Comments by Rafael Repullo on

The New Titans of Wall Street

A Theoretical Framework for Passive Investors

by

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Preamble (i)

- Why am I discussing this paper?

  → I am not a legal scholar

  → I am not an expert in corporate governance

- However, ECGI ambition

  → Bring together lawyers and economists

  → To shed light on corporate governance issues

Preamble (ii)

- Lawyers an economists: some differences

	Lawyers	Economists
→ Theory	General verbal argument	Mathematical model
→ Evidence	Collection of facts	Statistical model
→ Style	Fisch et al.	Bolton et al.
Words in text	12,486	13,026
Words in notes	11,601	625

BlackRock rides passive investing wave with record margin and $7tn in assets

RICHARD HENDERSON — NEW YORK

BlackRock achieved a record profit margin last quarter, as lower costs and new client money swelled assets to almost $7tn.

The world's largest fund manager attracted $84bn of inflows in the third quarter, with about half going to its iShares business, a juggernaut in passive investing. Its active equity funds attracted $5.3bn in net inflows.

Revenue from BlackRock's technology business, which includes its Aladdin platform that does everything from analysing the risk of investing in particular stocks to mining data sets, climbed 30 per cent from a year ago. Combined with lower than expected costs, the asset management's operating margin hit 46 per cent in the quarter.

BlackRock has been one of the big winners from the growth of index investing in which investors are charged a small fee for buying into funds that track benchmark indices such as the S&P 500.

Larry Fink, chief executive, told the Financial Times the wave of brokerages eliminating trading commissions had provided a tail wind for iShares, the fund manager's passive investing franchise. "Its great for investors," said Mr Fink. "The real opportunity is in the more rapid adoption of ETFs."

On the macroeconomy, Mr Fink warned that the trend toward negative interest rates in Europe and Japan had hurt investor sentiment without spurring economic activity.

"I don't see how the transmission of negative interest rates effectuates more activity in Europe," he said. "I get the theory but we are seeing the opposite — consumers and banks are pulling back."

BlackRock's net income in the quarter fell to $1.1bn, from $1.2bn a year ago, but the results exceeded Wall Street forecasts.

Overall revenues climbed 3 per cent to $3.7bn. Shares in BlackRock rose almost 3 per cent in New York.

BlackRock attracted $8bn in alternative investments for the third quarter. The asset class, which includes real estate, attracts higher fees than the typical stock or bond portfolio.

Two views on passive investors

- Bebchuk and Hirst (2019)

“Index fund managers have strong incentives to underinvest in stewardship and defer excessively to corporate managers.”

- Fisch et al. (2019)

“Contemporaneous with the growth of passive investors has been their increasing involvement in corporate governance.”

Bebchuk and Hirst

- Big Three devote an economically negligible fraction of their fee income to stewardship → about 0.15%
- Big Three engage with a very small proportion of their portfolio companies
- Big Three stewardship focuses on divergences from governance principles, with limited attention to firm-specific performance

Fisch et al.

- Passive funds, by virtue of their investment strategy, are locked into the portfolio companies they hold
  → Cannot use exit strategy ("Wall Street walk")
  → Higher incentives to stewardship
- Sponsors manage entire family of funds, which includes mixture of passive and actively-managed funds
  → Incentives to engage on behalf of active funds in family
  → Complementarities with respect to engagement

Overview of discussion

- A simple theoretical model

  → Free-rider problem in funds' monitoring

  → Strategic interaction between funds

- Some detailed comments

- Other relevant issues

- Concluding remarks

Part 1

A simple model

Model setup (i)

- Firm with two large shareholders (mutual funds)
- Each fund $i = 1, 2$ is characterized by

  → s_i = ownership share of firm

  → m_i = monitoring intensity of firm management

  → φ_i = management fee (charged to final investors)

Model setup (ii)

- Value of firm $v(m)$ depends on total monitoring $m = m_1 + m_2$

  → $v(m)$ is increasing

  → $v(m)$ is concave (decreasing returns to monitoring)

- Monitoring is costly: cost function $c(m_i)$

  → $c(m_i)$ is increasing

  → $c(m_i)$ is convex (increasing marginal cost of monitoring)

Funds' decision problem

- Fund 1 maximizes management revenues net of monitoring cost

$$\max_{m_1}\left[\varphi_1 s_1 v(m_1+m_2)-c(m_1)\right]$$

→ decision depends on monitoring by fund 2

- Fund 2 maximizes management revenues net of monitoring cost

$$\max_{m_2}\left[\varphi_2 s_2 v(m_1+m_2)-c(m_2)\right]$$

→ decision depends on monitoring by fund 1

- Strategic interaction between two funds

→ Nash equilibrium

Parametric example

- Value of firm

$$v(m) = v_0 + m - m^2$$

- Monitoring cost function

$$c(m_i) = m_i^2$$

Funds' monitoring decisions (i)

- Decision problem of fund 1

$$\max_{m_1}\left[\varphi_1 s_1\left[v_0+(m_1+m_2)-(m_1+m_2)^2\right]-m_1^2\right]$$

→ First-order condition

$$\varphi_1 s_1[1-2(m_1+m_2)]-2m_1=0$$

→ Solution: Best response of fund 1

$$m_1=\frac{\varphi_1 s_1}{1+\varphi_1 s_1}(0.5-m_2)$$

Funds' monitoring decisions (ii)

- Decision problem of fund 2

$$\max_{m_2}\left[\varphi_2 s_2\left[v_0+(m_1+m_2)-(m_1+m_2)^2\right]-m_2^2\right]$$

→ First-order condition

$$\varphi_2 s_2[1-2(m_1+m_2)]-2m_2=0$$

→ Solution: Best response of fund 2

$$m_2=\frac{\varphi_2 s_2}{1+\varphi_2 s_2}(0.5-m_1)$$

Properties of best response functions

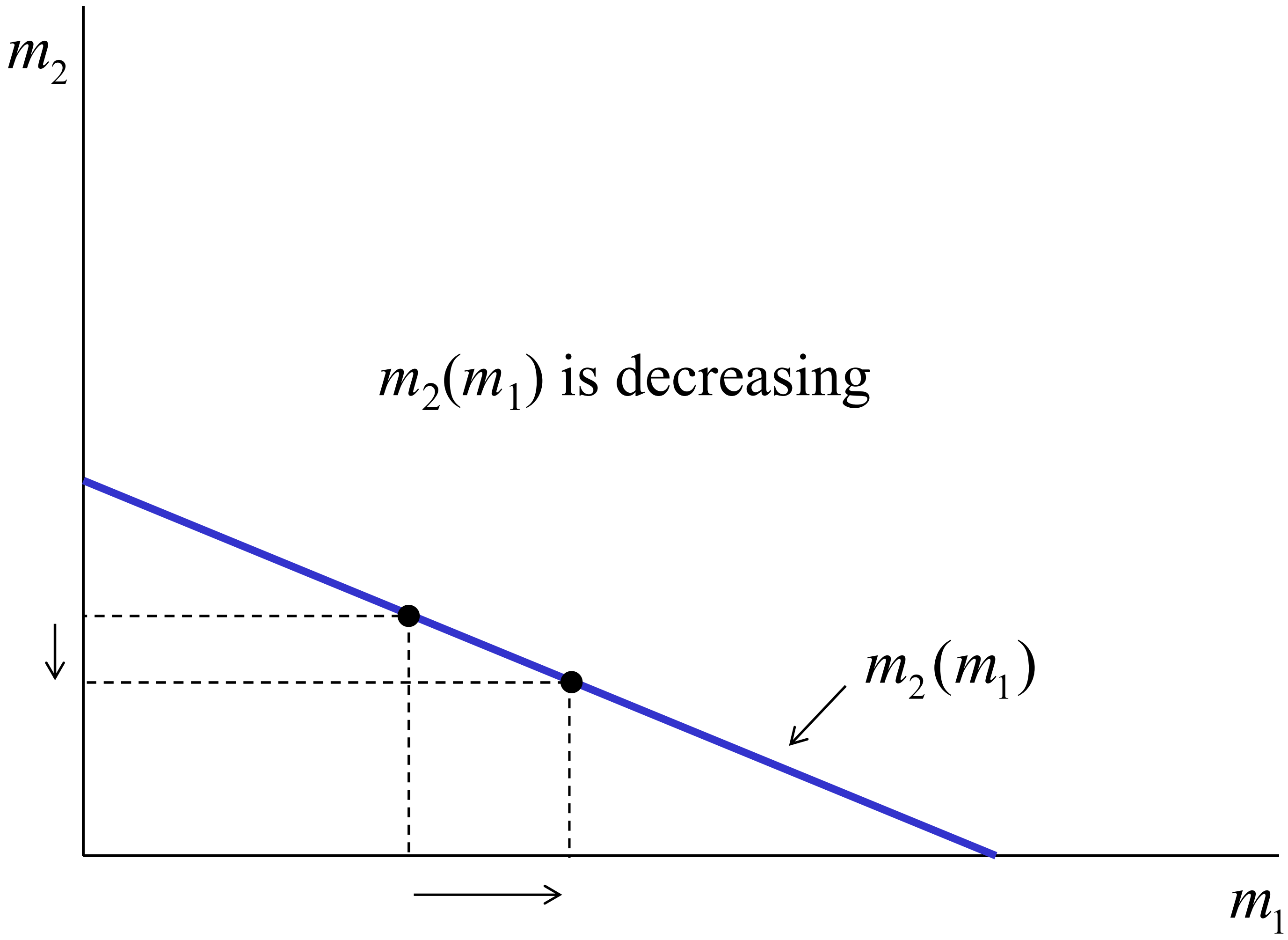
- Properties of the response function of fund 2

  → m_2 is decreasing in m_1

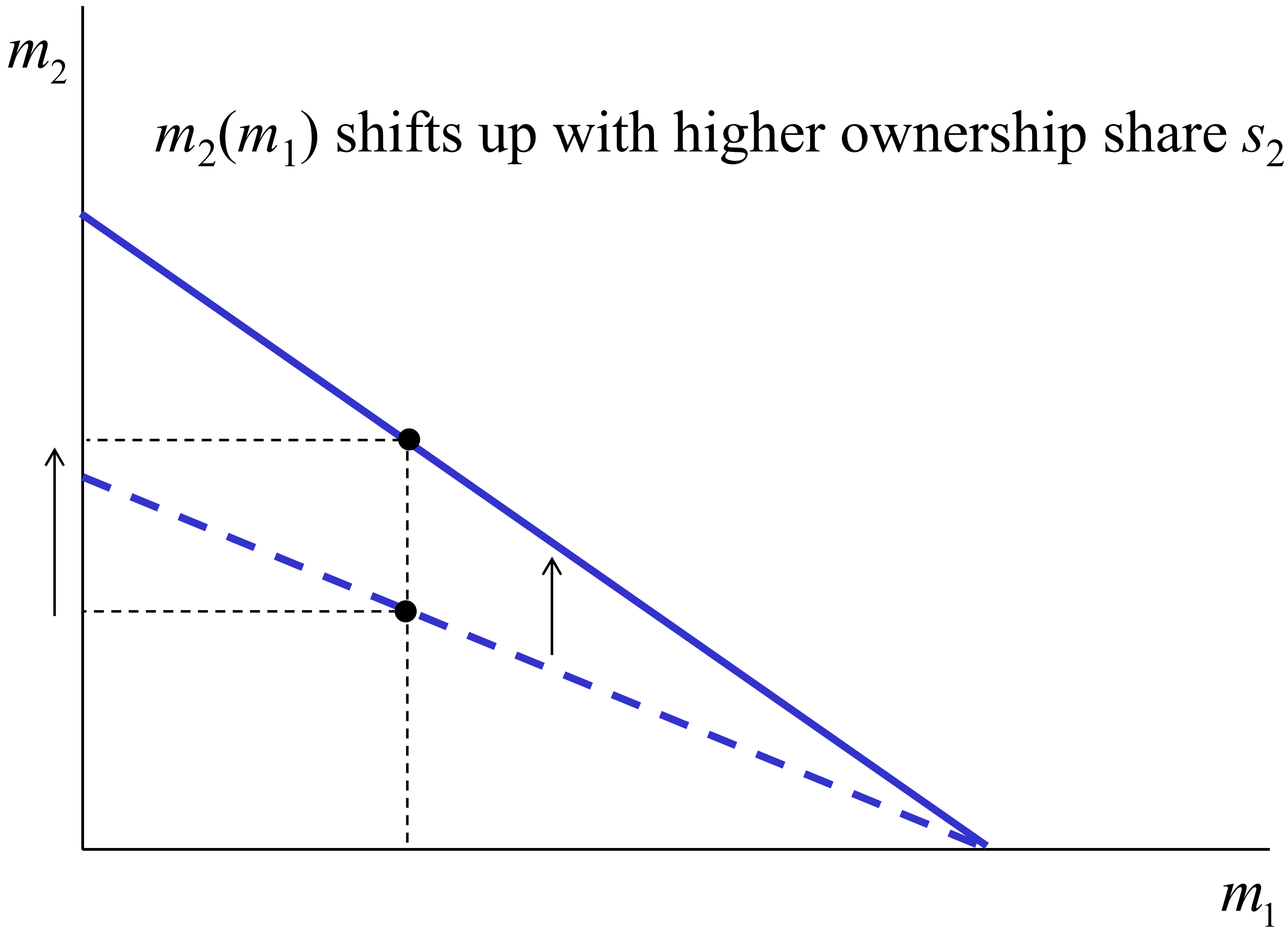
  → m_2 is increasing in ownership share s_2

  → m_2 is increasing in management fee φ_2

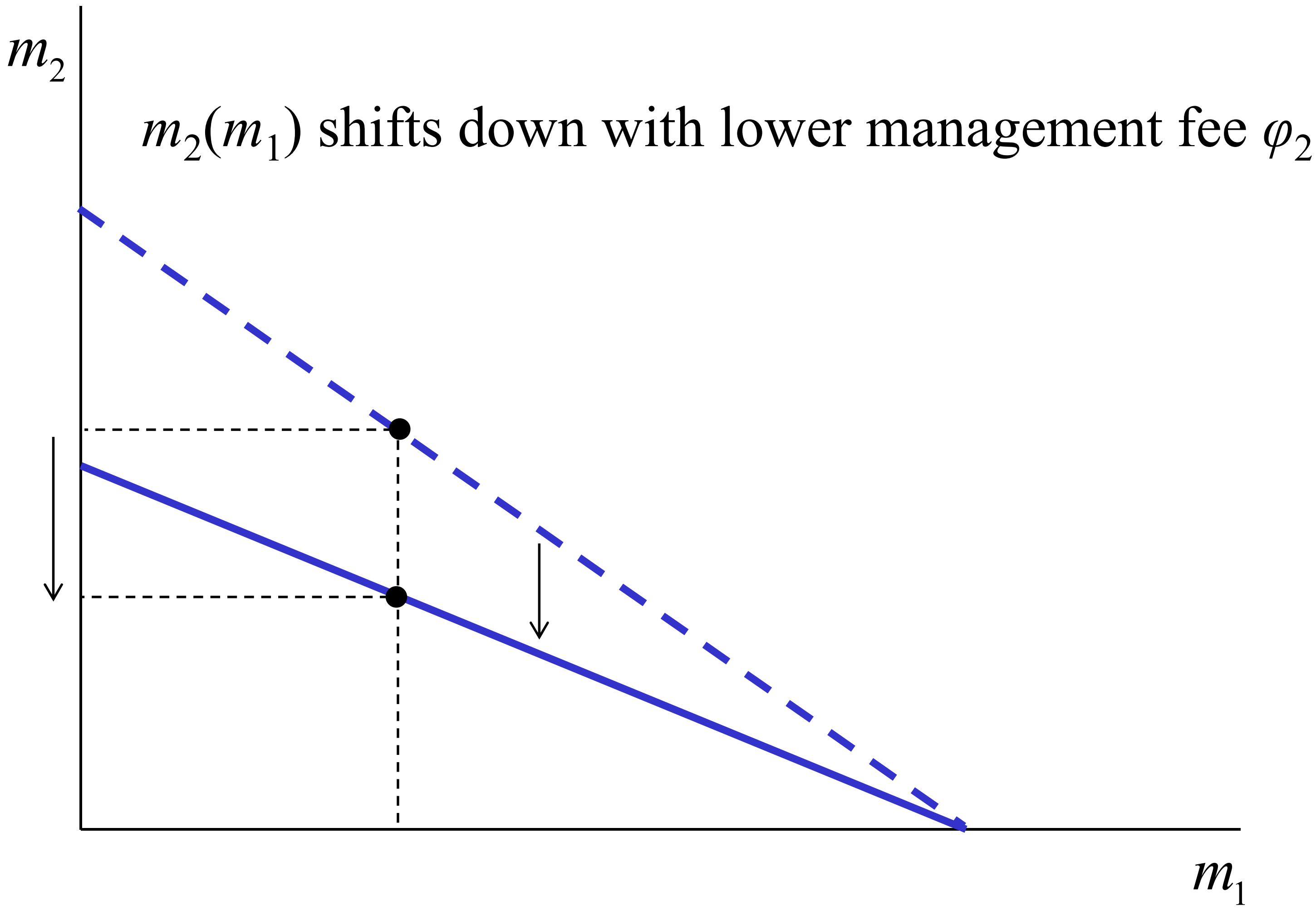
Properties of best response functions



Properties of best response functions



Properties of best response functions



Nash equilibrium

- Best response of fund 1

$$m_1 = \frac{\varphi_1 s_1}{1+\varphi_1 s_1}(0.5 - m_2)$$

- Best response of fund 2

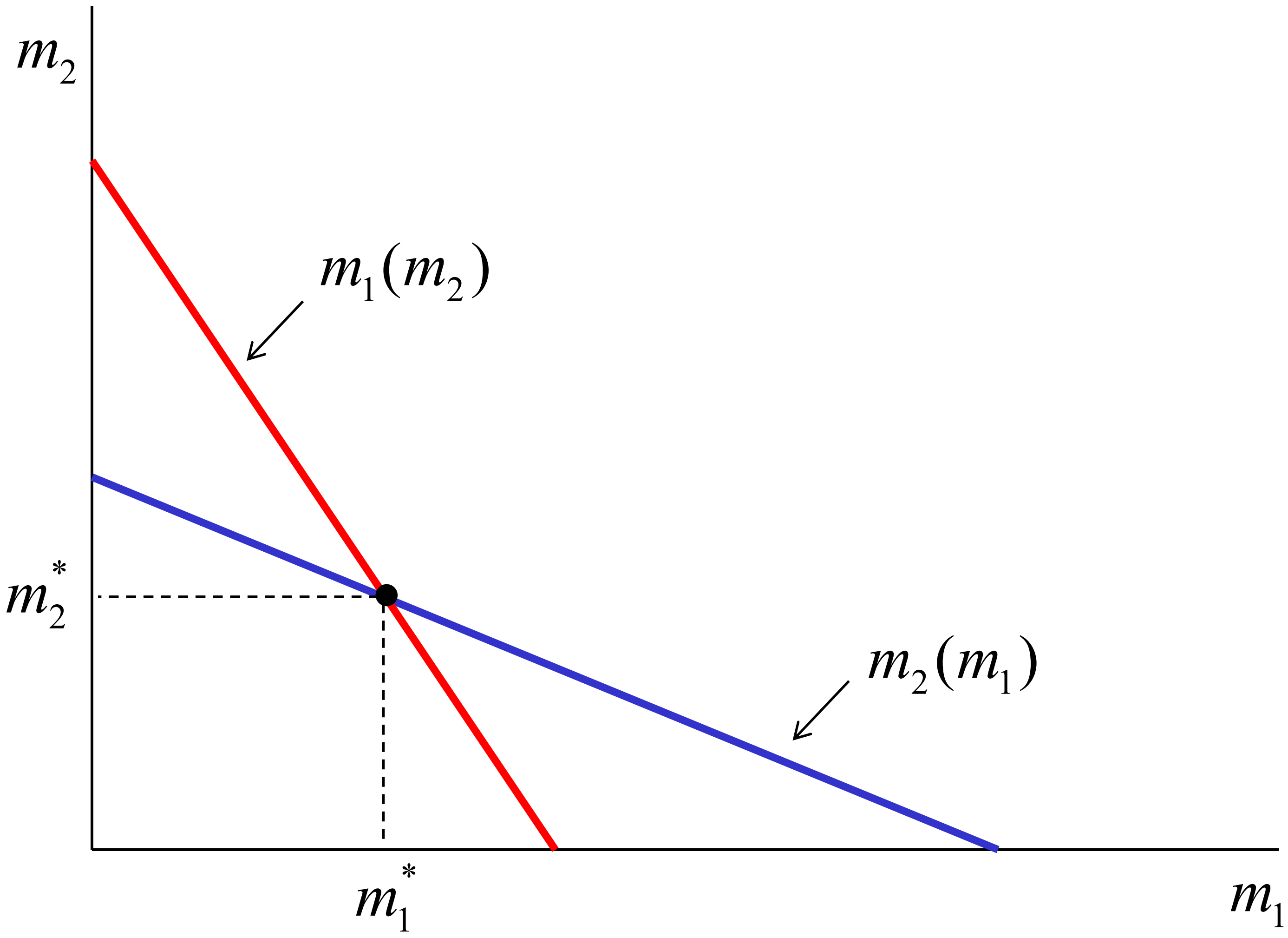
$$m_2 = \frac{\varphi_2 s_2}{1+\varphi_2 s_2}(0.5 - m_1)$$

- Two equations with two unknowns (m_1 and m_2)

  → Solution is Nash equilibrium

$$m_1^* = \frac{\varphi_1 s_1}{2(1+\varphi_1 s_1 + \varphi_2 s_2)} \quad \text{and} \quad m_2^* = \frac{\varphi_2 s_2}{2(1+\varphi_1 s_1 + \varphi_2 s_2)}$$

Nash equilibrium



Comparative statics (i)

- Two sequential parameter changes

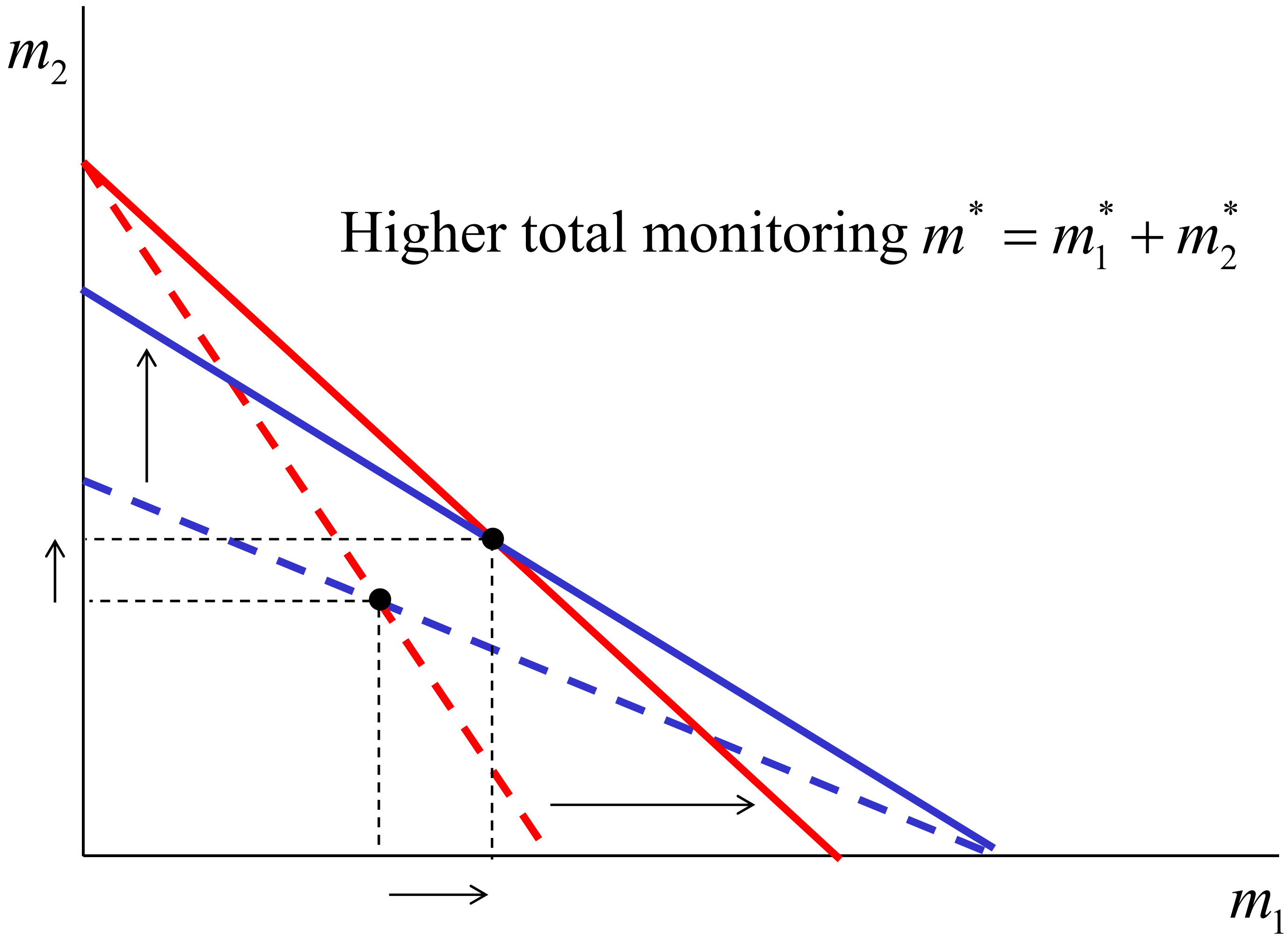
- Growth in assets under management

  → Increase in ownership share s_1 and s_2 of both funds

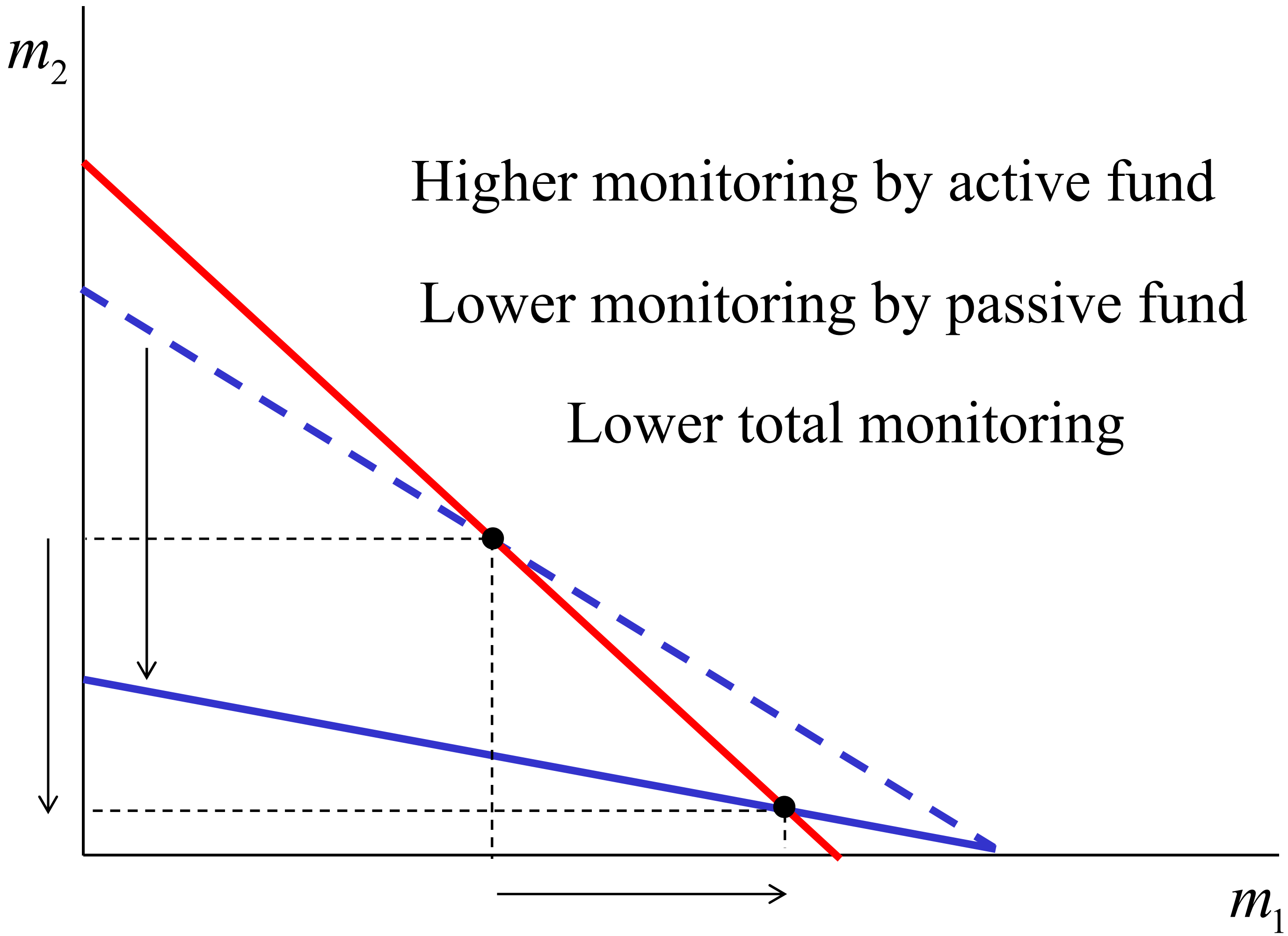
- Move from active to passive

  → Decrease in management fee φ_2 of (passive) fund 2

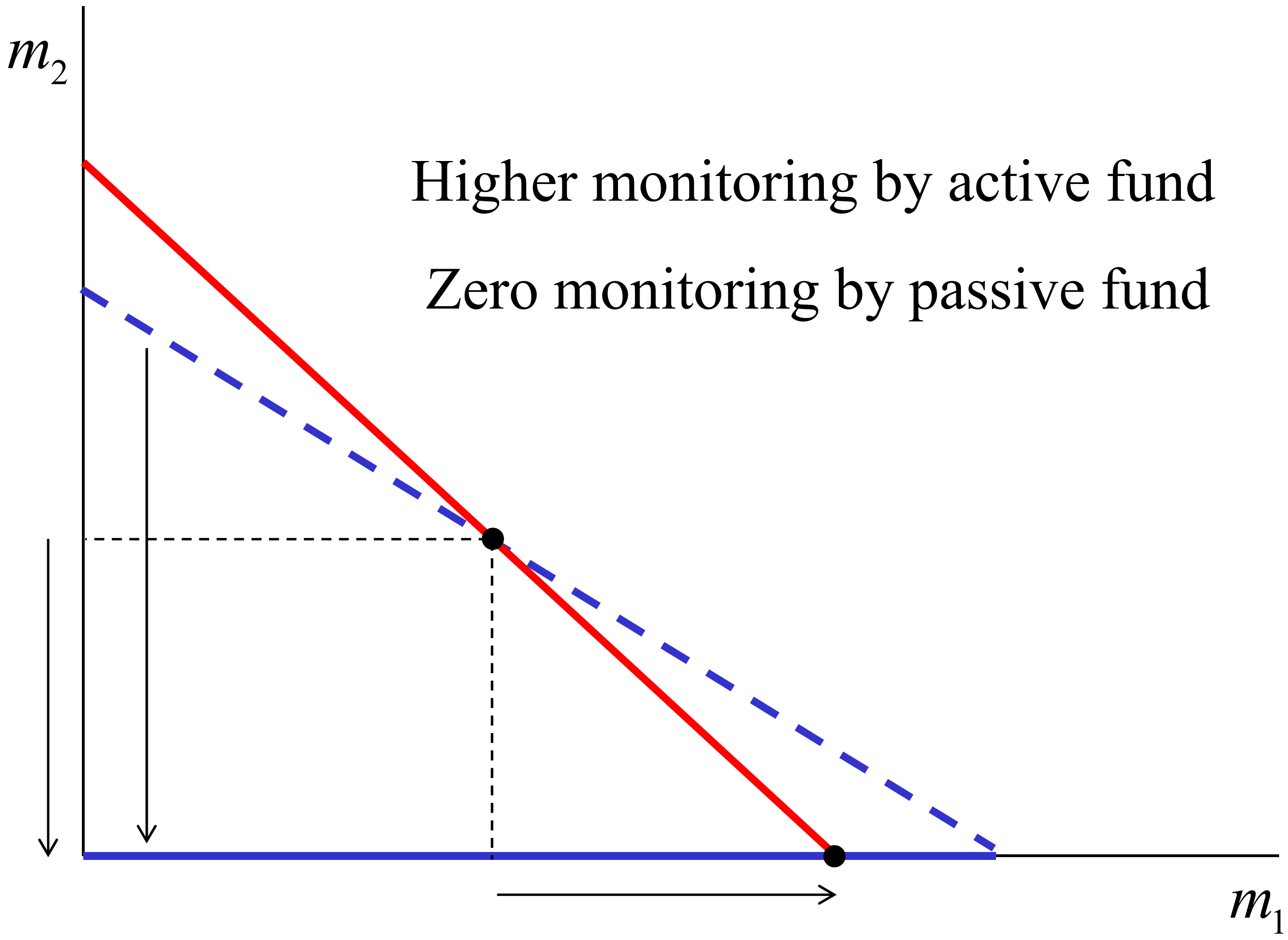
Growth in assets under management



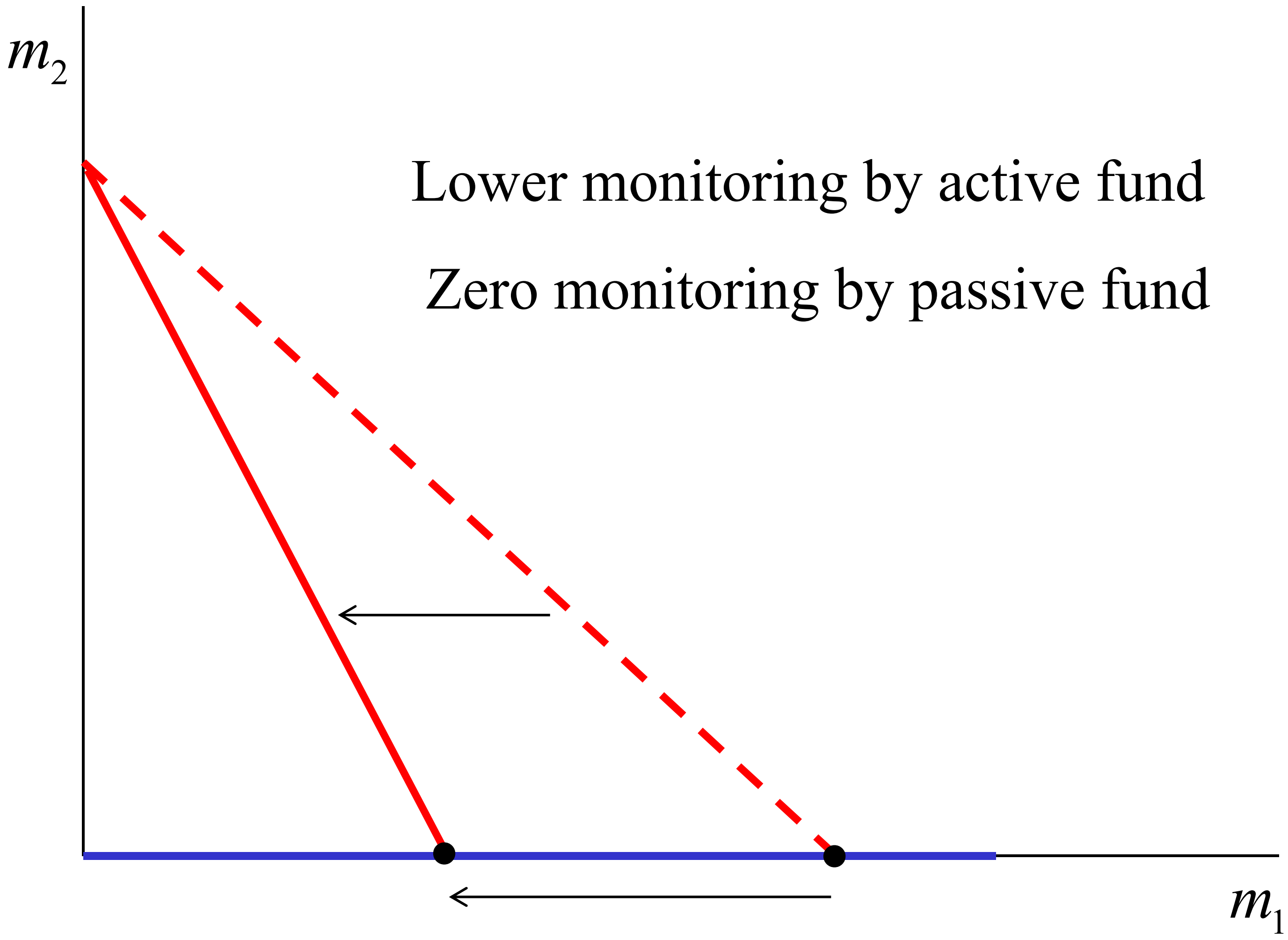
Fund 2 moves from active to passive



Management fee of passive fund goes to zero



Shift of assets from active to passive fund



Summing up

- Low management fees of passive funds imply

  → Lower monitoring by passive funds

  → Higher monitoring by active funds

  → Lower overall level of monitoring

- Growth of passive funds imply

  → Lower overall level of monitoring

Part 2

Some detailed comments

Detailed comments (i)

- "Neither the business model of passive funds, nor the way in which they engage with their companies, is well understood"

  → Business model not well understood?

- "We provide the first comprehensive theoretical framework for passive investment and its implications for governance

  → Really?

Detailed comments (ii)

- "We believe the substantial recent inflow to passive funds are a response, in part, to extensive media reports that active funds underperform passive funds"

  → Not just "media reports"

  → Pretty solid evidence on superior returns after fees

- "Becoming informed is more readily justified for large passive investors because of their role as pivotal voters"

  → Do they have incentives to collect information?

Detailed comments (iii)

- “Even though the overall expense ratios are low, because of their large size, they generate substantial fees for their sponsors, enabling them to devote substantial resources to governance”

  → “As of Jan. 2017, BlackRock had increased the size of its governance staff to 31 persons, Vanguard had 20 governance employees, and State Street had 11”

  → Tiny staff for a company with $7tn. in assets

Part 3

Other relevant issues

Possible side effects (i)

- Growth of passive funds may reduce liquidity of market

  → Active funds may have <u>more</u> incentives to monitor

  → Taking "Wall Street walk" is costlier (Bhide, 1993)

Possible side effects (ii)

- “As a substantial percentage of the market becomes indexed, the gains from having an informational advantage increase”
  - → Profiting from this advantage requires to find less informed counterparties
  - → Growth of passive funds may reduce noise trading
  - → Active funds may have <u>less</u> incentives to monitor

Possible side effects (iii)

- Impact of common ownership on market competition

  → Significant if Fisch et al. are right

  → Negligible if Bebchuk and Hirst are right

  > "…the real worry is not that index funds might do too much, but that they might do too little"

Concluding remarks

Concluding remarks (i)

- Given its current size and expected growth, studying the impact of passive investment on corporate governance is of paramount importance

  → Effects on company performance

  → Effects on competition (common ownership)

  → Effects on economy-wide performance

Concluding remarks (ii)

- Paper raises many interesting issues

  → But much more research is needed

  → Both on theoretical and especially on empirical front

- Area where lawyers and economists may fruitfully collaborate

  → Despite differences on meaning of theory and evidence

  → Most valuable role of ECGI

References

• Bebchuk, L., and S. Hirst (2019), "Indexed Funds and the Future of Corporate Governance: Theory, Evidence, and Policy," ECGI Working Paper.

• Bhide, A. (1993), "The Hidden Costs of Stock Market Liquidity," *Journal of Financial Economics*.

• Bolton, P., T. Li, E. Ravina, and H. Rosenthal (2019), "Investor Ideology," ECGI Working Paper.