
  - **Conflicts of interest** (Davis and Kim, 2007; Cvijanovic, Dasgupta, and Zachariadis, 2016)

- *What is novel*?
  - Focus on the effect of **firm characteristics** in determining the MFs' voting patterns
  - Instead of using vote support or market reactions to proposal passing, use **MFs' degree of consensus** about the optimality of governance structures
  - ***Which firms should adopt which governance provisions?***

Empirical Approach

- Use **revealed preference** argument to estimate MFs' preferences for different governance structures

Same governance provision & same year → ***Fund A votes "FOR" the proposal at Firm X*** **but** ***Fund A votes "AGAINST" the proposal at Firm Y***

1. Net out fund A's governance preferences and relate them to the characteristics of Firm X and Firm Y
2. Aggregate preferences across funds using M-H MCMC algorithm

→**Preference rankings** of firms in terms of various governance provisions

The Mallows Model & M-H MCMC

- Empirical approach based on Mallows (1957)
  - Well-established in the statistics literature but new to finance
  - Implementation on large datasets has only recently become feasible

- The paper makes a **methodological contribution**
  - Introduces a new machine learning technique (Vitelli et al., 2018)
  - Advantages and disadvantages of the approach are not well described
  - Many remaining questions about implementation make the approach difficult to follow by others

(Refocus the) Main Findings

1. **Funds use the voting process to address agency problems**
   - Vote for an increase in shareholder rights at firms with less independent boards

   → *"one-size-fits-all"* approach to governance is suboptimal

   (Coles et al., 2008; Duchin, Matsusaka, and Ozbas, 2010; Field and Lowry, 2019)

2. **Funds do not prefer stronger shareholder rights for large & mature firms**
   - Consistent with higher incidence of targeting by proposals (Bhandari, Iliev, and Kalodimos, 2019; Gantchev and Giannetti, 2020)

3. **Funds favor proposals by non-SRI and pension funds**
   - Proposals by individuals are especially disliked (Gantchev & Giannetti, 2020)

Rankings vs. Vote Support

- *Rankings* are based on variation in how funds vote across portfolio firms
  - Based on the revealed preferences of **common MF owners**
  - Put equal weight on each fund's preferences

- *Vote support* is based on the views of all investors
  - Value-weighted by the number of shares each investor owns
  - Impacted by the firm's **endogenous ownership structure**

- Rankings and vote support are only **moderately correlated**
  - *Perfect setting to investigate the role of (i) ownership structure and (ii) common ownership on firms' governance provisions*

Active vs. Passive Funds

- Ongoing debate about the role of passive funds in governance
  - On average, 25 passive funds and 35 active funds vote on a given proposal

- Based on their rankings, passive and active funds appear to have **similar governance preferences**
  - Relationship between fund preferences and firm characteristics is *more pronounced* for passive funds

- Passive funds also vote less uniformly and follow ISS to a lower extent
  - *What is the role of passive funds as active monitors?*

Conclusion

- A thought-provoking paper on an important research question:
  - *What firm characteristics influence MFs’ voting on proposals?*

- The unique empirical approach leads to many interesting findings.

- The paper’s contribution could be enriched by:
  - Comparing rankings to vote support to explore further the role of ownership structure and common ownership
  - Providing additional insights on the role of passive funds as active monitors