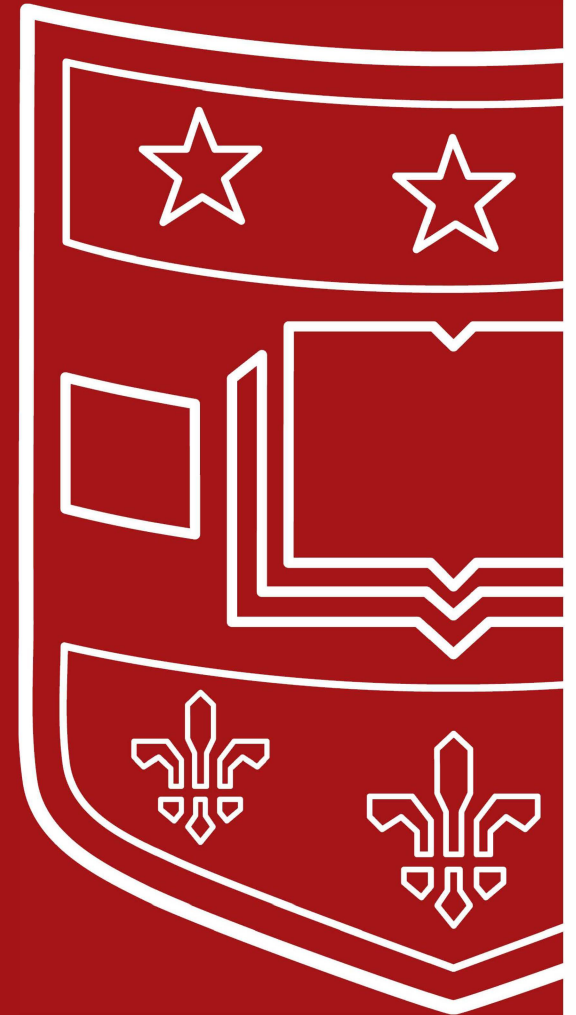


Indexing and Corporate Governance

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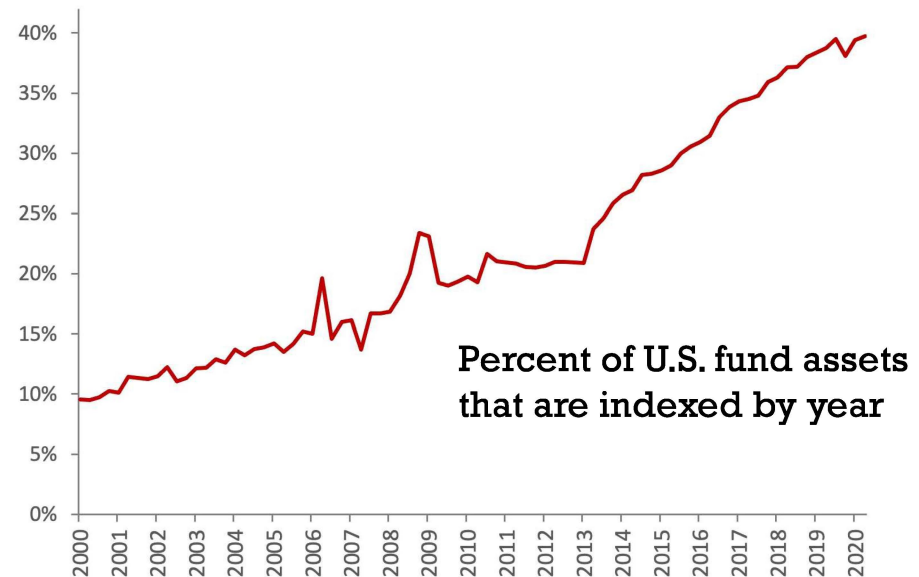
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Indexed investment strategies increasingly popular



- Percent of fund assets that are indexed has increased fourfold over last 20 years
 - The “Big Three” (Vanguard, BlackRock, State Street) dominate this market



Source: Data from Gormley, Keim, Li, work-in-progress

Hence, the Big Three are massive!



Rank	Company	Country	Total AUM, US\$b
1	BlackRock	US	9,464
2	Vanguard Group	US	8,400
3	UBS Group *	Switzerland	4,432
4	Fidelity Investments	US	4,230
5	State Street Global Advisors	US	3,860
6	Morgan Stanley	US	3,274
7	JPMorgan Chase	US	2,996
8	Allianz Group **	Germany	2,953
9	Capital Group	US	2,600
10	Goldman Sachs	US	2,372

Source: Global AUM as of September 31, 2021, as reported by www.advratings.com

On average, they hold about 16% of a U.S. public company's equity

And they account for 25% of votes cast for S&P 500 firms
[Bebchuk and Hirst, 2019]

This indexing growth raises many questions...



- What impact does this ownership shift have on stewardship?
- Does the resulting increase in common ownership matter?
- And many more...

This talk will by my attempt to summarize our current answers and the questions we still haven't answered...

But first, a few caveats...



- I will focus on governance implications only
- More papers than those I will cite
- I will use “index” rather than “passive,” and because influence is exerted at fund-family level, I will often describe the “Big Three” as driving any observed differences

Part I: Impact of indexing on stewardship



- The initial debate
- Evidence of a direct & indirect impacts
- Evidence on degree of activism



Could their growth be bad for governance?

“A rising chunk of the stock market sits in the hands of lazy investors. Index funds and exchange-traded funds mimic the market’s movements, and typically take little interest in how firms are run...”

- *The Economist*, Feb. 7, 2015

The Big Three disagree; e.g., Vanguard argued they were “Passive investors, **not** passive owners”





The debate ensues...

- Why they might **weaken** governance...
 - Lack influence; less able to do “Wall Street Walk”
 - Lack motivation; primarily focus on benchmark performance & cost
 - Lack time; huge portfolios make monitoring infeasible
- Why they might **strengthen** governance
 - Unable to exit, they care more about governance & long-term
 - Are motivated; increase in fund value benefits institution
 - Scale and scope; their size increases likelihood they are pivotal

Answering this question is challenging



- Ownership structures are not exogenous
- To overcome challenge, many rely on index ownership variation induced by Russell 1000/2000 inclusion [*e.g.*, *Mullins, 2014*]
 - But there is a debate on how best to do this...
 - Three forthcoming *CFR* papers provide guidance; Appel, Gormley, Keim; Glossner; Wei and Young



Evidence on direct impact – **Big 3's voice matters**

- From 1998 – 2006, index ownership associated with governance issues that the Big 3 focused on [*Appel, Gormley, Keim, 2016*]
- Big 3's board gender diversity campaigns in 2017 & 2018 had big impact [*Gupta, Gormley, Matsa, Mortal, Yang, 2021*]
- Additional evidence; e.g.,
 - *Azar, Duro, Kadach, Ormazabal, 2021*
 - *Filali Adib, 2019*

Estimates suggest Big 3 campaigns account for three-fourths of 2019 increase in appointed female directors



But evidence suggests **limits to their influence...**

- Prior evidence suggests Big Three successfully use low-cost approaches to push broad-based reforms
- But managers seem to take advantage of index-tracking institutions' weaker ability to engage in high-cost monitoring [*Schmidt and Fahlenbrach, 2017*]



Compelling idea that I think warrants further study as it undercuts Big 3's justification for their approach to stewardship!



Possible indirect impact on governance?

- Even if index-tracking institutions are less able to engage in high-cost monitoring, they might help others do it
 - Ownership blocks might lower expected costs of activism by others
 - And their presence might increase likelihood of success
- Or maybe not...

Might have conflict of interest [Ackman, 2016]



Might view activists as short-sighted [Fink, 2016]



Evidence suggests an indirect impact

- Index ownership (mostly) seems to improve activists' ability to discipline managers [*Appel, Gormley, Keim, 2019*]
- Activists also seem to tailor their campaigns to preferences of firms' largest investors [*e.g., Jha, 2022*]

“If you have some short-term strategy to make money that’s harmful to the company long-term, you’re not going to get the support to the BlackRocks, the Vanguards, and the others.” [*Ackman, 2017*]



Evidence on **degree of activeness**

- New work finds evidence indexers are active monitors...
but not as much as actively-managed funds; e.g.,
 - Evidence suggests they are not passive in proxy fights, but they are less likely to support activist [*Brav, Jiang, Li, Pinnington, 2021*]
 - They focus on firms where they can have biggest impact but do less research overall [*Iliev, Kalodimos, Lowry, 2021*]



However, the debate continues!

- Some still question whether indexers monitor at all [e.g., Heath, Macciocchi, Michaely, Ringgenberg, 2022]

- Big 3 do not file Schedule 13D forms
- More likely to vote with managers [and against ISS]
- Index ownership associated with...

- Decline in sensitivity of CEO pay to stock returns & board independence
- No impact on other governance dimensions



But these findings are certainly worth further study!

← **Harder to interpret in my view...**

Part II: The importance of common ownership

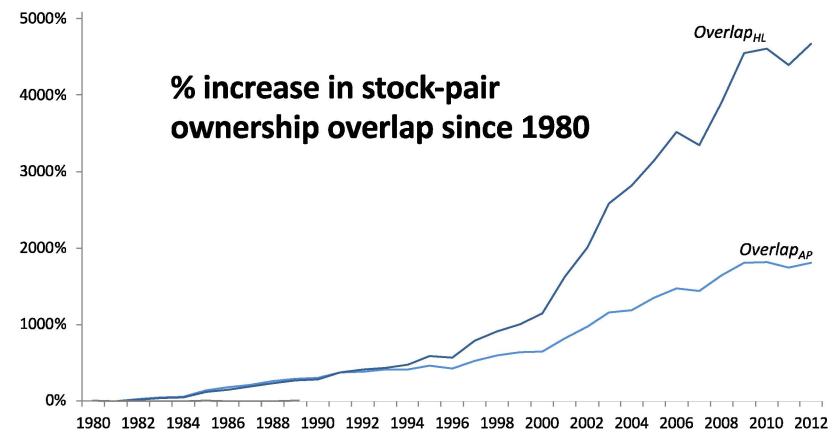


- Connection to indexing
- Initial evidence suggested big impact
- More recent evidence suggests otherwise



Rise of common ownership

- Common ownership is increasing, and growth of indexing seen as key driver
- Older literature suggests this could be important for investor incentives...
 - *E.g., Easterbrook and Fischel, 1982; Hansen and Lott, 1996; Rubin, 2006*



Source: Earlier draft of Gilje, Gormley, Levit (2020); ownership overlap measured using Hansen and Lott (1996) and Antón and Polk (2014)



Initial evidence suggests it matters (a lot)

- Several empirical papers argued common ownership affects governance, executive pay, **competition**, etc.; e.g.,
 - *He and Huang, 2017*
 - *Kempf, Manconi, Spalt, 2017*
 - *Azar, Schmalz, Tecu, 2018*
 - *He, Huang, Zhao, 2019*
 - *Azar, Raina, Schmalz, 2022*
 - *Antón, Ederer, Giné, Schmalz, 2022*

Evidence led some to advocate for limiting indexing [e.g., *Elhauge, 2016; Posner, Morton, Weyl, 2017*]

Not hard to see why indexers got attention; e.g.,



<i>JPMorgan Chase</i>	<i>[%]</i>	<i>Bank of America</i>	<i>[%]</i>	<i>Citigroup</i>	<i>[%]</i>
Vanguard	6.28	Berkshire Hathaway*	6.90	BlackRock	6.43
BlackRock	6.28	Vanguard	5.94	Vanguard	5.96
State Street	4.12	BlackRock	5.94	State Street	4.04
Capital Research	3.68	State Street	4.01	Fidelity	3.00
Fidelity	2.10	Fidelity	2.37	Invesco	1.67
<i>Wells Fargo</i>	<i>[%]</i>	<i>PNC Financial</i>	<i>[%]</i>	<i>U.S. Bancorp</i>	<i>[%]</i>
Berkshire Hathaway	10.46	Wellington	8.34	BlackRock	6.51
Vanguard	5.67	Vanguard	6.30	Berkshire Hathaway	5.94
BlackRock	5.42	BlackRock	5.03	Vanguard	5.59
State Street	3.68	State Street	4.33	Fidelity	4.12
Wellington	2.55	Barrow Hanley	3.71	State Street	3.84

Source: Table I, Panel C of Azar, Schmalz, Tecu, 2018

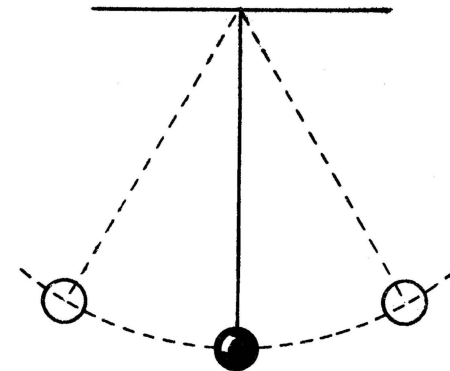


But do indexers hurt competition?

- Many potential problems with that argument...
 - What is the mechanism by which they influence prices & quantities?
 - Is it plausible that indexers solve such an optimization problem?
 - Should we expect the growth in index ownership to shift managers' incentives to internalize externalities?



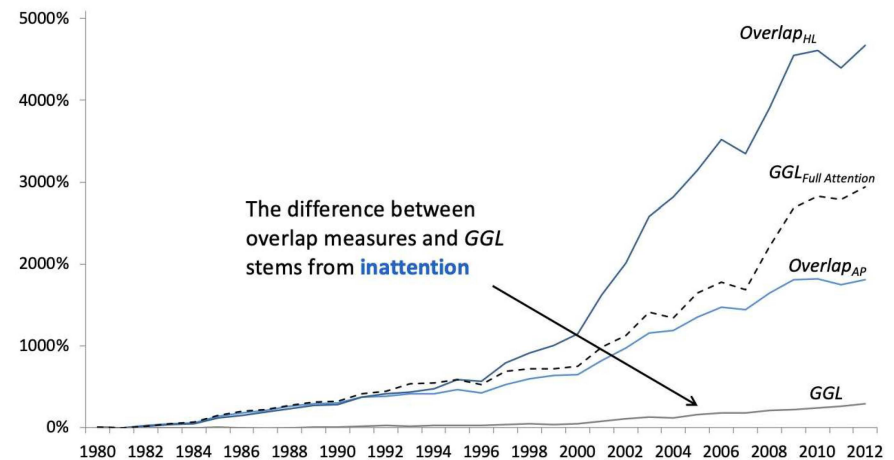
A pendulum swing too far? Using low-cost methods to push broad-based governance reforms is quite different than pushing individual firms to internalize externalities...





Theory & data suggests small impact on incentives

- Accounting for investor inattention casts doubt on idea that indexing significantly shifts managers' incentive to internalize externalities
[Gilje, Gormley, Levit, 2020]
 - Index inclusion has no clear impact on incentives



Source: Earlier draft of Gilje, Gormley, Levit (2020)



New evidence also casts doubt on early findings

- Differential responses of firms to 2008 financial crisis appears to drive many early findings [*Lewellen and Lowry, 2021*]
- Market share component of MHHID, not the ownership component, drives correlation [*Dennis, Gerardi, Schenone, 2021*]
- And yet more evidence; e.g.,
 - Appendix D of *Gilje, Gormley, Levit, 2020*
 - *Koch, Panayides, Thomas, 2021*



Where common ownership might matter more

- While evidence casts doubt on importance for public firms, common ownership might matter for private startups; e.g.,
 - *Eldar, Grennan, Waldock, 2020*
 - *Li, Liu, Taylor, 2021*
- **But if so, it has little to do with indexing**



Though, maybe it could matter in scenarios where broad-based, low-cost engagements could push firms to internalize externalities [e.g., emissions]?



Part III: Unanswered questions

- What motivates the Big Three?
- Does it matter where voting responsibility resides?
- Other indirect impacts on governance?
- A one-size-fits-all problem?
- And finally, what is the net impact?



What **motivates** the Big Three?

- Evidence suggests Big 3 use low-cost ways to push broad-based changes [e.g., board gender diversity]
- But what is their motivation?
 - **Increasing fund performance?** [e.g., Lewellen and Lewellen, 2021]
 - **Large active portfolios?** [e.g., Appel, Gormley, Keim, Kim, Shin, 2022]
 - **Attracting fund flows?** [e.g., Barzuza, Curtis, Webber, 2020]
 - **Staving off regulation?** [e.g., Kahan and Rock, 2019]
 - **Self-dealing?** [e.g., Fisch, 2020]

**The motivation is important
for the value implications!**



Does it matter where voting power resides?

- Voting responsibility can reside with centralized in-house proxy voting group or with individual funds or their investors
 - Fund families typically vote as a block [*Choi, Fisch, Kahan, 2013*]
 - This likely gives family more influence [*Kahan and Rock, 2020*]

Big Three have typically centralized their voting, but will recent changes on this front matter?



Are there more **indirect** governance impacts?

- Specifically, what about actively-managed funds?
 - Do the less-informed active funds exit?
 - Do they hold different stocks because of indexing?
 - Does their level of informed trading change?



Answers could have additional implications for governance!

Gormley, Keim, Li (work-in-progress) hopes to provide some answers...



A one-size-fits-all problem?

- Low-cost, broad-based governance reforms might lead to “check the box” type policies being implemented
 - But optimal governance structures likely vary across firms
[e.g., Coles, Daniel, Naveen, 2008; Duchin, Matsusaka, Ozbas, 2010]
 - **Might the Big Three’s proposed changes not always represent an improvement for individual firms?**

Finally, what is the **net impact**?



- Net impact of indexers likely depends on counterfactual and other conditions [*e.g.*, *Corum, Malenko, Malenko, 2020*]
 - E.g., if largely replacing dispersed, small retail investors, the implications could be quite different than if replacing active funds
 - **Can we assess indexing's net impact on performance?**



Concluding comments...

- Indexing and the Big Three are shifting governance
 - **Big 3 adopt low-cost tactics & push broad-based changes**
 - **Less able to do high-cost monitoring, but their presence might facilitate activists' ability to monitor**
 - **Motivation, net impact, and other implications still unclear**
- Thanks & apologies for any errors or oversights!

**Still much
exciting work
to be done!**

