Discussion of Corporate Governance Through Voice and Exit by Marco Becht, Julian Franks and Hannes Wagner

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Context: Increased Role of Institutional Investors in Corporate Governance

- Institutional investors increasingly represent a very large part of corporate ownership
- Asset management industry is a multi-trillion dollar industry
- Corporate governance reforms over time have increasingly transferred power from corporate boards to investors
  - Elimination of staggered boards
  - Annual election of directors
  - Say on pay

Context: Mutual Fund Industry in Transition

- Mutual fund industry is in transition
- Intense competition among mutual funds – there are more mutual funds than listed stocks
- A significant number of actively managed mutual funds have underperformed their bench marks over the last 20-25 years
- There is a significant outflow of funds from active funds into passive funds
- In response, mutual funds are cutting fees, and cutting research, increasing investments in marketing and distribution

Context: Some Features of Mutual Fund Industry

- Incentives of both fund company managers and portfolio managers are often more tied to the fund size than to fund performance
- More focus on liquidity, less on long-term investing – average holding period of stocks by US mutual funds has significantly declined over time
- Heavy reliance on third-party governance advisors such as ISS who have their own potential conflict of interests (governance evaluation vs governance consulting)

Becht, Franks and Wagner Paper

- Focuses on a very interesting questions
  - How do active fund managers engage with portfolio firms
  - How do they integrate stewardship into the investment process?
  - What role does monitoring and engagement play in funds' trading decisions?
- Deep dive into one well-known institutional investor's internal workings
  - Interactions of analysts, governance & stewardship group, and portfolio managers with corporate executives and boards
  - changes in analysts' recommendations
  - Shareholder votes
  - Additions to the governance watch list
  - Three case studies of engagement – Vodafone, Easy Jet, Sports Direct

Key Findings of the paper

- It is clear that analyst recommendation changes trigger significant trading decisions, and generate significant excess returns
  - Even here, surprising findings of no trading, or contrarian trading
- While voting decisions have some effect on trading, the effects seem to be relatively small
- Addition to the governance watch list is associated with significant trading activity

Some Comments and questions

- Given that this asset managers is considered one of the “best”, the results should be seen as an upper-bound on investor engagement and its trading consequences
- The analyst recommendation findings are consistent with what we know from other studies of buy-side analysts and of private meetings between investors and companies.
- Should we use trading as an indicator of the quality of enegement? If investors have significant influence on governance, shouldn’t they then hold on to the shares to bear the consequences?
- Is the governance engagement mostly related to compliance related matters, or is it related to broader business decisions? What does the rising role of activist investors to fix governance problems say about the effectiveness of mutual fund investors’ governance engagement?