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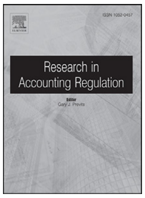

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Index investors and the return of stewardship accounting

Thomas A. King

Case Western Reserve University, Cleveland, OH 44106, USA

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ABSTRACT

Passive asset managers, seeking to deliver investment returns that mirror market indices, now control and vote about 30% of all managed U.S. shares. When bad news surfaces, index investors do not sell a company's shares. Instead, these beneficial owners protect the value of equity investments by influencing governance practices to restore long-term value creation. Interviews with stewardship offices at leading index investment firms suggest that passive investors do *not* use financial accounting information to value securities. The implication of this study is that the current focus of accounting standard setting – predicated on the idea that the purpose of financial reporting is to permit prediction of future cash flows – does not meet the needs of a particular group of financial statement users who have considerable influence over the governance of leading listed companies around the world.

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As the Cold War came to a close, *The Economist* lamented how emerging "punter-capitalists" acted more like short-term traders than long-term owners (Penant-Rea, 1990). The subsequent rise of hedge funds, electronic communication networks, derivative markets, and flash trading reduced average equity holding periods to the point where they may no longer be measurable. Shrinking horizons diminish investor concern for managerial stewardship: why should a "quant"[1] chasing a fleeting arbitrage opportunity bother to read a proxy statement? Loss of interest in corporate governance contributed to horrendous acquisitions, misleading financial reporting, and egregious compensation awards that characterized Enron-era scandals (Elson & Gyves, 2003) and the Global Financial Crisis (Kirkpatrick, 2009).

The recent rise of firms specializing in index mutual funds and exchange-traded funds (ETFs) suggests that a growing group of investors use financial reporting to assess corporate stewardship rather than to value securities. Passive investors do not sell a company's shares when bad news surfaces. Interviews show that these money managers use accounting information to assess board composition, business risks, and compensation plans before influencing directors to restore long-term value creation. Passive investors do *not* use financial reporting to forecast cash flows and value securities.

The implication of this paper is that accounting standard setting – resting on the assumption that the purpose of financial statements is to help investors predict the amount, timing, and certainty of future cash flows – does not meet the needs of a particular group of financial statement users who have growing influence over the governance of leading publicly traded firms around the world. Future standard setting efforts should devote more attention to helping these long-term beneficial owners assess how well firms carry out key governance activities including refreshing board membership, monitoring risks to the long-term sustainability of the business model, and compensating executives.

Rise of passive investing

About 85% of assets held by U.S.-registered investment companies are in mutual funds, which date back to 1924, and 13% are in ETFs, which emerged in 1993 (Reid, 2017). Both investment vehicles pool investor funds to buy portfolios of securities. Mutual funds sell fund shares directly to investors, and fund managers stand ready to buy back shares at prices calculated after the close of each trading day. Shares in ETFs are sold through brokers and traded on security exchanges at prevailing market prices. A mutual fund and an ETF holding the same basket of securities deliver similar returns.

Some mutual funds and most ETFs hold portfolios of securities designed to mimic the financial return of a market index (e.g., S&P 500 or Russell 2000) or sector (e.g., healthcare or oil & gas). Since the median investor earns market returns, passive investing out-performs half of all active money managers over time. After considering low operating expenses (it does not cost much to buy and hold a basket of securities), passive portfolios tend to produce above-average net returns. About 30% of cash invested in U.S. mutual funds and ETFs is passively managed (Tu, 2017). The two largest money managers in the world are now BlackRock, the

E-mail address: tak30@case.edu

[1] An investor who relies on computer algorithms to make investment decisions.

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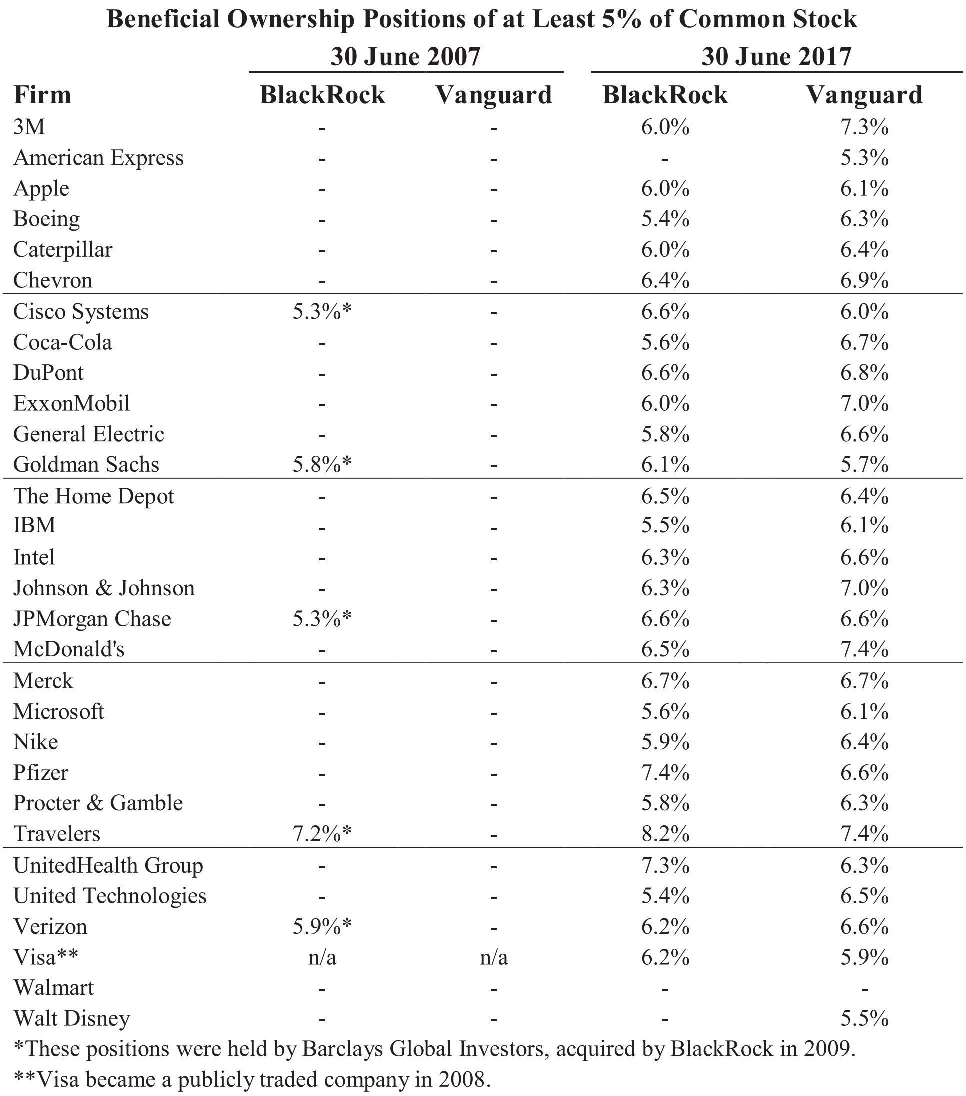

Beneficial Ownership Positions of at Least 5% of Common Stock

	30 June 2007		30 June 2017	
Firm	**BlackRock**	**Vanguard**	**BlackRock**	**Vanguard**
3M	-	-	6.0%	7.3%
American Express	-	-	-	5.3%
Apple	-	-	6.0%	6.1%
Boeing	-	-	5.4%	6.3%
Caterpillar	-	-	6.0%	6.4%
Chevron	-	-	6.4%	6.9%
Cisco Systems	5.3%*	-	6.6%	6.0%
Coca-Cola	-	-	5.6%	6.7%
DuPont	-	-	6.6%	6.8%
ExxonMobil	-	-	6.0%	7.0%
General Electric	-	-	5.8%	6.6%
Goldman Sachs	5.8%*	-	6.1%	5.7%
The Home Depot	-	-	6.5%	6.4%
IBM	-	-	5.5%	6.1%
Intel	-	-	6.3%	6.6%
Johnson & Johnson	-	-	6.3%	7.0%
JPMorgan Chase	5.3%*	-	6.6%	6.6%
McDonald's	-	-	6.5%	7.4%
Merck	-	-	6.7%	6.7%
Microsoft	-	-	5.6%	6.1%
Nike	-	-	5.9%	6.4%
Pfizer	-	-	7.4%	6.6%
Procter & Gamble	-	-	5.8%	6.3%
Travelers	7.2%*	-	8.2%	7.4%
UnitedHealth Group	-	-	7.3%	6.3%
United Technologies	-	-	5.4%	6.5%
Verizon	5.9%*	-	6.2%	6.6%
Visa**	n/a	n/a	6.2%	5.9%
Walmart	-	-	-	-
Walt Disney	-	-	-	5.5%

*These positions were held by Barclays Global Investors, acquired by BlackRock in 2009.

**Visa became a publicly traded company in 2008.

Fig. 1. Beneficial ownership positions of at least 5% of common stock.

leader in ETFs, and Vanguard, the leader in index mutual funds (IPE Research, 2017).

The Securities and Exchange Commission (SEC) regulates U.S.-registered mutual funds and ETFs and requires disclosure of investment positions. Publicly traded companies use these disclosures to identify investors who hold more than 5% of outstanding common stock and report these ownership positions in annual proxy statements. Money managers are classified as beneficial owners because they use client money to pay for security purchases.

Fig. 1 shows beneficial ownership positions greater than 5% of the common stock held by BlackRock and Vanguard in the 30 companies that comprise the Dow Jones Industrial Average (DJIA). Data come from the most recent proxy statements filed before June 30, 2007 and 2017. An astonishing fact is that these two money managers accumulated at least 5% of the common stock of 27 and 29 of DJIA firms over the past decade.

State Street, the world's third largest money manager (IPE Research, 2017) and another leader in passive investing, acquired eleven positions on this list that crossed the 5% threshold as of June 30, 2017. These three firms now hold sizable voting rights in companies comprising the S&P 500 and similar market indexes. As long as an equity is in an accepted benchmark index, passive investors have an incentive to buy and hold that stock. Perhaps the best expression of this sentiment comes from a speech given by a Vanguard CEO Bill McNabb:

> *And, remember, when it comes to our indexed offerings, we are permanent shareholders. To borrow a phrase from Warren Buffett: Our favorite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits. In other words, we're big, we don't make a lot of noise, and we're focused on the long term (McNabb, 2015).*

Money managers owe clients the duty of protecting the value of invested funds. Index investors employ a staff of stewardship managers to influence the selection of directors who oversee the management of investee companies. Skilled directors guide executives and replace weak CEOs. Evidence that high-quality directors add value dates to the beginning of the 20th century when the presence of a JP Morgan banker on a firm's board was associated with 30% higher stock valuation arising from better operating performance (DeLong, 1991).

A literature search suggests that accounting scholars have not yet studied how the presence of a near-permanent investment

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