Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism

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Executive Summary

The willingness of investors to engage in activism has grown rapidly in recent years. About 400 U.S. activist campaigns are launched per year, and *The Economist* noted that "one in seven [companies in the S&P 500 index] has been on the receiving end of an activist attack" over the past five years. The goals of activists have become more ambitious and the success rate of the campaigns has improved. Activists increasingly wage proxy fights to obtain board representation; more than 70 percent of these campaigns were successful in 2014.

The determinants of this shift in activist tactics and success rates are not well understood. Why do activists seem more willing in recent years to engage in hostile and costly tactics, like initiating a proxy fight? And what factors affect their likelihood of success?

One potential contributor to the rise of activism is the growing presence of large, passive investors. Passive and index mutual funds have quadrupled their ownership share of the U.S. stock market over the last 15 years and now account for more than a third of all mutual fund assets. Passive institutions, and their increasingly large ownership stakes, might facilitate activism by decreasing the costs of intervention by lowering coordination costs during a proxy solicitation process, or by increasing the expected payoff of intervention by increasing activists' likelihood of success. Ian Appel, Todd Gormley, and Donald Keim investigate whether the increased presence of passive institutional investors influences the types of campaigns undertaken by activists, the tactics they employ, and their eventual outcomes.

To identify the effect of passive investors on the strategic choices of activists, they exploit variation in stock ownership by passive and index mutual funds that occurs around the cutoff point used to construct two widely-used market benchmarks, the Russell 1000 and Russell 2000 indexes. The Russell 1000 comprises the largest 1,000 U.S. stocks in terms of market capitalization, and the Russell 2000 comprises the next largest 2,000 stocks. Because portfolio weights assigned to each stock within these indexes are value-weighted, a stock's index assignment has a significant impact on the extent of passive ownership.

The researchers find a sharp difference in ownership by passive mutual funds—40 percent on average during the sample period—for stocks at the top of the Russell 2000 relative to stocks at the bottom of the Russell 1000, even though these stocks are otherwise similar in terms of their overall market capitalization. There is no corresponding difference in ownership by actively managed mutual funds between stocks at the bottom of the Russell 1000 and the top of the Russell 2000.

They find that passive mutual fund ownership is associated with significant differences in the goals and tactics of activist campaigns. During the sample period, 2008-2014, activists were more likely to pursue changes to corporate control or influence, such as board representation, and to forego more incremental changes to corporate policies, such as increased payouts, when a larger share of the target company's stock was held by passively managed mutual funds. Regarding the tactics of activist campaigns, higher passive ownership was associated with increased use of hostile, expensive tactics, such as proxy fights, rather than relying on shareholder proposal or exempt solicitation.

Passive mutual fund ownership is also associated with an increase in the successes of activists. While passive ownership is not associated with the rate at which activists win proxy fights, it is positively associated with the likelihood of a settlement with managers. When passive ownership is higher, the researchers also find that activists are more likely to successfully influence outcomes related to corporate control such as removing takeover defenses, facilitating the sale of the targeted firm to a third party, and engaging in a hostile offer.

Overall, the findings suggest that the rise in activism and the growth of passive investors—both of which are recent and fundamental shifts—are interconnected. The increased presence of passive investors affects the behavior of activist investors.