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## As more money flows into index funds and ETFs, what does that mean for the role of IROs?

BY DAVID TOBENKIN

**T**he rise of passive investing has some IR officers wondering where they fit into an evolving investor landscape increasingly dominated by index funds rather than active fund managers who care about frequent meetings with IROs to understand their companies' recent operational and financial details.

Playing devil's advocate, how exactly would an IRO respond, for example, if a C-suite executive pulled them aside and asked:

"Why do we need an IR team and why do you need to spend time meeting with the buy and sell side when much of our stock is held by passive funds?"

Senior NIRI members, after noting that they are not aware of any major companies who have actually made such a query, say the question reflects an inaccurate and incomplete view of how the IR function has expanded and evolved.

"Anybody asking the question has a narrow assessment, and probably an inaccurate one, of the role of investor relations," says Sally J. Curley, IRC, senior vice president, investor relations, at Cardinal Health, Inc. "IR is much more than organizing meetings for active investors. For example, in the 2005 *Flowserve* case, the SEC recognized the role of IR as the gatekeeper of a company's information."

"I'd say if anything the influence and reach of IR is greater than it has ever been before," says Valerie Haertel, IRC, global head of investor relations at BNY Mellon and the chair of the NIRI Board of Directors. "IR has become strategically integrated into the fabric of companies, helping

business leaders shape the strategic messaging for the firm.

“At BNY Mellon, IR is a part of the strategic planning process, working closely with our strategy team and business leaders to understand all the facets of our business, how we are performing and to think through how we are going to grow. For example, we provide competitive intelligence and analysis to our business leaders to understand our relative performance to industry peers, and to help drive awareness and improvement.

“As it relates to passive investors, we partner with our corporate secretary’s office to communicate our position on environmental, social, and governance issues, which are becoming increasingly important to all investors. Our partnerships both internally and externally help to ensure the relevancy, accuracy, and transparency of information we provide to the investment community. All of that will not go away with a change in the composition of our investor base.”

IROs say that the hypothetical question also overlooks that the rise of passive investing is enhancing, rather than diminishing, the role of IROs. The real question, they say, is how IR professionals can best adapt to the particular opportunities and challenges of passive investing to optimally perform the IR function and deliver value to their companies.

### **The Rise of Passive Investors**

There is no denying that passive investing is on the rise. According to a January 2017 UBS report, *Active vs Passive: How Will the World of Investing Evolve? (part 1 of 2)*, the share of equity fund assets allocated to ETFs and index funds has increased significantly, rising from 11 percent in 2000 to 43 percent in 2015.

And the trend appears poised to continue. In February 2017, Moody’s Investors Service released a report, *Asset Managers - Global: Passive Market Share to Overtake Active in the US No Later than 2024*, stating that the popularity of passive investments, including ETFs and index funds, will continue to outpace active investments and

achieve a leading share of the U.S. market by 2024, or sooner.

“We believe that the passive phenomena is more appropriately viewed as the adoption of a new technology,” Stephen Tu, Moody’s vice president and senior analyst, said in a written statement, which noted that passive investments currently account for \$6 trillion of assets globally and 28.5 percent of assets under management (AUM) in the U.S. “Investor adoption of passive and low-cost investment products will continue irrespective of market environments, and we estimate that passive investments will overtake active market share by sometime between 2021 and 2024.”

Passive investing vehicles include ETFs, index funds, quants, and smart beta funds, among others. Still, at many companies, there are plenty of active investors who remain and passive investors are often in the minority, says J.T. Farley, managing director of investor relations at Investment Technology Group, Inc. “Whatever the number of active investors is – even if it is less than half – these are crucial relationships to manage,” Farley says. “A healthy mix of long-term investors and shorter-term hedge funds is important for the liquidity of your stock.”

### **Passive Aggressive?**

A passive investing strategy does not mean that an investor will be reluctant to raise concerns about a company’s management, NIRI members say.

“To adapt to the needs of passive investors, it is helpful to understand the fundamental operational differences between active and passive funds,” says Theresa Molloy, vice president of corporate governance at Prudential Financial, Inc. “Active managers have the option of [completely] selling a stock in their portfolio if the manager believes that the stock is underperforming. But passive investors must own the stock as long as it remains in the index. As [Vanguard Principal and Fund Treasurer] Glenn Booraem stated in a recent *Wall Street Journal* article, ‘We’re riding in a car we can’t get out of.’

“Absence of liquidity as an exit strategy should not be confused with lack of interest about a port-



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folio company performance," Molloy observes. "To the contrary, passive investors leverage their proxy votes as a means to express support or dissatisfaction with management and as a way to protect their investment. Voting against CEO compensation plans, board members, or a proposed merger supports the passive manager's value priorities when engagement with a company falls short of their expectations. That is why it is critically important for companies to build strong relationships with passive investors."

Passive funds are increasingly willing to use their growing power to block takeovers, decide the fates of CEOs, and make other crucial decisions, noted the *Wall Street Journal* in an October 2016 report on the rise of passive investor activism. The story, *Meet the New Corporate Power Brokers: Passive Investors*, by Sarah Krouse, David Benoit, and Tom McGinty, noted that recent influential voting actions taken by passive shareholders included Vanguard Group's vote in May 2016 to block an investor effort to remove the CEO of Green Dot Corp.; a June 2016 vote by passive investor BlackRock Inc. against the executive pay plan at Mylan NV; and a 2015 BlackRock vote in favor of the \$18 billion merger between professional-service providers Towers Watson & Co. and Willis Group Holdings PLC.

### Governance Engagement

Still, it is not always easy to connect with, much less influence, passive investors, IROs say. Forming relationships with passive investors can take effort. "It took me awhile to get to the right portfolio manager at Vanguard," Curley says. "We talk and I send him information periodically, and he's thanked me for including him. A good market surveillance firm will have a list of portfolio managers, and failing that, the old-fashioned way still works – call the institution to obtain the manager's name."

Once the right person is found, it is key to establish a relationship before passive investors voice their concerns. "Before they have reason to weigh in, do an intro to the firm about important developments," Farley says. "Show them that you are thinking about corporate governance, the best

Given corporate governance and longer-term concerns of passive investors, there has been a blurring of the investment and corporate governance roles at passive investors that is being reflected and emulated at some companies, including efforts by both corporate governance officers and IROs to meet with passive investors together.

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global head of investor  
relations, BNY Mellon

interests of shareholders in operating the business, and establishing corporate governance rules."

Still, there are often limits to relationships with passive investors. "It's a much less deep relationship," Farley adds. "Corporate governance teams at passive investors look at thousands and thousands of positions. Active managers look after a couple dozen. So there's not as much of a relationship." The *Wall Street Journal* story reported that Vanguard has 15 people overseeing work on about 13,000 companies based around the world.

Working with passive investors also means anticipating and trying to understand their concerns. "Many companies are currently adopting or enhancing engagement strategies to meet the needs of large passive institutions," says Molloy. "At Prudential, an important component of our shareholder engagement strategy is to understand the distinct metrics passive managers use to evaluate their portfolio companies' governance structures. These guidelines are not 'one fits all' and each asset manager has a unique policy. For this reason, it is important to know the manager's voting guidelines and how it complements or diverges from your company's governance structure before meeting with the investor."

Still, Molloy says that at Prudential the basic approach for outreach to passive investors is the same as for active. "Even if J.P. Morgan is an active manager and State Street is passive, from the governance side, our approach is the same," Molloy explains. "Both managers are interested in our company's long-term goals and objectives, the organization's structure from the top down, how the board oversees the company's strategy and interacts with senior management, and how our governance policies are created and implemented."

Many IROs are adapting to the needs of passive investors and re-engineering their presentations to combine the company's financial results, the company's long-term strategy, and its governance practices.

"It is important that IROs actively engage with their [company's] corporate secretary's office to be a part of the governance conversations with passive investors throughout the year," Haertel



adds. “It enables a more holistic performance and governance conversation while strengthening and unifying the company’s messaging overall.”

### **Monitoring Passive Behavior**

Keeping tabs on which passive vehicles are holding a company’s stock, and why, will be an important part of the IRO function going forward, says Farley. This is because index or ETF inclusions and exclusions can create big trading swings and sizable impacts upon trading volumes in a particular stock. “These aren’t static factors – they can change a few times each year,” Farley says.

Looking under the hoods of different passive vehicles to understand their designs is important, Farley adds. “Smart beta index funds can use overlays on indexes, seeking to track the index but outperform it, such as having an S&P 500 fund but having stocks with consistent dividend growth weighted more heavily than the shares of the others in the index,” Farley says. “Understanding that could help you understand that growing or cutting dividends could make you overweighted or underweighted and affect stock price. You also have to understand how ETFs are built and that what they include can have an impact on the stock.”

### **The Future of the Profession**

As noted, the rise of passive investing appears poised to continue and leading IROs say it will likely affect aspects of the IR profession. “While the shift toward passive does not in any way render IR obsolete, it could change the roles of some small-cap IROs, giving rise to more “IR-plus” positions, such as IR and Corporate Communications or IR and Corporate Development (M&A), IR and


Treasury, or others,” Farley says.

Given corporate governance and longer-term concerns of passive investors, there has been a blurring of the investment and corporate governance roles at passive investors that is being reflected and emulated at some companies, including efforts by both corporate governance officers and IROs to meet with passive investors together, Haertel says.

On the other hand, some IRO duties are unlikely to change. Curley notes that there is another reason C-suite executives will want to keep investor relations personnel around in a passive investor-dominated world: to keep their companies and themselves out of legal and regulatory trouble.

In 2005, the Securities and Exchange Commission (SEC) settled an enforcement action against Flowserve Corp. based upon violations of Regulation Fair Disclosure and Section 13(a) of the Securities and Exchange Act of 1934, based upon improper selective disclosure of material, non-public information.

“The SEC release on the settlement made clear that the IRO had the authority and obligation to interrupt the C-suite executive to prevent a misstatement and/or sharing of non-public information,” Curley says. “It made clear that the IRO role is much more than just maintaining relationships with active investors. The fundamental disclosure component of the IR function sometimes goes unrecognized.”

She adds that the role of IR as the conduit of key information to the C-suite is also underappreciated, noting, “The typical IR department manages relationships with the sell-side, investors, the stock exchanges, and, increasingly, governance outreach. We often hear information from so many different channels that IR alone can piece together the mosaic, in a way that the other company departments cannot.” 

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**DAVID TOBENKIN** is a freelance writer in the Washington, D.C., area. For more on the governance concerns of passive investors, please visit the NIRI Corporate Governance Resource Library online at [www.niri.org/resources/resource-libraries](http://www.niri.org/resources/resource-libraries).