Some mutual funds do business with firms whose shares they own

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Major decisions in public corporations are subject to a democratic process: Proposals for change are presented at annual general meetings (AGMs), company managers indicate their preferred outcome, and shareholders then vote. Mutual funds have significant voting power by virtue of their extensive shareholdings. They also often have business ties with firms held in their portfolios because they manage company pension plans. In a recent paper, forthcoming in the *Journal of Finance*, we show that mutual fund families vote significantly more in line with company managers' recommendations for firms in their portfolios with which they have business ties. Our results suggest that this may affect outcomes on contested proposals, that fund families may put business ties ahead of portfolio value, and that company managers may demand support from fund families with whom they have business ties on votes where they fear defeat.

What is proxy voting and why does it matter?

In the US and the UK (and in many other parts of the world), public corporations are widely held (i.e., they have many shareholders) but closely controlled (a handful of managers make decisions). How do shareholders – the providers of capital – ensure that managers act in their best interest? One way in which shareholders can "govern" corporations is to challenge current strategy by presenting proposals at company annual general meetings, where shareholders can vote on them. Such *shareholder activism* has become more prominent in recent decades. Even conservative estimates suggest that the passage of shareholder proposals can significantly enhance company value: activism matters.

Why are mutual funds important for shareholder activism?

Mutual funds are the main investment vehicle for individuals. They also affect retirement savings as a major component of individual retirement accounts in the US and the UK are invested directly or indirectly in mutual funds. As a result, mutual funds are important voters: they collectively own 24 per cent of US corporate equity and large

mutual fund families hold blocks of 10 per cent or more in many large corporations. If mutual funds use their voting power at annual meetings to raise the value of their portfolio firms, they would not only enhance corporate governance, but also enrich a vast swathe of individual investors.

Is there anything to worry about?

Mutual funds often have business relationships with portfolio firms, because they manage company pensions plans. Average earnings from such business ties represent 14 per cent of the revenues of fund families. Since company managers – who may be opposed to shareholder activism – allocate these lucrative business ties, market observers have worried that mutual funds may vote in a conflicted manner. In response, the SEC instituted rules to ensure that mutual fund proxy votes were made public. Yet, prior academic literature (see here and here) offered a reassuring view, suggesting that – when voting on proposals at an annual meeting of a firm – fund families do *not* take into account business ties with that firm in deciding how to vote.

We should worry!

We disagree with prior literature. Since we have a much larger data set – spanning nine years and a very wide class of proposals – we can use key statistical methods to control for unobserved factors to paint a more precise picture. We find that business ties with a given firm at a given time *are* associated with how fund families vote in AGMs of that firm at that time.

Do our findings matter?

By focusing on contested proposals (those that pass or fail narrowly), we show that our findings matter in at least two ways. First, we show that the influence of business ties can affect voting outcomes. In our data, replacing a fund without ties to one with ties leads to an increase in pro-management voting by over 12 per cent in proposals that pass or fail by less than 20 per cent. Second, we show that mutual fund families appear to weigh business ties over portfolio value when their choice matters. In contested proposals, each family's vote matters. By voting for a proposal, a family may enhance portfolio value but anger company managers and lose business. We show that it is precisely for such proposals that the association between business ties and pro-management voting is strongest.

Is it demand or supply?

Does the link between business ties and voting arise from pressure on mutual funds by corporate managers (a demand effect) or from an attempt to capture lucrative business by fund families (a supply effect)? Our results favour the former. In the absence of ties large fund families that are more likely to get business contracts vote no more pro-management than small fund families that are less likely to get contracts. Instead – in the presence of business ties – larger fund families are more likely to vote pro-management. This could be because company managers afraid of losing votes try to influence the largest families with whom they have business ties, as those are the most influential voters.

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Notes:

- *This post is based on the authors paper Ties that Bind: How Business Connections Affect Mutual Fund Activism, Journal of Finance, Forthcoming, LSE's Paul Woolley Centre Working Paper No39, LSE's Financial Markets Group Discussion Paper No731, European Corporate Governance Institute (ECGI) – Finance Working Paper No. 438/2014, UNC Kenan-Flagler Research Paper No. 2317212*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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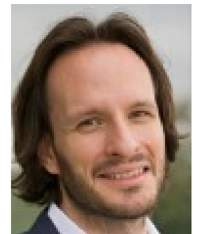
Dragana Cvijanović is Assistant Professor of Finance at Kenan-Flagler Business School, University of North Carolina at Chapel Hill.

Amil Dasgupta is Associate Professor of Finance at the London School of Economics, research fellow at the Centre for Economic Policy Research (CEPR) and CES-IFO, and research associate of the European Corporate Governance Institute (ECGI).

Konstantinos E. Zachariadis is Assistant Professor of Finance at the London School of Economics.



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