



The great shareholder shift:

Developing financial policies for an evolving shareholder base

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1. Introduction

Corporate finance decisions are often evaluated in the context of a traditional set of established wisdom. The tenets of efficient markets, capital asset pricing and portfolio theory (among others) form the toolbox of financial decision-making. Yet these tools seem incomplete in an environment where algorithmic trading platforms make buy and sell decisions in timeframes measured in nanoseconds, and active managers continue to lose assets to passive index funds. It is not surprising that shareholders look and act differently today than they have in the past, as institutional investors represent an increasingly large portion of investor bases, passive index ownership has jumped and shareholder registers are increasingly concentrated (see Figure 1).

Figure 1

S&P 500 shareholder trends over time - pre-financial crisis vs. today

	2006	Current	Change
Median company size (\$bn) ¹	\$13.2	\$21.0	+60%
% retail	32%	16%	(16 pp)
% index	14%	26%	+12 pp
% holding of top 5 shareholders	19%	30%	+11 pp
Trading liquidity ²	0.72%	0.68%	(5%)

Sources: Bloomberg, FactSet

Note: The change in % retail, % index and % holding of top 5 shareholders reflects the actual change while the change in size and trading liquidity reflects the relative change

¹ Based on market capitalization as of 12/31/2006 and 11/30/2018

² Trading liquidity reflects the median of the aggregate volume dollar value of the S&P 500 over the total S&P 500 market cap on a weekly basis as of 2018 YTD

Corporate finance decisions designed to maximize shareholder value need to take into consideration who those shareholders are and what they ultimately value. Understanding how a shifting investor base influences these decisions is of paramount importance to value creation.

In this report, we will:

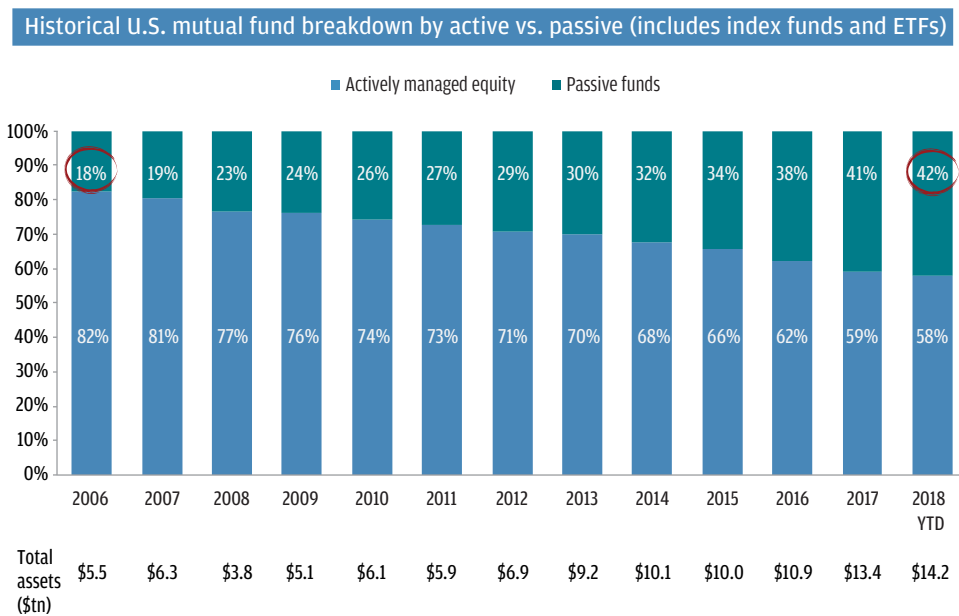
- Identify key themes in how investor bases have changed
- Analyze how the changes in shareholder bases have impacted investor behavior
- Discuss how corporate decision-makers should develop their financial policies, given the shareholder base backdrop

2. Passive gets aggressive: More than just active to passive

Passive investment strategies seek to track a predefined index, typically a market benchmark. To achieve this, passive portfolio managers hold securities proportionally with the benchmark. No buying or selling is required outside of changes to underlying index composition. Passive investment strategies have become increasingly popular in recent years, given their low cost and strong performance over the long term.

While passive investing has become more popular, capturing the precise magnitude of the trend toward passive investment is challenging. Many investors do clearly identify themselves as index-oriented. Based on an analysis of U.S. mutual funds and ETFs, 42% of assets or about \$6.0 trillion, is now allocated to passive fund strategies (see Figure 2). That’s up from just 18% in 2006.

Figure 2



Source: Simfund; as of Q3 2018

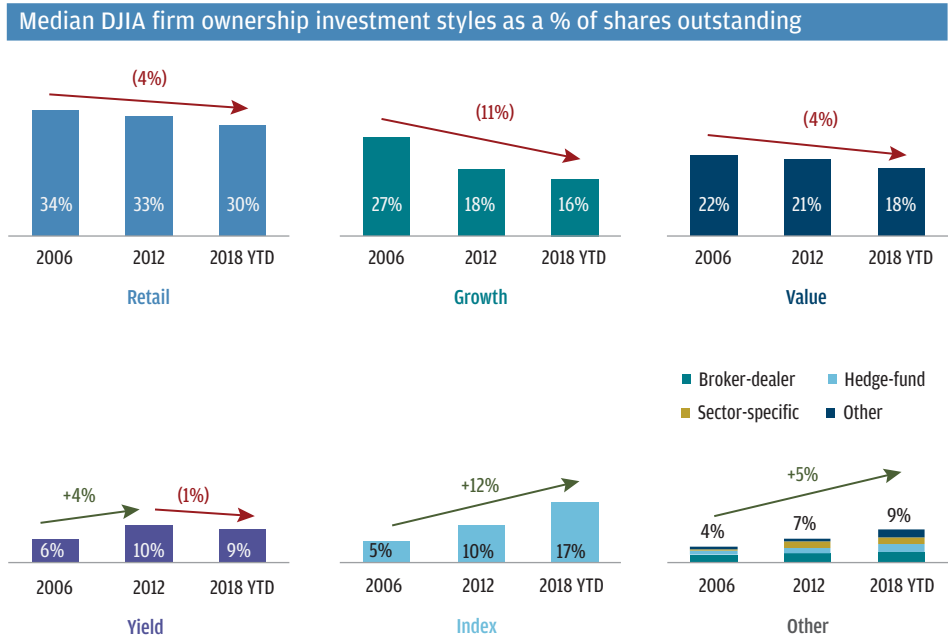
Note: Actively managed equity is defined as all mutual funds that are not following an index and all active ETF funds.

Passive funds are defined as all index funds and all passive ETF funds

These figures don’t fully reflect the index investment trends in the market. While only a portion of investors classify themselves as passive index investors, nearly all fund managers are evaluated on their performance relative to an index benchmark. The more an active manager deviates from the index constituents, the more relative performance risk they take on. In practice, many so-called “active” managers might be better described as “closet indexers”. Furthermore, entities like state pension funds have historically managed their internal funds predominantly based on index-based investment strategies, even though they would be unlikely to be classified as index investors. Both the trend in closet indexing and the index investment strategies of entities like state pensions plans suggest that the prevalence of passive investing is even more significant than implied by simply evaluating mutual fund and ETF data.

The shift between active and passive investor styles is not the only significant investor trend observed over the last decade. As demonstrated in Figure 3, the investor base for the typical Dow Jones Industrial Average (DJIA) firm is as much characterized by the decline in retail, growth and value shareholders as it is by the increase in passive index and other investor categories (sector specific, hedge funds, etc.).

Figure 3



Source: Eikon; as of Q3 2018

Note: Analysis conducted at fund level; growth includes aggressive growth, core growth, growth and growth at a reasonable price (GARP); value includes core value, deep value and income value

Each trend comes with a corresponding interpretation:

- Retail (down 4%):** Retail investors have increasingly held stocks via mutual funds and other institutional intermediaries, reducing the impact of retail investors on the overall market. While retail investors continue to maintain significant ownership in large-cap and household names such as in the DJIA, the typical S&P 500 firm sees institutional ownership above 80% as in Figure 1
- Growth (down 11%):** Despite an attractive financing environment, opportunities for organic and inorganic investments have been hard to find post financial crisis, especially for large firms. That has led investors to search for growth in smaller firms or specific industries (e.g., healthcare, information technology) with stronger top-line growth expectations. It's particularly noteworthy that growth investor interest has fallen, given the survivorship bias of the index: Firms like GM and HP (both with long-term earnings growth estimates of ~6% prior to their removal from the index) have been replaced by the likes of Nike and Visa (with long-term growth estimates of 14% and 19%, respectively), and yet the decline of growth investment is still pronounced
- Value (down 4%):** As valuations continued to climb across the market, flirting with historic peaks over the last couple of years, strategies to identify "undervalued" securities have proved more difficult and become more firm specific. Value-oriented strategies have also underperformed the broader market over these periods, potentially contributing to the trend of reduced ownership representation

- **Yield (up 3%):** In a low-rate environment, high-dividend paying stocks became more attractive as investors searched for yield. In 2012, the DJIA dividend yield was 2.8%, significantly higher than the 10-year U.S. Treasury that stood at 1.8%. The current rising rate environment and strong valuations have caused the trend to reverse, with 10-year UST surpassing the DJIA dividend yield in late 2017 for the first time since early 2015, likely contributing to the decline in yield investor interest
- **Index (up 12%):** The growth in passive index investor holdings at the DJIA constituent level has increased by more than 3x (from 5% to 17%) since 2006 and is now approximately in line with growth and value ownership. The DJIA passive investment trend exceeds the broader market trend, which increased by just more than 2x from 18% to 42% (as shown in Figure 2). This is further evidence that the market-wide data understates the magnitude of the shift toward passive investment strategies

With the significant changes that have occurred over the last decade (a global financial crisis, record-low interest rates, government stimulus), it's not surprising that significant shifts in investor bases have taken place. It is important to understand not only the drivers of those changes but also the potential implications for financial decision-making.

3. Drivers of the shift toward passive investing

Many factors have contributed to a shift in investor preferences from active investing to passive strategies:

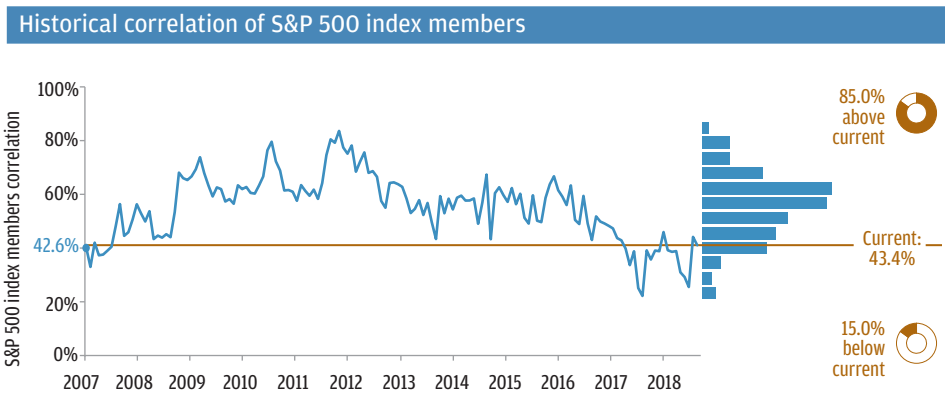
3.1. Poor performance of active strategies

Perhaps most importantly, active strategies have often underperformed the broader market, and by extension passive strategies. Even in the recent bull market, by one measure only 36% of active managers outperformed their passive peers over the 12 months ending in June 2018.¹ In 2017, only 43% of managers were able to outperform their passive peers. Numerous academic pieces support these findings over the longer term, as well.

3.2. Elevated correlations among firms reduce opportunities for active outperformance

For an active investor to make money, they must identify and seek outsized exposure to select securities that outperform the broader market. In the years following the financial crisis, however, correlation amongst firms remained high. This meant that the ability for active managers to outperform was limited simply because stock price performance across the entire market was so similar. Figure 4 illustrates how the stock price correlation between S&P 500 firms remained high from the financial crisis through most of 2016.

Figure 4



Sources: Factset, Bloomberg and Chicago Board Options Exchange. Market date is 11/30/2018

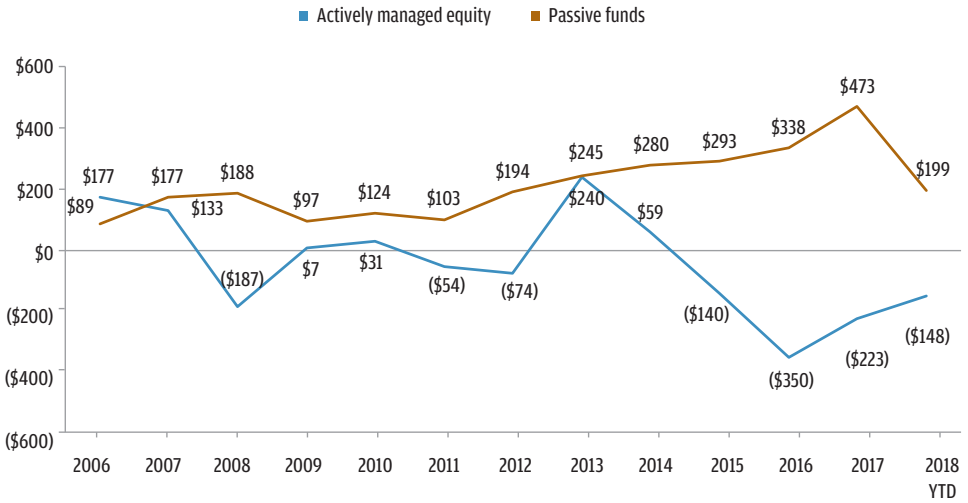
Note: Implied correlation based on "S&P 500 Index Members Correlation" published by Chicago Board Options Exchange (CBOE)

Notably, correlations in the market today are the lowest they have been in more than 85% of the time since 2007. There are a few interpretations of how this trend in correlations could impact the active/passive investing dynamic. While the trends toward passive investment are likely to continue, today's low market correlations offer active investors a unique opportunity to demonstrate relative outperformance. Net outflows from actively managed funds have slowed in 2018 and lower market correlations may be a driver of this trend (see Figure 5). Conversely, the increase in passive investing may be a contributing cause of higher correlations amongst firms in recent years. Because passive funds buy and sell shares ratably across the market, the resulting impact could be that firms across a given index experience magnified buying and selling pressure, thereby increasing correlations.

¹ Morningstar (<https://www.morningstar.com/blog/2018/08/23/actively-managed.html>)

Figure 5

Historical net flows to U.S. equity mutual funds (\$bn)



Source: Simfund; as of Q3 2018

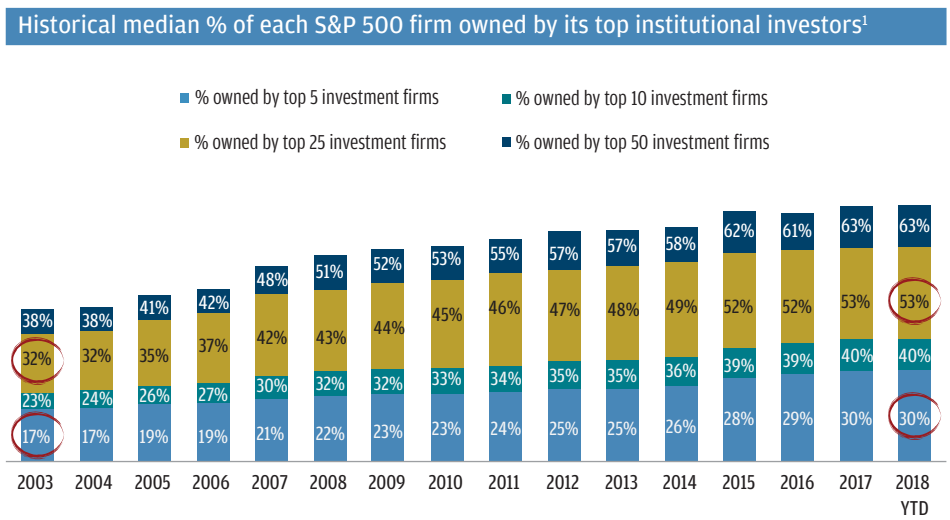
Note: Actively managed funds are defined as all mutual funds that are not following an index and all active ETF funds. Passive funds are defined as all index funds and all passive ETF funds

3.3. High fees for active management

Even for fund managers who are able to beat the performance of the benchmark index, their outperformance must justify the higher fees they charge investors. As passive fund managers have continued to reduce costs, the relative outperformance required for a competing active fund must be even higher to justify the additional expense.

The competition to be the lowest-cost investment platform has also encouraged the development of larger and larger fund managers, as firms compete for economies of scale. In 2017, 81% of all new investor dollars went to Vanguard or BlackRock.² The result is an increasingly concentrated shareholder base where the typical S&P 500 firm has more than half of its outstanding shares held by just 25 institutional investors (see Figure 6).

Figure 6



Source: Eikon; as of Q3 2018

Note: Percentages based on % of total shares outstanding held

¹ Analysis conducted at parent level

² Morningstar (<https://www.morningstar.com/blog/2018/03/12/fund-flows-charts.html>)

4. Implications of a changing investor base

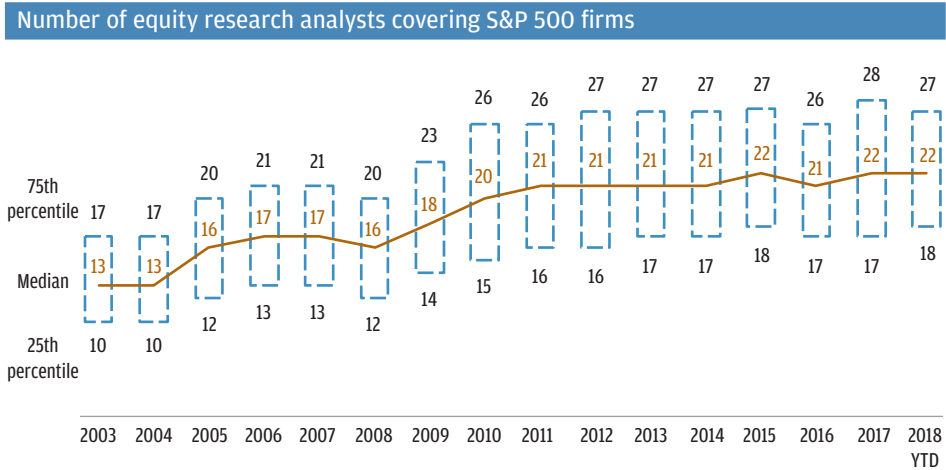
In evaluating shareholder base trends, we have observed that there continues to be a significant shift toward passive investing strategies despite lower correlations across the market (which should favor active investment strategies). At the same time, institutional ownership has become even more concentrated. Should these trends continue, there are likely to be increased implications for capital markets and issuers.

4.1. More passive investors mean fewer market participants “doing the work”

Passive investors by their nature have little interest in the idiosyncratic risks that would make one stock better than another. Rather, passive investors focus on trends likely to impact the broad portfolio. Passive investors are therefore “free-riding” on the work of active investors in seeking out security-specific information. A pickup in passive investors could result in a corresponding reduction of information embedded in share prices to the extent fewer market participants are doing the company-specific analysis.

So far, it does not seem like this potential consequence has manifested. To the extent the number of equity analysts publishing research on S&P 500 firms is an indication of the single-name evaluation taking place, there has not yet been a decline in such research. The level of equity research coverage for a typical S&P 500 firm is actually higher than it was 10 years ago (see Figure 7), and the same trend can be observed in the S&P 400 mid-cap index.

Figure 7



Sources: Bloomberg, FactSet; data as of 11/30/2018

While a significant change in research coverage has not yet materialized, to the extent the trend toward passive investment strategies continues, the benefits to brokers and other firms maintaining equity research coverage are likely to shrink. Coupled with changes in the regulatory environment (as seen in Europe with MiFID II) many issuers may find themselves with reduced analyst coverage and lower market visibility. This is probably especially true for firms at the lower end of the size spectrum.

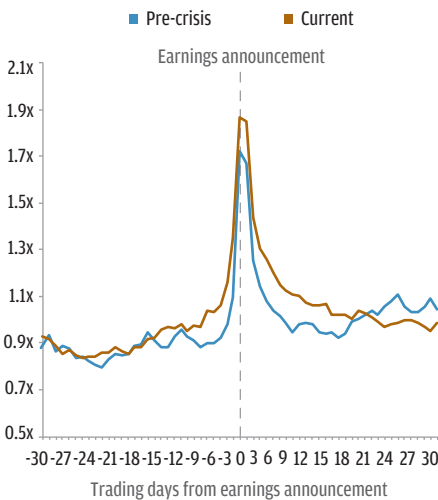
4.2. Reacting to what I say, not just what I do...

With an increasingly small group of active investors focused on understanding the specific nuances of a given firm, corporate communication and investor relations strategies become even more important. This is not only because of the potential reduction in investors spending the time and resources to understand a company's story, but also because of the increasing influence of automated trading strategies that rely on corporate events (such as earnings releases) to drive trading decisions. While these factors are difficult to precisely quantify, the effects are observable in the market.

Figure 8 illustrates the trading around earnings announcements pre-crisis and in today's market. The analysis shows that in today's market we see a bigger pickup in relative trading volumes around earnings announcements versus more than a decade ago. Similarly, the magnitude of the absolute price reaction to earnings announcements has increased relative to pre-crisis. This trend is likely partially driven by the increasing prevalence of automated investment strategies that trade off information disseminated on earnings calls.

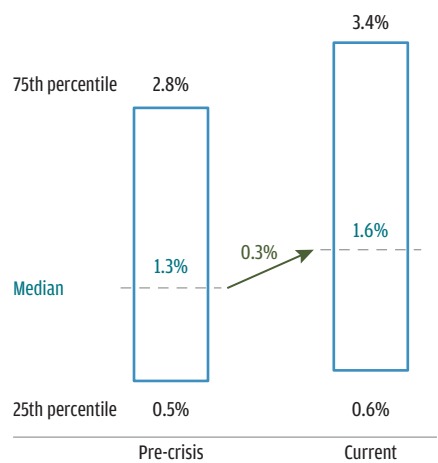
Figure 8

Median ADTV/equity float relative to unaffected ADTV/equity float for S&P 500 firms at earnings announcements



Source: Bloomberg
 Note: Unaffected average daily trading volume (ADTV)/equity float uses 6-month unaffected average daily trading volume ADTV relative to the unaffected date; pre-crisis defined as each firm's FYE 2006, current defined as FYE 2017

Historical S&P 500 absolute price reaction to earnings announcements

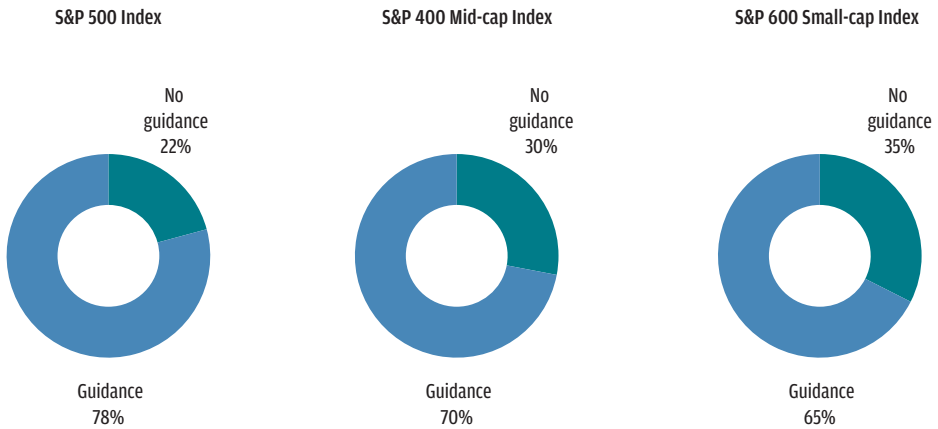


Source: Bloomberg
 Note: Data reflects S&P 500 firms in 2006 and Q3 2018 LTM; data reflects the absolute market reaction 1-day post-earnings for each year across all S&P 500 firms

From the perspective of public company management teams, this trend illustrates how important the earnings release process is—not just in what is reported but how information is communicated. When considered in conjunction with the possibility of a shrinking equity research universe, the decision of whether to provide guidance to the market should also be revisited. As shown in Figure 9, most large firms provide some form of guidance to the market. Smaller companies, however, do so less frequently. Small- and mid-cap management teams may be well-served to consider revisiting market guidance on an annual basis, particularly if research coverage is limited or otherwise lackluster in quality.

Figure 9

Percentage of firms providing guidance metrics in earnings calls¹



Source: Bloomberg; data pulled as of 11/30/18; guidance as of latest earnings report

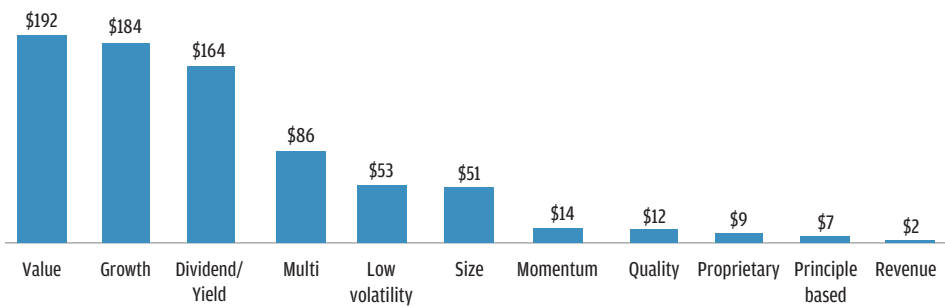
¹ Percentage of firms that provide guidance on any of the following metrics: Capex, EPS, sales, free cash flow, cash flow from operation and EBITDA

4.3. Learning from investor trends

It is tempting to view the “rise of the machines” in trading as an increasingly impersonal challenge for issuers trying to better understand shareholder objectives. In practice, the trends of investment flows into automated strategies may provide insight into more nuanced investor preferences.

Figure 10

2018 Smart beta ETF AUM by systematic strategy (\$bn)



Compound annual growth rate (CAGR) since 2012¹



Source: Bloomberg; data as of 11/30/2018

¹ Since 12/31/12

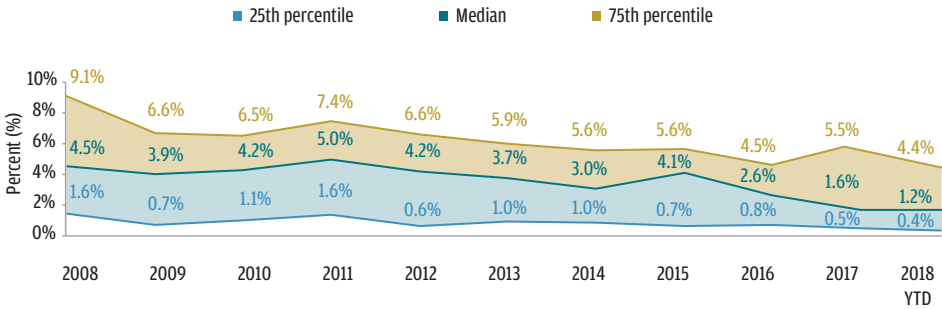
Figure 10 illustrates the current assets under management (AUM) for “smart beta” ETFs. These ETFs use automated strategies to define the underlying portfolio rather than a predefined index. While traditional strategies like value and growth still dominate, less-common strategies like low volatility have attracted significant funds. Low volatility strategies have also outperformed

the broader market, a surprising result for those who subscribe to efficient market theory. Whatever the underlying cause (many studies point to the influence of behavioral economics), the result should encourage firms to evaluate steps to reduce earnings and cash flow volatility. Strategies to lower volatility could include a reduction in financial leverage, de-risking of pension plans and hedging interest rate and FX risks.

4.4. Fewer active investors does not mean fewer activists

Even as the pool of active investors has continued to shrink, shareholder activists have arguably continued to see their influence increase. This rise in influence has been driven by a number of factors, including a persistently high level of assets under management and the increasing sophistication of activist campaigns.³ Perhaps most notable is that shareholder activists have been agitating for corporate change with smaller and smaller stakes (see Figure 11). Whereas 10 years ago the typical high profile activist would maintain a 4-5% stake, today that figure is closer to 1%.

Figure 11
SharkWatch50 activist positions as a percentage of target shares outstanding



Source: FactSet
 Note: SharkWatch50 represents a compilation of 50 significant activist investors, based on factors such as the number of publicly disclosed activist campaigns waged and the ability to effect changes at target companies

An activist can influence change with such a small stake only to the extent they have support from other investors. Traditional long-only investors have demonstrated support for activist campaigns over the past several years and the trend toward a more concentrated shareholder base makes the influence of a small number of large organizations all the more significant.

³ Additional information can be found in “The Activist Revolution” published by J.P. Morgan’s Corporate Finance Advisory and Mergers and Acquisitions teams

5. An action plan for a shifting shareholder base

The trends in shifting shareholder bases observed over the past decade are expected to continue. More capital is likely to flow into passive strategies. Asset managers are likely to get even larger and shareholder bases more concentrated as investors seek out the lowest cost alternatives. With this backdrop, public company management teams should continue to develop their financial policies with an eye toward continually evolving shareholder bases:

Refine investor communications

With fewer active investors and more programmatic trading driving stock performance, refining investor communication is crucial in terms of both what is said and how information is disseminated in public forums. For smaller firms where equity research may be limited, providing guidance may help educate and orient investors.

Learn from passive investor trends

Investor preference for low volatility is just one potential takeaway from recent trends in investor preferences. These trends can offer insights into how financial policy decisions can cater to investor demands.

Be informed about investor policies

Large asset managers continue to refine their policies and procedures around governance decisions. In some cases, policy guidance may be provided above the level of the portfolio manager, reducing the influence of direct interaction with some investors. Engaging with large investors is crucial—even if they maintain primarily passive stakes—to understand their policies.

Consider the impact of passive investors in strategic actions

Passive index investors may not participate in certain corporate actions (e.g., tender offers). When evaluating these actions, either for one's own firm or a potential transaction counterparty, one must consider the added execution risk of a significantly index-oriented shareholder base.

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