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Index-Fund Firms Gain Power, but Fall Short in Stewardship, Research Shows

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By Simon Constable
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The three largest index-fund managers have grown so big that they ultimately could hamper the performance of public companies and the economy, according to research from corporate-governance scholars.

The researchers—Lucian Bebchuk, professor of law, economics and finance at Harvard Law School, and Scott Hirst, a law professor at Boston University School of Law—recently published two papers that raise issues for investors.

Together, the largest fund managers— BlackRock Inc., BLK +0.28% Vanguard Group andState Street Corp.'s STT +0.04% State Street Global Advisors—control an average of one in five shares of S&P 500 companies, and that portion is likely to jump to more than 33% of shares over the next two decades, the professors say in a working paper issued by the National Bureau of Economic Research in June. The fund managers own 16.5% of shares in companies in the Russell 3000 index, the research shows, a total that the professors say could grow to 30.1% over the next two decades.

Also, these large fund managers collectively fall short in their role, as shareholders, of oversight of public companies, the researchers find in a second report to be published later this year.

"We show and document that the Big Three have incentives to underinvest in stewardship and to be excessively deferential to the corporate managers of portfolio companies," says Prof. Bebchuk.

"Given this analysis and empirical evidence, we worry that the increased concentration of shares in the hands of institutional investors will not produce the improved oversight of public companies that would be beneficial for public companies and the economy," he says.

Leaders at BlackRock, Vanguard and State Street all disagree with the analysis, saying that they act in the best interests of their shareholders.

The professors also say that the influence of the fund firms is greater than the portion of shares they own. These three firms are together responsible for 25% of the votes cast in company ballots for S&P 500 companies and 22% of the votes cast at Russell 3000 companies, the paper says.

If the same relationship between control of shares and votes cast holds in the future and the funds' ownership of shares grows as predicted, then the three index-fund companies could together account for more than 40% of all votes, on average, on shareholder resolutions at S&P 500 companies.

Cautious approach?

In their second report, due to be published in the December 2019 issue of the Columbia Law Review, Profs. Bebchuk and Hirst say the index firms are found to be extremely cautious when it comes to their own spending on corporate stewardship or taking action to change the way public companies do business.

The three fund managers “very rarely” oppose corporate managers in votes on executive compensation “and are less likely than other investors to oppose managers in proxy fights against activists,” says the new report.

“Our analysis of the voting guidelines and stewardship reports of the Big Three [BlackRock, Vanguard and State Street] indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance,” the report continues.

These firms don’t agree with the professors’ conclusions.

Last year, State Street voted against 266 companies on pay-related issues and took more action against company directors than advisory firm Institutional Shareholder Services recommended, says Rakhi Kumar, head of ESG (environmental, social and governance) investments and asset stewardship at State Street. At the same time, the firm takes a nuanced approach to activist proposals, she says: “We also have to hold activists accountable.”

In a statement, Vanguard said that voting is “only one part of the larger corporate governance process. We regularly engage with companies on our shareholders’ behalf and believe that engagement and broader advocacy, in addition to voting, can effect meaningful changes that generate long-term value for all shareholders.”

Asked for comment, BlackRock pointed to multiple past comments, including Chief Executive Officer Larry Fink‘s 2018 letter to shareholders and the company’s ViewPoint publication of July 2018. “We must be active, engaged agents on behalf of the clients invested with BlackRock,” Mr. Fink said in his letter to shareholders. “This responsibility goes beyond casting proxy votes at annual meetings—it means investing the time and resources necessary to foster long-term value.”

What they spend

The professors’ coming paper asserts that the amount of cash the three fund-management firms spend on corporate governance is minuscule.

“We show that the Big Three devote an economically negligible fraction of their fee income to stewardship, and that their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies,” the report says.

The professors estimate that spending on stewardship by BlackRock, Vanguard, and State Street is less than 0.2% of the fee income each receives. Staffing also is thin, the professors say.

BlackRock's July 2018 ViewPoint publication states: "BlackRock has over 30 professionals in this area, which represents the largest dedicated investment stewardship capability in the asset management industry to our knowledge, and we have announced plans to continue to invest in this function." BlackRock also said in that publication that some clients choose not to delegate voting authority to BlackRock. That's the case for around 9% of the shares that BlackRock holds in funds with so-called "equity mandates," the company said; those are funds that are set up to hold stocks. The firm has also stated that proxy services can hold even greater influence over shareholder votes.

Vanguard says it has "invested considerably" in stewardship.

"They are using a framework that for us is not relevant," says State Street's Ms. Kumar, pointing to extensive thought-leadership work that the company believes influences corporate behavior.