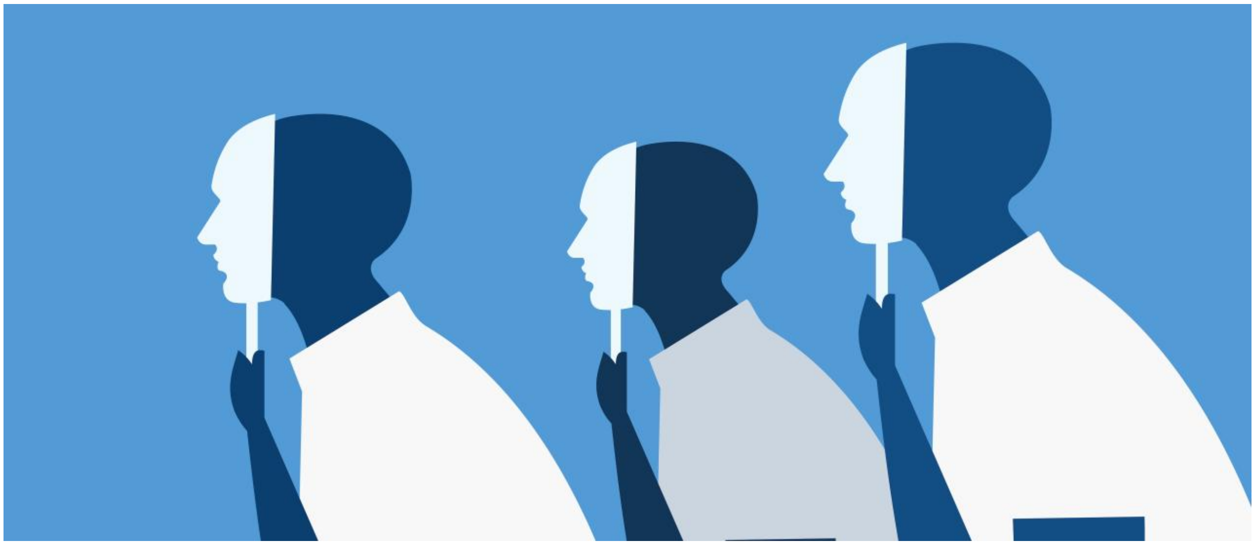
The Politics of Mutual Fund Managers' Voting



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Fund managers' politics sway the way they vote, impacting company governance at the expense of company performance.

Fund managers are meant to be focused on value creation, paid to take decisions that financially benefit the firm they invest in and by extension the fund they manage. Yet, our recent research suggests that's not always the case. In the United States at least, their decisions can be driven by political motivations. What's more, these managers engage in "signal jamming" to avoid any potential backlash for breaching their fiduciary duties.

This finding is based **on our analysis** of the proxy voting behaviour of asset managers at corporate annual general meetings over the last 20 years. Specifically, we looked at how their voting behaviour was influenced by their politics, identified by their personal contributions to campaign candidates in either the Democratic or Republican parties. At first glance, the patterns of voting seemed relatively neutral or balanced. In other words, fund managers did not appear to vote in support of CEOs whose political views they shared.

Yet, when we examined voting behaviour more closely, we found this wasn’t really the case. Instead, when a vote was contentious – which we defined as when the management recommendation differed from proxy advisory firms’ recommendations to institutional investors – the asset managers consistently voted in support of CEOs whose political views they shared. This was regardless of the financial benefits that such action entailed.

All too human

The fact that individuals are biased is not surprising. What’s unexpected was how the fund managers tried to conceal their bias. In all the other non-contentious votes, the fund managers voted against the management. So, on the whole, their selective support of CEOs was “hidden”. That is, on average fund managers voted in the “good governance way” but supported politically aligned CEOs when the latter most needed it.

Over the period studied (2005-2017), both Republican and Democratic supporters engaged in such deceptive voting. In fact, this behaviour intensified when the opposing political party was in power. Republicans would do more to hide their true allegiance when Democrats were in the White House; Democrats would hide more when Republicans ruled the roost.

Interestingly, this “signal jamming” behaviour was more pronounced at funds under greater public scrutiny. These could be fund families and funds that had more influence on the voting outcomes or were more involved in the political arena; funds whose investors were more sensitive to performance-related implications; and funds linked to firms with higher profile because of their size, presence in the S&P 500 index or news coverage. Concealing one’s biased voting pattern hints at the fact that the behaviour is conscious and deliberate.

Impact on value creation

Perhaps such subterfuge is to be expected. Asset managers are just human, and people tend to support those whom they perceive to be on the same team. Such behaviour could even be justified if there was some form of benefit – say, useful information about the firm – for the fund managers acting this way.

Yet, we found that this simply wasn't the case. Instead, biased voting by fund managers had a negative impact on value creation for companies and therefore for the mutual funds holding a stake in them. By following their politics, the mutual fund managers were practicing bad governance.

Interestingly, given that professional investors are more likely to sanction this breach of fiduciary duty, biased voting was more prevalent in funds sold to retail investors than funds sold to institutional investors.

This is a problem when you consider the outsized role of mutual funds run by the big four firms – BlackRock, Vanguard Group, Fidelity Investments and State Street Global Advisors – in US investments. Combined they account for around US$30 trillion worth of investments in thousands of US firms.

While the likes of BlackRock maintain clear rules that prevent them from sitting on boards of companies they invest in, they remain shareholders. As a result, despite their preference to remain neutral they are obliged to vote during those firm's AGMs. In principle, that obligation means voting in a way that improves the fiduciary value of the company, but as our research shows this is not always the case.

On paper, BlackRock does have further checks and balances in place, for example a stewardship team is tasked with ensuring a coordinated approach to voting. Yet the reality is that this team consists of fewer than 60 people, and BlackRock has investments in over 10,000 companies. This means thousands of AGMs and thousands of votes each year which means the responsibility can potentially fall to the individual fund manager.

The bottom line vs. the party line

Listed firms benefit from the increased liquidity that comes from selling shares but this also means they are subject to the "political" manoeuvring of short-term owners who, based on the voting behaviour we observed, don't practise good governance. This should be expected. Mutual funds don’t govern a company through voting but by “walking the Wall Street way” – that means selling their shares when they dislike the performance of the company.

Direct monitoring and voting are more typical for long-term investors and family firms. This makes a difference between a stock-exchange-based governance model (US) and a more owner-based governance model (Europe). In the US model, governance is provided by selling shares and allowing a company to be taken over by activists that discipline the managers. In the European model, big blockholders of shares play a monitoring role and often sit on the board.

As the US heads to the polls later this year, American politics is set to get more divisive and heated. The concern is how this heightened political climate will influence the behaviour of investors and in particular mutual fund managers. Managers following their party line in proxy voting could have a very negative impact on companies’ bottom line.

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About the research

"**Political Affinity and Mutual Fund Voting**" is a working paper.