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"INDEX FUNDS AND CORPORATE GOVERNANCE: DO PASSIVE INVESTORS EXERCISE THE POWER THEY HOLD?"

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ABSTRACT

Questa tesi analizza se i fondi di investimento passivi, divenuti negli ultimi due decenni i maggiori azionisti delle società quotate americane, esercitano effettivamente il potere di governance che appartiene loro data la posizione proprietaria. Il lavoro parte da un paradosso strutturale, in quanto non potendo vendere le proprie quote senza compromettere la replica dell'indice di riferimento, questi fondi dovrebbero avere un incentivo naturale a monitorare con attenzione le società partecipate; eppure, il modello di business che li rende così economici per i risparmiatori, basato su commissioni estremamente basse, sembra al contempo limitarne la capacità di esercitare una sorveglianza realmente efficace.

Attraverso la revisione di alcuni contributi accademici chiave, la tesi ricostruisce un dibattito empirico in cui la medesima metodologia di ricerca conduce a risultati opposti a seconda di quali aspetti della governance vengano messi sotto esame. L'analisi prosegue con una lettura diretta del Report Annuale di Stewardship 2025 di BlackRock, che permette di verificare se le evidenze accademiche trovino conferma nei dati resi pubblici da uno dei principali attori del settore.

I risultati suggeriscono una risposta articolata ma dal segno chiaro, ovvero che i fondi passivi sono in grado di promuovere forme di governance standardizzate e a basso costo, come il sostegno all'indipendenza dei consigli di amministrazione, ma faticano a garantire il monitoraggio continuativo e specifico che le decisioni più rilevanti richiederebbero. L'elaborato si chiude riflettendo su cosa questo significhi concretamente per i milioni di risparmiatori ordinari la cui pensione dipende, spesso a loro insaputa, dalla qualità con cui queste società vengono effettivamente governate.

SUMMARY

INTRODUCTION

Every time a worker in the United States makes a contribution to their retirement plan, a small fraction of their savings flows, almost automatically, into a passive index fund, where it is pooled with billions of dollars of other people's money and invested across hundreds of companies at once. Most of those people have never heard the names BlackRock, Vanguard, or State Street, and yet those three firms, as a direct consequence of that daily and unremarkable act of saving, have come to hold combined stakes averaging 20% in virtually every major American listed company (Bebchuk and Hirst, 2019b), which makes them collectively the most powerful shareholders in modern capitalism.

This work starts from a simple but unsettling observation, namely that owning a share in a company means, at least in theory, having the right and the responsibility to monitor its management, to vote on strategic decisions, and to hold executives accountable when their choices destroy value rather than create it, and yet the very structure of passive investing, which is precisely what makes it so cheap and so attractive to ordinary savers, also creates a set of economic incentives that may work systematically against the exercise of those very rights. A passive fund cannot sell the shares of a company it disagrees with, because the moment it does it ceases to replicate its benchmark and the whole architecture of its business model begins to unravel, which makes it, in a sense, the ideal long-term shareholder, permanently tied to the fortunes of its portfolio companies, but it also means that the only tool left to influence management is voice, and voice requires time, analytical resources, and genuine engagement, which are exactly the inputs that the fee structure of passive investing makes structurally scarce.

The question this paper asks is therefore not whether passive funds should care about governance, since the theoretical answer is clearly yes, but whether the structural conditions of their business model allow them to do so in a way that is truly effective, and what the empirical evidence, combined with a direct reading of one of their own public documents, reveals about the distance between the governance they claim to exercise and the governance they actually provide; this question ultimately matters not only for financial economists but also for the millions of ordinary savers whose retirement security depends on whether the companies they indirectly own are governed well or not.

Section 1: THE RISE OF PASSIVE INVESTING

In 2023, for the first time in history, the total assets managed by passive funds surpassed those managed by active funds in the United States, crossing the $13 trillion mark (Morningstar, 2024), completing a remarkable structural transformation in barely two decades. To understand why this shift matters far beyond the world of finance, it is necessary to start from a fundamental distinction between the two main types of investment funds, namely active funds and passive funds, since only by understanding this structural difference is it possible to fully appreciate the peculiar nature of the incentives that characterize the latter and that make them a different kind of shareholder compared to any other institutional investor.

Active funds are managed by analysts and portfolio managers who select individual securities based on their own assessments of companies' future prospects, with the stated goal of outperforming their benchmark, and for this reason they charge relatively high management fees; on the other hand, passive funds simply replicate the composition of a market index (such as the S&P 500 or the Russell 3000) by purchasing its constituent securities in the same proportions in which they appear in the index, without any discretionary selection, and, precisely for this reason, they are able to offer their investors extremely low fees, often below 0.10% of assets under management.

The explosive growth of passive funds over the past two decades is the result of a combination of structural factors, including the growing concern among investors that the vast majority of active funds fail to outperform their benchmark on a net-of-fees basis, the regulatory reforms that have encouraged retirement savings and channelled them towards diversified, low-cost investment vehicles, and finally the rise of ETFs as a liquid and tax-efficient investment instrument. These forces have produced an enormous shift of capital, so much so that between 2009 and 2018 passive funds attracted over $3.4 trillion in net new flows, compared to less than $200 billion directed towards active funds in the same period (Bebchuk and Hirst, 2019a).

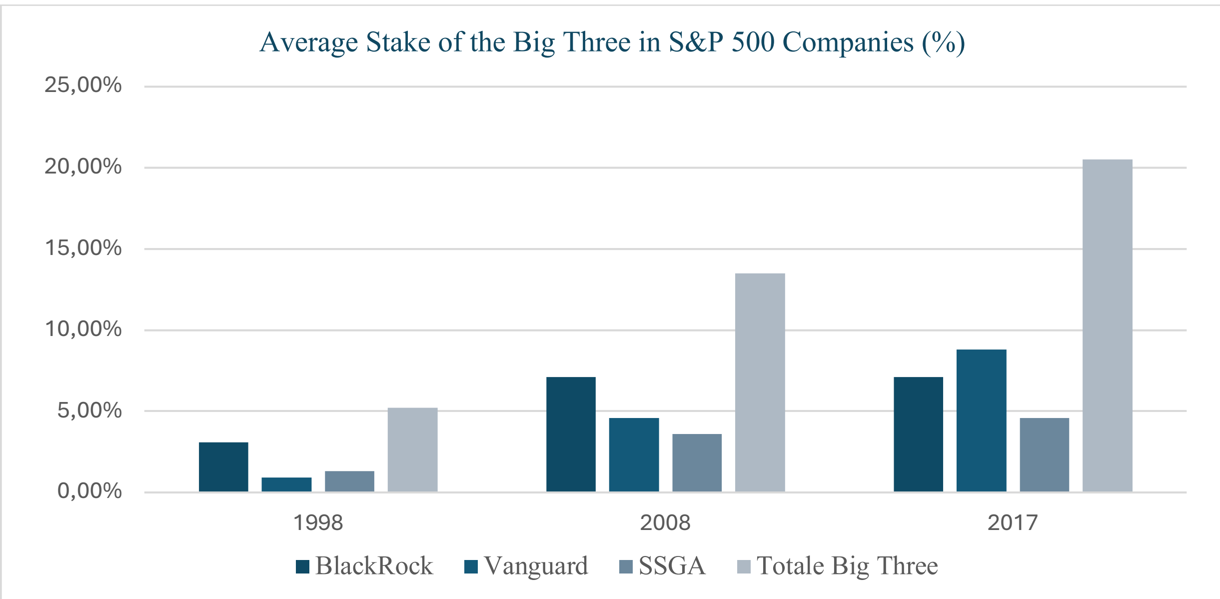
At this point it's necessary to introduce the central concept that defines passive funds as shareholders, meaning their nature as locked-in owners of their portfolio companies; since a passive fund must replicate an index and cannot freely sell the shares of the companies included in it, as long as a company remains part of the reference index the fund is forced to hold its shares regardless of the company's operational performance or management decisions; consequently, while an active fund that views a company's management negatively can simply sell its stake, exercising what the literature refers to as the Wall Street walk, the most powerful weapon an investor has to signal dissatisfaction with management, a passive fund does not have this option and remains structurally tied to the company's long-term performance. From this characteristic derives a theoretical implication that represents the starting point of the entire debate developed in this paper, essentially that passive funds would have, at least in theory, a natural incentive to care about the long-term strategic health of their portfolio companies, since they cannot simply exit a position that turns out to be problematic.

The aggregate growth of passive funds has also resulted in a remarkable concentration of the industry in the hands of just three players, specifically BlackRock, Vanguard, and State Street Global Advisors, which academic literature has come to collectively refer to as the Big Three and which today dominate the index investment market, thanks to economies of scale, the liquidity advantages of their large ETFs, and the ability to quickly imitate competitors' products. The combined stake held by the Big Three in S&P 500 companies has almost quadrupled over the past two decades, rising from 5.2% in 1998 to 20.5% in 2017, and, more importantly, since the Big Three systematically vote all of their shares while many other shareholders do not, their effective weight in shareholder meetings is even greater than their ownership stake, reaching on average 25% of votes cast (Bebchuk and Hirst, 2019b).

Table 1. Average combined stake of the Big Three in S&P 500 companies, 1998-2017; source: Bebchuk and Hirst (2019b).

Years	BlackRock	Vanguard	SSGA	Total Big Three
1998	3.1%	0.9%	1.3%	5.2%
2008	7.1%	4.6%	3.6%	13.5%
2017	7.1%	8.8%	4.6%	20.5%

Figure 1. Average combined stake of the Big Three in S&P 500 companies, 1998-2017; own elaboration based on data from Bebchuk and Hirst (2019b).



Section 2: TWO COMPETING VIEWS ON PASSIVE FUND GOVERNANCE

In January 2018, Larry Fink, CEO and co-founder of BlackRock, the world's largest asset manager with over $6 trillion under management, wrote an open letter to the CEOs of the major listed American companies, declaring that BlackRock would, from that point on, vote against the management of those companies that didn't show a clear long-term orientation and a sustainable strategy, adding that to prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society (BlackRock, 2018). The letter caused quite a stir, and many interpreted it as definitive proof that large passive funds had become the new guardians of American corporate governance, namely the ideal shareholders who would finally keep short-term oriented managers under control; but is that really the case? Academic literature, as we'll see, tells a much more complicated and contradictory story.

To understand where the problem comes from, it's useful to start from a distinction that is often overlooked, as the people who make governance decisions in passive funds are not the savers who have invested their money, but the fund managers themselves, and their interests do not necessarily align with those of their clients. This is exactly the problem that Bebchuk and Hirst (2019a) define as the agency costs of index funds, building a theoretical framework that has become the most influential analytical reference on the topic. The central idea is clear: Big Three managers are paid with very low fees, often below 0.10% per year of assets under management, and this means that for every billion dollars invested the fund earns around one million dollars a year, a figure that sounds large, but has to cover all the operating costs of an organization that manages stakes in thousands of different companies. In this context, seriously investing in the monitoring of each individual portfolio company (hiring analysts, attending shareholder meetings, engaging management on strategy) is too expensive relative to the benefits that the fund is able to capture, and this creates a structural incentive to do the bare minimum in terms of stewardship. On top of this comes a second problem, even more subtle, since the Big Three often manage the corporate pension funds of many of the same companies whose shares they hold, and an overly critical attitude towards the management of one of these companies would put at risk that business relationship, creating a conflict of interest that systematically pushes towards voting in favour of management positions. The empirical data from Bebchuk and Hirst (2019a) is striking, as in 2019 the Big Three had no direct contact with around 90% of their portfolio firms, and spent on average less than $4,500 per year on stewardship for every billion dollars invested, a figure that makes it hard to imagine truly effective monitoring.

This theoretical framework, however, is not without its critics, and this is where the debate becomes really interesting, since Appel et al. (2016) published a paper that was destined to become a classic in the literature, in which they ask the same fundamental question but with a particularly sophisticated methodological approach that is worth explaining because it's elegant in its simplicity. The challenge for anyone studying the effect of passive funds on governance is that the two things tend to move together for independent reasons, given that companies with good governance attract more institutional investors, and institutional investors improve governance, making it difficult to understand which one causes the other. To solve this problem, the authors take advantage of a peculiar feature of the Russell 1000 and Russell 2000 indexes, to which companies are assigned each year, based on their market capitalization, whereby companies that sit right at the boundary between the two indexes, being practically identical in size, end up having very different levels of passive ownership depending on which index they are assigned to, with those in the Russell 2000 receiving a share of passive funds on average 66% higher than those in the Russell 1000; this variation in passive ownership thus becomes a kind of natural experiment, and it allows measuring the effect of passive funds on governance, eliminating the problem of reverse causality. The results are surprising for anyone who expected passive and inactive shareholders, and show that greater passive ownership leads to boards with more independent directors, the removal of anti-takeover defences, and fairer voting structures, with improvements in long-term operating performance measured through ROA, painting a picture in which passive funds are anything but passive bystanders when it comes to the governance of their portfolio companies.

How is it possible that the same phenomenon produces such opposite conclusions? The answer comes from Schmidt and Fahlenbrach (2017), who use exactly the same methodology as Appel et al., but look at different dimensions of governance, and the distinction they propose is very telling, since passive funds seem able to positively influence low-cost governance activities by using standardised voting on a few predefined topics as a tool in shareholder meetings, but they do not have the resources or the incentives for the kind of monitoring that the most important strategic decisions require. As the table above sets out, they find that greater passive ownership goes hand in hand with stronger CEO power and worse outcomes on the decisions that matter most, as if investors were already pricing in the fact that the few new directors are not truly independent from a CEO left with more room to manoeuvre. The picture that emerges from comparing the two papers is therefore one of passive funds that are capable of promoting some surface-level good governance practices, but unable to exert the deep and continuous pressure that would be needed to truly keep management in check on the decisions that matter most, and this is the paradox at the heart of this paper: the locked-in owners have the right incentives, at least in theory, but the structure of their operating costs and their conflicts of interest transforms those theoretical incentives into something much weaker in practice.

To see how the two papers can reach such different conclusions from the same kind of method, it is useful to place their main features side by side, since what each chooses to measure proves as revealing as their results.

Table 2. Comparative overview of the two key empirical studies; own elaboration based on Appel et al. (2016) and Schmidt and Fahlenbrach (2017).

	Appel et al. (2016)	**Schmidt & Fahlenbrach (2017)**
Sample period	1998 - 2006	1998 - 2010
Sample & data	~ 1,600 large U.S. firms; focus on the ~ 500 straddling the Russell 1000/2000 boundary, near-identical in size.	Firms that switched between Russell 1000 and 2000 (2,803 switches), each compared with itself before and after.
Research Question	Does passive ownership improve corporate governance structures and long-term firm performance?	Does passive ownership affect the quality of CEO oversight and strategic decision-making?
How causality is established	Near-identical firms get very different passive ownership purely from which index they fall into: a natural experiment.	Same logic, but only for firms that switched index, so each is its own before-and-after control.
What is measured	Independent directors; removal of anti-takeover defenses; shareholder meeting rights; voting on proposals; profitability.	CEO also chairman (concentrated power); quality of new directors; market reaction to appointments; M&A returns.
Main findings	More passive ownership: more independent boards (+ 0.65 to 0.76 standard deviations), more anti-takeover defenses removed (+ 3.5 percentage points), better long-term profitability.	More passive ownership: CEO likelier to also chair (+ 1.7 to 2.2 percentage points), negative market reaction to new "independent" directors (- 51 to - 69 basis points), worse M&A returns.
Overall conclusion	Strengthens formal, low-cost governance and improves long-term performance.	Entrenches the CEO and weakens deep, ongoing monitoring, destroying shareholder value.

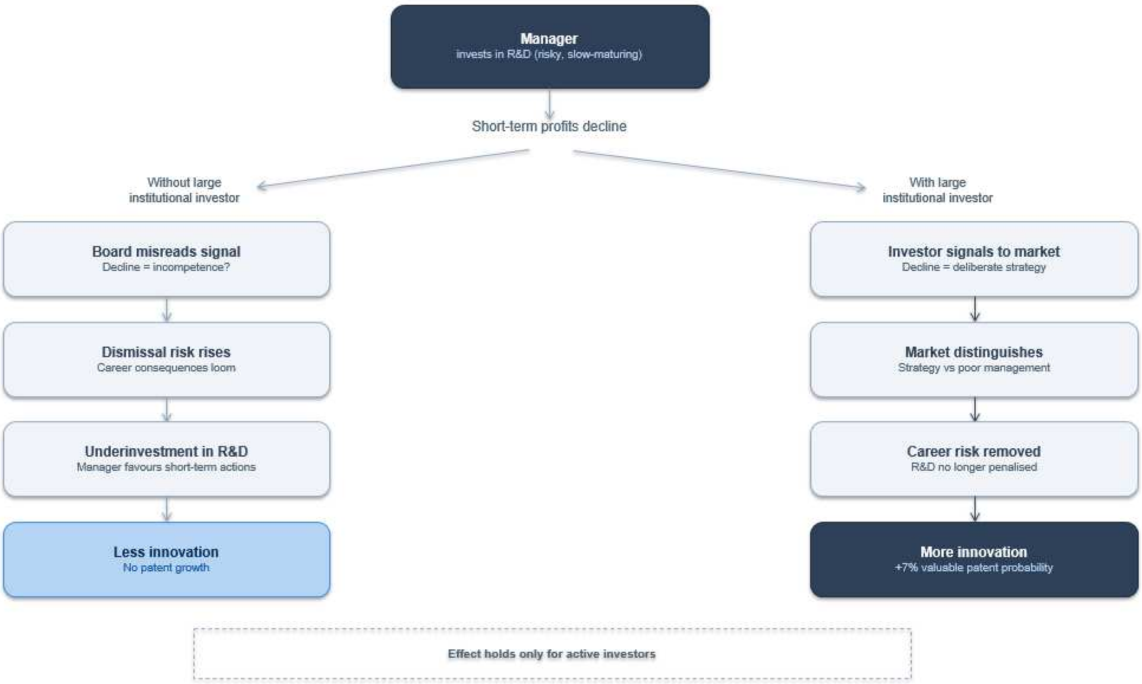
Section 3: INNOVATION AS A LITMUS TEST

The debate previously analysed, between passive funds as effective stewards or as structurally poorly equipped monitors, risks remaining abstract unless it's confronted with a concrete and measurable outcome; innovation represents the ideal test to understand whether large shareholders genuinely support long-term value creation or merely claim to do so, since investment in R&D is by its very nature long-term, risky, and easily sacrificed under the pressure of short-term results.

The foundational paper on this question is that of Aghion, Van Reenen and Zingales (2013), who built a panel dataset of over 800 large publicly listed American firms during the 1990s and asked a deceptively simple question: does institutional ownership make firms more or less innovative? Rather than relying on R&D expenditures, which measure inputs but not quality, the authors used the number of patents granted to a firm, weighted by how often each patent is later cited, a measure widely considered the best approximation of an innovation's economic value. The results are surprisingly clear, since every time the share held by institutional investors grows by ten percentage points, moving for example from 40% to 50%, the probability of generating an additional valuable patent increases by 7%, an effect that's even more significant when one considers that this ten-percentage-point increase corresponds exactly to what happened on average across the firms in the sample over the decade studied.

What makes the paper notable, however, is not only the result itself but also the way in which it's explained, through a mechanism that the authors call the career concerns model, which starts from the simple premise that innovation is risky, and a manager who invests in a slow-maturing R&D project faces a real probability of being dismissed before those results materialise; the board of directors could in fact interpret the absence of short-term profits as evidence of incompetence rather than as the inevitable cost of a long-term strategy, and therefore the rational response of a risk averse manager is to underinvest in innovation, favouring instead actions that produce visible results quickly. In the presence of a large institutional investor that monitors the firm independently, however, the market is able to distinguish a temporary profit decline caused by a deliberate strategic choice from one caused by poor management (thanks precisely to the effectiveness of communication with the public made by the large investor), thereby protecting the manager from the career consequences associated with innovation and removing the main disincentive to long-term investment. This prediction is empirically confirmed by the authors, who show that CEOs are significantly less likely to be dismissed following a profit decline when institutional ownership is high.

Figure 2. The career concerns mechanism in innovation decisions; own elaboration of the mechanism described in Aghion, Van Reenen and Zingales (2013).



The paper introduces a fundamental distinction, however, since not all types of institutional investors produce the same effect. Distinguishing data based on owner type, the authors showed that the positive effect belongs exclusively to active investors, while quasi-indexed funds (the category most similar to today's large passive funds) have no measurable impact on the innovation of their portfolio firms, since a fund that holds tiny stakes in thousands of companies has neither the capacity nor the incentive to monitor them seriously, and therefore does not represent a real source of pressure for management. This result overlaps perfectly with the criticism of Bebchuk and Hirst (2019a) examined in the previous chapter and suggests that the problem with passive funds is not a matter of intentions, but of structure.

Section 4: PUTTING THEORY TO THE TEST THROUGH BLACKROCK'S STEWARDSHIP ANALYSIS

The best way to ground the theoretical debate addressed in the previous chapters into practice is to look closely at how one of the main actors describes itself, and the BlackRock Investment Stewardship Annual Report 2025 (BlackRock, 2025) offers exactly this opportunity. It's indeed a public document in which BlackRock accountably reports its stewardship activities over an entire year, with a level of detail sufficient to allow a critical evaluation, and which makes it possible to wonder whether the statements of Larry Fink (CEO and co-founder of BlackRock), who in 2018 promised an active and responsible ownership, truly find confirmation in the actual numbers.

The first striking data point concerns the dedicated resources, as the BIS team, responsible for stewardship for indexed strategies, currently counts more than 60 professionals distributed across 9 global offices, a figure the report proudly contrasts with the 16 people of 2009, undoubtedly a sign of growing commitment; however, the report does not provide the precise number of companies covered by indexed strategies, and knowing that in 2025 BlackRock voted altogether in 12,389 companies, the ratio between analysts and investee companies remains nevertheless very high. Those numbers make it difficult to imagine a truly complete monitoring for each company, especially considering that a non negligible part of those 60 professionals handles operational functions, communication, and reporting rather than actual analysis.

The data on engagements confirms this same impression, highlighting that in 2025 BIS conducted 2,373 engagements with 1,811 distinct companies, a number that sounds remarkable in absolute terms but which, compared to the overall universe of investee companies, proves to be rather limited, leaving the vast majority of firms without any direct contact with their large shareholder. And this happens even six years after Bebchuk and Hirst (2019a) denounced the very same problem, that in 2019 the Big Three had no contact with about 90% of their investee companies, suggesting that the progress, while real, has not resolved the structural tension at the heart of the matter, but has merely reduced it in part.

On the voting front, the report reveals that BlackRock approved management in 88% of cases out of a total of 154,644 proposals, and that out of the mere 807 proposals submitted by shareholders (less than 1% of the total) it supported just 92, meaning about 11%, and that even when ISS, the leading proxy advisory firm, recommended voting against management on shareholder proposals, BlackRock nonetheless voted in favor of management in 77% of those cases, exercising an independent judgment that systematically aligns in the same direction. One would spontaneously wonder whether this systematic nature reflects an independent case-by-case evaluation, or if it's the symptom of those distorted incentives that Bebchuk and Hirst (2019a) describe with such precision? The honest answer, at least for the writer, is that we don't know for certain, and it probably contains a bit of both things.

And yet it would be dishonest to ignore the cases that point the other way, the most striking being the 2021 proxy battle at ExxonMobil, when a tiny activist fund, Engine No. 1, holding barely 0.02% of the shares, elected three of its candidates to the board against the opposition of management (Ball et al., 2021), and it succeeded only because the Big Three, who together held around 20% of the capital, chose to back them, with BlackRock itself voting against management. This seems to refute everything argued so far, and yet it confirms it, since it was a single vote on a highly visible, symbolic issue such as climate, cast through exactly the standardised, low-cost channel that, as Schmidt and Fahlenbrach show, passive funds can use well, and not the deep, continuous monitoring of everyday decisions that the agency cost framework predicts they will fail to provide, so that the case shows with unusual clarity where their power begins and where it ends.

Another element that deserves attention is BlackRock's deliberate choice not to participate in any form of collaborative engagement with other institutional investors in 2025, a decision the report records without particular emphasis, almost as a choice of principle rather than a limitation, but with significant implications. Indeed, renouncing the coordination of one's action with other large shareholders means voluntarily giving up a leverage that could significantly amplify one's bargaining power over the management; therefore, one may wonder whether this choice truly reflects a preference for independence of judgment, as the report suggests, or rather a caution dictated by the conflicts of interest that Bebchuk and Hirst (2019a) describe with such clarity.

At this point, it's useful to introduce a reflection that might seem counterintuitive but that I find convincing. The fact that stewardship decisions are made by funds rather than individual savers is not necessarily a problem, since savers rely on funds expressly to delegate portfolio management and decisions to them, recognizing their expertise. This is because, fortunately, the world is not made only of economists, which means that most people reasonably prefer to focus on their own work and entrust these decisions to those who deal with them professionally, making the delegation not only understandable but also functional, provided, however, that those who receive that delegation truly exercise it with rigor and independence. It is telling, in this respect, that BlackRock itself seems to have sensed the delicacy of this delegation, since in 2022 it launched Voting Choice, a programme through which a growing share of its clients can now choose how the shares held on their behalf are voted, selecting among external voting policies instead of leaving every decision to the fund, with several trillion dollars of assets eligible by 2025; and one may read this in two ways, either as a sincere attempt to return a fragment of ownership power to the savers it ultimately comes from, or as a convenient way of diluting a responsibility, and the conflicts of interest attached to it, that had become uncomfortable to bear alone.

And it's precisely here that the unresolved knot lies: BlackRock's report shows an organization that has genuinely invested in its stewardship function, which has nearly quadrupled the size of its team in fifteen years, which produces transparent and detailed documentation, and which has significantly expanded its capabilities over the years, but it also shows an organization that, for structural reasons that are difficult to eliminate without disrupting the business model of index funds, still fails to exercise with full effectiveness the enormous power it holds. The progress is there, it's documented, and it would be wrong to ignore it, but the distance between statements of principle (such as Fink's in 2018) and operational reality remains visible, and perhaps the most honest question is not whether BlackRock does enough, but whether the system of incentives in which it operates ever allows it to truly do so.

CONCLUSION

This paper set out to ask whether passive funds exercise the governance power they hold in a way that is proportionate to the enormous ownership position they have come to occupy, and the answer that emerges is mixed, but not ambiguous. Passive funds are not the merely indifferent, absent shareholders they are sometimes accused of being, since they vote their shares systematically, engage with at least some companies, back selected reforms, and in rare and visible cases such as ExxonMobil they can even tip the balance of a board election.

And yet the same evidence shows just as clearly where that power stops, because the whole model of passive investing rests on broad diversification, index replication, and fees so low that no fund could realistically monitor thousands of companies with the depth that genuine oversight demands, which is what makes these funds so cheap and so valuable to ordinary savers in the first place. The result is a kind of governance that works well where it can be standardised and inexpensive, such as supporting board independence or backing voting reforms, but almost completely breaks down when continuous, firm-specific attention is needed, from CEO oversight to strategy and innovation. BlackRock's own stewardship report confirms this rather than contradicting it, showing real progress and real transparency alongside a visible distance between the power the firm holds and the intensity with which it actually uses it. After all, these are profit-driven firms whose goal is to maximise their own returns, and keeping fees low is the very strategy through which they attract the enormous volumes of capital that make those returns possible, so deep monitoring is not something they are structurally built to prioritise.

It is worth remembering, in the end, who sits at the other side of all this, because the worker from the opening page never chose to become the part-owner of hundreds of companies, and likely never knows that he is, and yet the quality of his retirement depends, in a small and invisible way, on whether the funds holding his savings watch those companies well. The honest answer this paper can give him is that his shares are not unwatched, but not truly watched either, held by owners who have every reason to care and never quite enough reason to act on it, and that gap, between a power that keeps growing and a stewardship that struggles to keep pace, is the real paradox of passive investing.

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