Do Index Funds Monitor?

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Discussion by

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Overview

» 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 due 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

» 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

» 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
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

» 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!