KIM: Are passively-managed funds too "dumb" to vote?

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According to the University of Chicago Law School's Dorothy Shapiro Lund in "*The Case Against Passive Shareholder Voting* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2992046," there are several reasons to believe the exploding popularity of passively-managed funds will have "harmful consequences for firm governance, shareholders and the economy."

Actively-managed funds attempt to outperform a benchmark index (and competitors) ***over time*** by picking stocks the manager believes are undervalued, based on earnings, cash flow and/or other "*fundamentals*." Actively-managed funds compete primarily on *investment performance*.

Passively-managed funds (which include index funds and ETFs) care nothing about fundamentals, but robotically replicate the daily performance of a benchmark index (minus fees) by owning the same stocks in exactly the same proportions as the index. Since all passively-managed funds geared towards that index own identical portfolios, they are a true commodity product and compete mostly on *fees*.

Passively-managed funds have reached $4 *trillion* in assets and account for 34% of the U.S. mutual fund market, up from just 4% in 1995. This huge and rapidly growing market is dominated by just three firms: BlackRock, Vanguard and State Street. Collectively, the "Big Three" firms boast a 70% market share and are the largest shareholder in 88 percent of the S&P 500 firms.

Until recently, active managers set the prices (and valuations) of stocks. Passive managers were just along for the ride. In my recent column, "Passive indexing boom might turn into bust," I theorized passive investors had assumed that role and warned of the risk of a mindless buyer distorting prices and valuations.

Lund similarly contends the growth of passive funds "will distort and dampen the market for corporate influence." The presence of active managers "provides a check against managerial slack, primarily because they identify underperforming firms as part of their investing strategy and are incentivized to discipline wayward management."

Because passive funds *do not* choose stocks based on performance potential, Lund asserts they "lack a financial incentive to ensure that each of the companies in their very large portfolios is well run."

"First, passive funds tend to have very large portfolios and thus, an investment in improving governance at a single firm is especially unlikely to enhance the fund's overall performance." By definition, every S&P 500 index fund owns a whopping *500* stocks, so the smallest positions have little impact on overall performance. In contrast, our portfolios at Kirr, Marbach contain about *50* stocks, so *every* position is important to performance.

"Second, passive funds face an acute collective action problem because investments in governance interventions equally benefit all funds tracking the index, while only the activist fund bears the costs." If the Big Three own XYZ and BlackRock spends to challenge XYZ's management, Vanguard and State Street get a "free ride."

"Third, governance interventions are especially costly for a passive fund" because it has to "expend additional resources gathering firm-specific information, as well as developing governance expertise."

In sum, the danger to corporate governance of "passive" crowding-out "active" is passively-managed funds (as commodity products that compete on fees) "have no financial incentive to invest in improving firm governance because any such investment will hurt the fund's relative performance." Because passive funds are loath to incur costs to become informed investors, Lund believes they should be restricted from voting at shareholder meetings.