Do Index Funds Monitor?

Davidson Heath, Daniele Macciocchi, Roni Michaely, and Matthew C. Ringgenberg

Discussion by

Benjamin Maury

Hanken School of Economics

Overview

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- The paper studies whether **increased index investing** (and the reduction of other investing) leads to more agency conflicts
- Increases in holdings by index funds could **accommodate more agency problems** between managers and shareholders du to the governance "vacuum"
  - The **sources** of the classical agency conflict include: short time horizon, overinvestment, low risk taking, perk consumption, low effort
  - Increase in **total agency costs** (monitoring, bonding, and residual loss (Jensen and Meckling, 1976))
  - => **lower firm value** (index fund ownership and firm value also an important topic to study in more depth)

Overview

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- The recent rise of **agency capitalism** (e.g. Gilson and Gordon, JACF 2019): increases in well-diversified institutional ownership in listed firms
  - What is the **role of the growing body of index funds** (e.g., Vanguard and BlackRock)?
- There is a clear **gap** in the literature that the present paper aims to fill
- Message: **index funds** are **weak monitors**
- Three alternative hypotheses:
  - The **exit hypothesis**
    - this is a credible threat (and governance mechanism) only if there is **liquidity** and blockholders do **not have trading restrictions** due to the index membership (that index funds have)
  - The **engagement hypothesis**
  - **Managers follow policies preferred by index funds**

Empirical Findings

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- Index funds are more likely to **side with firm management on contentious corporate governance votes**
- Index funds are **less likely to exit** their position after loss of vote
- Index fund do **not file Schedule 13Ds** to affect firm policies

==> Index funds seem to cede power to firm managers

Comments

- The role of **other concentrated owners** affecting agency conflicts
  - The classical agency problem is likely to be larger in firms without dominant shareholders (founders, family owners, other large blockholders with concentrated portfolios)
  - The effects of index funds could thus be studied in firms without a large concentrated blockholder
- Other **non-owner monitors** reducing asymmetric information
  - Analysts

Comments

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- Index funds and **ESG issues**
  - Responsibility of large index funds on environmental and social problems
  - Climate change issues, board diversity etc.

- **Coordination** of action beyond fund families?
  - Can coordination/coalitions be observed?
  - Hermes etc.

Thank You!