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Bonds Improve Institutional Investors' Equity Monitoring

BY TODD GORMLEY and MANISH JHA *May 10, 2023*

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In new research, Todd Gormley and Manish Jha find that institutional investors holding bonds may experience greater investor attention and more active shareholding voting on their equity positions.

As institutional investors continue to grow in size and influence, questions arise as to whether they are effective stewards for equity investors. The fact that the three largest mutual fund families in terms of total net assets (Vanguard, BlackRock, and Fidelity) each hold equity positions in around 5,000 U.S. companies raises concerns about their ability to actively monitor and vote on every company in their vast portfolios. However, our research suggests that mutual fund families that hold corporate bonds are more likely to experience improved investor attention and demonstrate more active shareholding voting on their equity positions.

Institutions offer various mutual fund and exchange-traded fund (ETF) options to investors, and corporate bond holdings often make up a significant portion of their portfolios. At the end of 2020, one-fourth of U.S. mutual funds and ETFs held corporate bonds, with more than half of those funds holding both equity and bonds. Moreover, between 2008 and 2020, 36.2% of institutions casting votes on contentious shareholder proposals—defined as proposals where company management and Institutional Shareholder Services (ISS), a proxy advisory firm, gave conflicting vote recommendations—also held a bond position in the underlying firm, accounting for an average of 28.9% of their exposure to the firm.

There are several reasons why bond holdings might affect how actively institutions monitor and vote their equity positions. For one, encouraging Environmental, Social, and Governance (ESG) improvements can positively impact both equity and bond values by reducing downside risk and credit-rating agencies' risk assessments. Bond owners also have strong motives to encourage active voting by their equity counterparts, given that bond holdings tend to be less liquid and more sensitive to long-term viability risks. In addition, fixed-income managers conduct extensive research on companies and their default risk, which, if shared internally within the fund family, could affect how informed and attentive the institution is when voting shares.

However, there are also reasons why institutions' corporate bond holdings might not affect their overall stewardship activities. For example, managers with bond holdings might be given little weight in how the fund family votes its shares, especially if the bond holdings are in bond-only funds that lack voting rights. Additionally, institutions' fiduciary duty obligations could limit the extent to which institutions allow managers with a bond holding (and hence, a potentially conflicting interest) to influence their voting decisions.

We explored the importance of bond holdings for institutional investors' attention and how they influence their voting behavior. We started by constructing a proposal-by-institution-level dataset of how institutions voted on every proposal from January 2008 to June 2020 and paired this data with institutions' aggregated holdings at the time of the vote. We then regressed a proposal-level, vote-based measure of investor attention onto the share of the fund family's total net assets (TNA) held in that company's bonds. We proxied for an institution's attention using votes that go against the recommendation of ISS.

Using within-proposal and within-institution-by-month variation in votes, we found a positive association between an institution's bond position size and the likelihood it does not follow the ISS recommendation when voting its shares. The positive association is robust and economically important, similar in magnitude to that observed for equity holdings. A one percentage point increase in a bond's share of total net assets predicts a 3.1 percentage point increase in the likelihood that the institution votes against the ISS recommendation.

We also constructed an alternative proxy for investor attention: if a fund family accesses a company's proxy filings via EDGAR in the days before a shareholder meeting. The size of an institution's bond holdings positively predicts if it views a company's proxy filings before voting. A one percentage point increase in a bond's share of total net assets is associated with a 6.1 percentage point increase in the likelihood of accessing the company's proxy filing.

The observed association between bond holdings and voting concentrates among firms with low ESG scores, consistent with bondholders' likely focus on capital preservation. Governance proposals, rather than proposals connected to socially responsible investing, drive the association between bond holdings and voting.

We also found a positive association between portfolio weights and investor attention concentrates on bonds held in mixed-asset funds, which include both equity and fixed-income positions. The findings suggest that fixed-income managers are more active and likely to exert influence in mixed-asset funds, where they can leverage an equity counterpart's ownership to exert influence. Additionally, the positive association between portfolio weights and investor attention is stronger for bonds held in actively managed funds, where monitoring is more likely to occur.

Lacking the ability to participate in shareholder votes, bond investors are not typically thought to play an important governance role. Nevertheless, bond investors have many reasons to be concerned about firms' governance structures, which can influence credit ratings and the likelihood of repayment. Moreover, bonds represent a large proportion of institutional investors' portfolios, providing bond investors a potential voice in how actively their institutions monitor and vote their shares. Our findings show that corporate bond holdings predict greater investor attention, suggesting that the popularity of mixed-asset funds and institutions' tendency to hold bond positions in companies can enhance investor stewardship.

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