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Heterogeneity and peer effects in mutual fund proxy voting ☆

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ABSTRACT

This paper studies voting in corporate director elections. We construct a comprehensive data set of 2,058,788 mutual fund votes over a two-year period. We find systematic heterogeneity in voting: some funds are consistently more management-friendly than others. We also establish the presence of peer effects: a fund is more likely to oppose management when other funds are more likely to oppose it, all else being equal. We estimate a voting model whose supermodular structure allows us to compute social multipliers due to peer effects. Heterogeneity and peer effects are as important in shaping voting outcomes as firm and director characteristics.

> The election of directors is the most important shareholder franchise. Larry Sonsini, Chairman, NYSE Proxy Working Group (NYSE, 2006).

1. Introduction

Despite its importance, voting in the elections of corporate boards remains relatively unexplored. A major obstacle for detailed analysis of voting is the lack of data on individual votes: until recently, voting was confidential, with only the aggregate outcomes reported by the firms. Of course, aggregate data on voting outcomes can be very useful. For instance, Cai, Garner, and Walkling (2009) have used these data to study firm- and director-level determinants and consequences of director votes. It is, however, hard to gain insight into shareholder-specific determinants of voting using aggregate data. In 2003, the Securities and Exchange Commission (SEC) introduced a new rule, requiring mutual funds to report their votes. In this paper, we present the results of our analysis of mutual fund proxy voting behavior, based on the votes of the funds in the first two years after the SEC rule change took effect. Our comprehensive data set contains 2,058,788 votes by 2,774 mutual funds in 13,588 director elections of 1,388 companies. This rich data set allows us to look at the behavior of individual voters.

Our first finding is that mutual funds systematically differ in their voting behavior. Some mutual funds are consistently more likely to cast votes in favor of directors sponsored by

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Table 1
Votes in director elections by 10 popular index funds.

This table presents sample voting data for 10 popular mutual funds tracking the S&P 500 index in the elections of directors proposed by management. The votes are for the July 2003–June 2004 and July 2004–June 2005 voting periods. All votes other than "for" and "withhold" were discarded. Data source: SEC Edgar (N-PX filings).

Mutual fund	July 1, 2003–June 30, 2004			July 1, 2004–June 30, 2005		
	# "For"	# "Withhold"	% "Withhold"	# "For"	# "Withhold"	% "Withhold"
Vanguard 500 Index Fund	2,686	559	17.2%	2,921	351	10.7%
USAA S&P 500 Index Fund	2,992	199	6.2%	3,028	223	6.9%
Schwab S&P 500 Index Fund	2,791	173	5.8%	2,888	208	6.7%
Merrill Lynch S&P 500 Index Fund	3,200	118	3.6%	3,130	107	3.3%
Morgan Stanley S&P 500 Index Fund	3,183	115	3.5%	3,112	130	4.0%
UBS S&P 500 Index Fund	2,954	103	3.4%	2,970	80	2.6%
T. Rowe Price Equity Index 500 Fund	2,942	96	3.2%	2,996	112	3.6%
Fidelity Spartan 500 Index Fund	3,089	63	2.0%	3,124	38	1.2%
Smith Barney S&P 500 Index Fund	2,920	53	1.8%	3,182	42	1.3%
Dreyfus S&P 500 Index Fund	3,176	6	0.2%	3,135	15	0.5%

the management than others. Our second finding is the presence of peer effects in mutual fund voting: a fund is more likely to oppose management when other funds are more likely to oppose it as well. These strategic interactions amplify funds' equilibrium voting responses to factors that affect fund voting. For example, a negative change in director quality will first have a direct effect: each fund is less likely to support a lower-quality director. But there is also an additional force: knowing that other funds are less likely to support the director, a fund has an additional reason to withhold its support. Thus, in equilibrium, the direct effect of any policy change will be magnified.

It is instructive to contrast these findings with hypothetical "straightforward" voting behavior. In the hypothetical case, all shareholders have the same incentive: to promote the behavior of directors that serves the best interests of the company. Each fund evaluates each director and then votes accordingly. Of course, even under such "straightforward" behavior, we would expect to see differences in fund voting behavior, simply due to random noise. However, we would not see systematic differences, and the identity or characteristics of the shareholders casting proxy votes would not play a role. In contrast, our results show that they matter. Moreover, the magnitudes of fund heterogeneity and peer effects are comparable economically to the effects of firm and director characteristics on voting outcomes.

To show that some funds are systematically more management-friendly than others, we use a fund's past voting record as an estimate of its friendliness. We find that among funds who vote on the same director in the same meeting, funds with a higher estimate of friendliness are significantly more likely to vote "for". In other words, fund friendliness, as measured by the past voting record, is an important determinant of mutual fund voting in board of directors elections.

A simple example of voting patterns provides an illustration of both heterogeneity and persistence of fund voting behavior. Table 1 presents the number of "for" (i.e., in support of a management-proposed director) and "withhold" (i.e., against a management-proposed director) votes for 10 large, popular mutual funds tracking the S&P 500 index for two voting seasons. While the holdings of these funds are, by construction, very similar, the votes are not. The least management-friendly fund, Vanguard 500 Index Fund, withheld support from management-proposed directors 559 times, or in 17.2% of cases, in the first voting season, and 351 times, or in 10.7% of cases, in the second one. The corresponding numbers for the friendliest fund, Dreyfus S&P 500 Index Fund, are 6 (0.2%) and 15 (0.5%)—lower than Vanguard's by a factor of almost 100 in the first voting season and almost 25 in the second. The 10 funds' voting policies are also highly persistent: the correlation between their votes in the first voting season and in the second one is equal to 0.93.

There are several reasons why mutual funds may systematically differ in their management-friendliness. One is the degree to which they worry about potential management retaliation. In particular, funds may care about the current and potential future business ties with the firm, such as managing pension plans.[1] Davis and Kim (2007) find that fund families that derive a larger part of their revenue from management fees from their portfolio firms use voting policies that are friendlier to management. It can therefore be costly for a single fund to vote against directors recommended by management. However, management may have a hard time severing business relations with many funds holding its shares. Similarly, if the firm were to retaliate by other means, such as restricting funds' access to their management,[2] its ability to punish any individual fund would be diminished if it had to retaliate against a larger number of funds. In the extreme case, if all funds vote against directors

[1] Other potential reasons include differences in proxy guidelines, differences in how proxy voting is organized and monitored within fund families, and fund manager individual differences in disutilities of opposing management and resisting the pressure to support management-nominated directors.

[2] For example, in its comments to the SEC on vote disclosure rules, a mutual fund company states that "this retaliation could be in the form of denial of access to company management in the course of our investment research on behalf of our shareholders." http://www.sec.gov/rules/proposed/s73602/rmason1.txt. Accessed July 27, 2009.