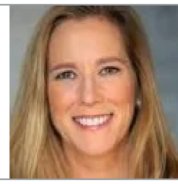
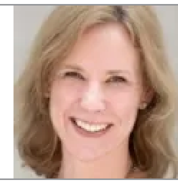
John C. Coffee, Jr. – Boeing and the Future of Deferred Prosecution Agreements



Leveraging Information Forcing in Good Faith

By Hillary Sale



The Dark Side of Safe Harbors

2 By Susan C. Morse

Do Bonds Affect Equity Monitoring?

By Todd A. Gormley and Manish Jha April 12, 2023

As institutional investors grow in size and influence, questions arise as to whether they are effective stewards for equity investors. That the three mutual fund families with the most total net assets each holds equity positions in around 5,000 U.S. companies raises concerns about their ability to monitor and vote on every company in their vast portfolios. Our research suggests that their corporate bond holdings might affect how actively they monitor and vote 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 holding both equity and bonds. Moreover, 36.2 percent of institutions casting votes on contentious shareholder proposals, defined as proposals where Institutional Shareholder Services (ISS) and management gave conflicting vote recommendations, between 2008 and 2020 also held a bond position in the underlying firm, accounting for an average of 28.9 percent 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 increase both equity and bond values by reducing downside risk and credit-rating agencies' risk assessments. Bond owners also have strong incentives to encourage 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. 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 duties 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 explore the importance of bond holdings for institutional investors' attention and how they influence their voting behavior. We start by constructing a proposal-by-institution-level dataset of how institutions voted on every proposal from

January 2008 to June 2020 and pair this data with institutions' aggregated holdings at the time of the vote. We then regress 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 use votes that go against the recommendation of the proxy adviser ISS as a proxy for an institution's attention.

Using within-proposal and within-institution-by-month variation in votes, we find 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 1 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 construct as an alternative proxy for investor attention whether 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 whether it views a company's proxy filings before voting. A 1 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 is concentrated 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 find that a positive association between portfolio weights and investor attention is concentrated 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 typically not 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.

This post comes to us from professors Todd A. Gormley at Washington University in St. Louis and the European Corporate Governance Institute (ECGI) and Manish Jha at Georgia State University. It is based on their recent article, "Bonds Lie in the Portfolio of the Beholder: Do Bonds Affect Equity Monitoring?" available here.