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Passive investors, not passive owners[☆]

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ABSTRACT

Passive institutional investors are an increasingly important component of U.S. stock ownership. To examine whether and by which mechanisms passive investors influence firms' governance, we exploit variation in ownership by passive mutual funds associated with stock assignments to the Russell 1000 and 2000 indexes. Our findings suggest that passive mutual funds influence firms' governance choices, resulting in more independent directors, removal of takeover defenses, and more equal voting rights. Passive investors appear to exert influence through their large voting blocs, and consistent with the observed governance differences increasing firm value, passive ownership is associated with improvements in firms' longer-term performance.

"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. That is precisely why we care so much about good governance."

– F. William McNabb III, Chairman and CEO of the Vanguard funds

1. Introduction

While there is considerable evidence that institutional investors influence the governance and policies of firms (e.g., Aghion, Van Reenen, and Zingales, 2013; Brav, Jiang, Partnoy, and Thomas, 2008), this evidence primarily focuses on the role of activists that accumulate shares and make demands upon managers or active fund managers that exit positions when managers perform poorly. Yet,

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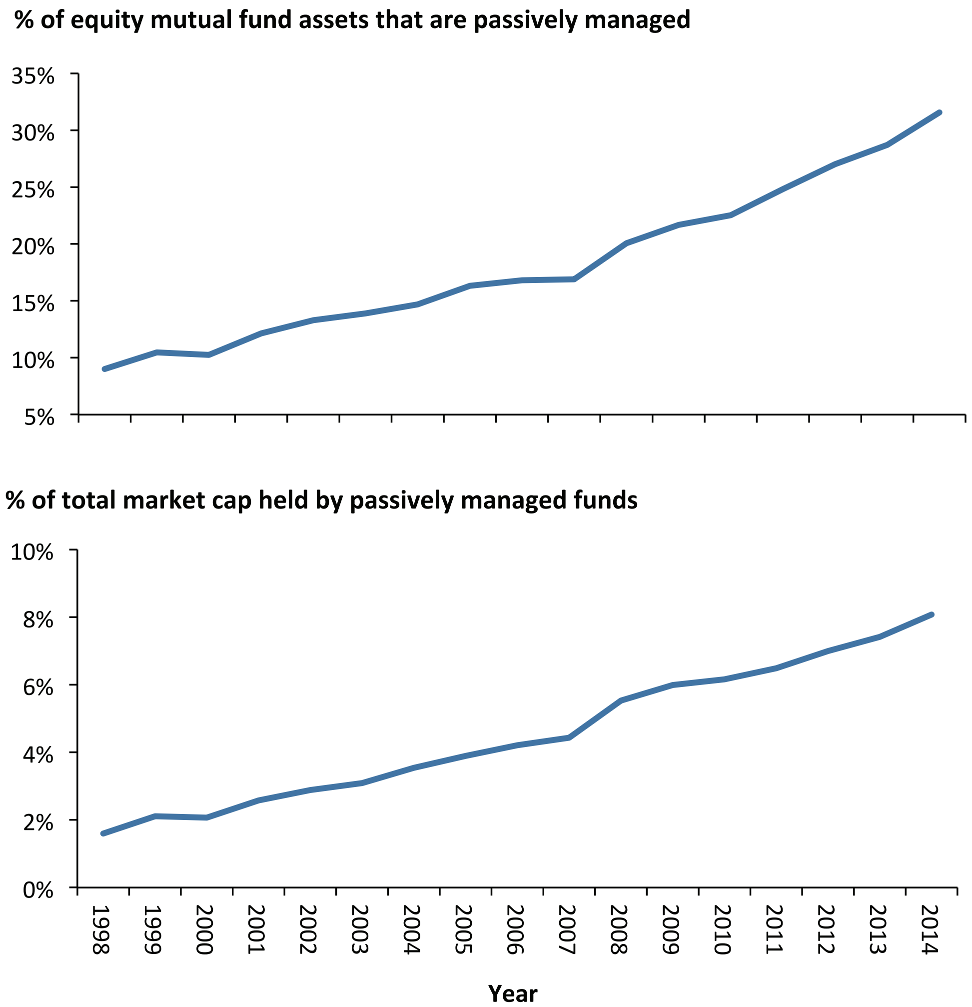

Fig. 1. Growth of passive investors, 1998–2014. This figure plots the estimated percent of all U.S. equity mutual fund assets under management between 1998 and 2014 that are held in passively managed funds and the estimated percent of total U.S. market capitalization held by passively managed mutual funds. We construct the figure by matching the S12 mutual fund holdings data compiled in the Thomson Reuters Mutual Fund Holdings Database to market caps reported in CRSP and fund names in the CRSP Mutual Fund Database. We use a name-parsing procedure along with the index fund identifier from the CRSP Mutual Fund Database to classify mutual funds as passively managed. Our procedure is described in Section 2.1 of the text. Holdings and market cap are calculated each year at the end of the third quarter.

such active investors represent only a subset of institutions. Many institutions are instead passive in that they do not actively buy or sell shares to influence managerial decisions. The investment objective of such institutions is to deliver the returns of a market index (e.g., Standard & Poors (S&P) 500) or investment style (e.g., large-cap value) with low turnover, diversified portfolios, and minimal expenses. As shown in Fig. 1, passive investors have grown significantly in recent years; the share of equity mutual fund assets held in passively managed funds tripled over the 1998–2014 period to 33.5%, and the share of total U.S. market capitalization held by passively managed funds quadrupled to more than 8%. However, the growth of passive investors raises questions about how effectively managers are being monitored. Some worry that passive investors lack the motives and resources to monitor their large, diverse portfolios, and that the increasing market share of such "lazy investors" weakens firm-level governance and hurts performance.[3] Others counter that passive investing does not equate with passive ownership.[4] In this

[3] An example of this viewpoint was expressed in *The Economist* (2015) on February 7. As it stated, "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; conventional mutual funds and pension funds that oversee diversified portfolios dislike becoming deeply involved in firms' management."

[4] For example, the title of this paper, "Passive Investors, Not Passive Owners," was the title for an article written by Glenn Booraem, controller of Vanguard, in April 2013 highlighting the care Vanguard takes when voting proxies. See https://personal.vanguard.com/us/insights/article/proxy-commentary-042013. Similar views regarding the distinction between being a passive investor, but active owner, were espoused by Rakhi Kumar, head of corporate governance at State Street Global Advisors in *The Financial Times* on April 6, 2014 in an article titled, "Passive investment, active ownership," and by David Booth, chairman and cofounder of Dimensional Fund Advisors, in the *New York Times* on March