Systematic Stewardship

By Jeffrey Gordon

Comments by Jill Fisch

Penn Law
UNIVERSITY of PENNSYLVANIA LAW SCHOOL

Institutional Investor Stewardship

Investor stewardship involves asset managers engaging and voting to influence positively the assets in which they invest

Globally we see an increasing focus on institutional investor stewardship

Some commentators (such as Lucian Bebchuk & Scott Hirst) argue that institutional investors underinvest in stewardship (although I am not sure what "underinvest" means)

Outside the United States investor stewardship is increasingly framed as an obligation

- See, e.g., the UK Stewardship Code (2020)
- See generally Global Shareholder Stewardship: Complexities, Challenges and Possibilities (Dionysia Katelouzou & Dan W. Puchniak eds, Cambridge University Press, forthcoming)

Challenges to Stewardship

Large diversified institutional investors are poor sources of firm-specific operational improvements

Such investors also seek to minimize costs (especially index funds), making it hard to justify significant expenditures on stewardship

Institutional investors may face their own agency problems

And stewardship may involve decisions that sacrifice economic value (see DOL)

See Fisch, The Uncertain Stewardship Potential of Index Funds (2020),forthcoming in GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3525355

Some commentators conclude that mutual funds (or at least index funds) should not vote, but

- We lose the potential for stewardship
- We leave voting to investors with potentially more problematic incentives
- Disenfranchising a substantial proportion of shareholders delegitimizes the role of voting

Summary of the Project

Motivating question: can investor stewardship be defended in terms of economic value?

Particular case of index funds – diversified, low cost, no exit

Answer: Yes. Systematic stewardship is both within index fund competence and consistent with the interest of maximizing fund economic value

Underlying theory: Systematic stewardship is about mitigating risks that affect a broad range of companies within the index fund portfolio

Implications: The project provides a defense of index fund engagement and a rationale for the focus on specific systematic risks such as climate change

Key Insight I

Index funds have the competence to engage in systematic stewardship

Reducing portfolio risk does not require firm-specific analysis

ESG and governance initiatives can be defended in terms of their effect on the average firm

- Example – Vanguard's voting policy on staggered boards

Consistency of this insight with fund engagement and voting policies

- Index funds support accountability through governance – one share/one vote, annual election of directors
- Index funds support effective monitoring boards – director independence, limits on overboarding, limits on director tenure
- Index funds increasingly support greater environmental disclosures

Key Insight II

Risk mitigation is consistent with index fund incentives

A diversified investor seeks to maximize risk-adjusted return

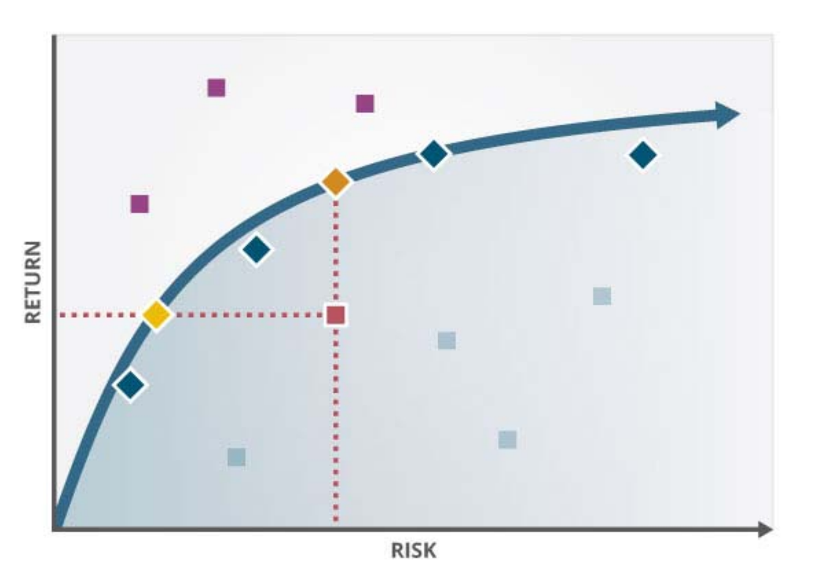
Systematic risk reduces risk-adjusted returns across an investor's overall portfolio

But

- Does systematic stewardship increase returns or reduce risk?
- Aren't investors compensated for bearing risk?
- So does reducing systematic risk affect expected returns?

And

- If systematic stewardship reduces systematic risk in the market
- Will market returns decrease?



An Additional Concern – Stewardship Priorities

Figure 3. **The index manager ownership fragmentation challenge**

Stewardship Priorities

The paper responds with the argument that index funds should address risks that have broad economic effects

Examples

- Climate change
- Financial stability risk
- Social stability risk

The paper further suggests that institutional investors need not confront critical trade-offs

- Focus on disclosure to identify and price (rather than mitigating) particular risks
- Supporting third-party disclosure initiatives is also a low-cost strategy

But should economically significant risk disclosures be addressed through firm-specific private ordering?

- See Fisch, *Is Sustainability Disclosure Sustainable?,* 107 Geo. L. J. 923 (2019)
- Fisch & Williams, Petition to the U.S. Securities and Exchange Commission for a rulemaking on environmental, social and governance (ESG) Disclosure (Oct. 1, 2018)

Conclusion

Timely and important topic

Possible to go beyond a defense of systematic stewardship and to identify the particular circumstances in which it is most likely to be effective

Value in identifying the limits as well as the value of systematic stewardship – what are reasonable expectations for its impact?