How the Votes of Big Index Funds Feed CEO Greed and Put Americans’ Retirement Savings in Peril
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By David Winters and Liz Cohernour, Wintergreen Advisers

The rush of money into index equity funds has officially ballooned into a market mania. Trillions of ordinary investors’ dollars are now committed to a mechanistic strategy that day in and day out simply buys stocks without a thought for their actual underlying value. Since the S&P 500 is market capitalization weighted, it suffers from the flaw of being driven by momentum. Rising markets cause more money to flow into the biggest companies, which drives their prices higher, which triggers more buying by passive index funds, in a seemingly virtuous cycle.

For the year ended 2014, it has been estimated that passive U.S. equity funds gathered $167 billion in assets, ending the year with about $2.2 trillion in AUM. Supported by huge advertising and PR budgets, index giants Vanguard, BlackRock and State Street garnered much of this new money and account for the lion’s share of assets indexed to the S&P 500. All told, these three giants control more than $8 trillion of assets, much of it in passive investment strategies.

Students of market history know that index mania – like other market fads before it – will not end well. But investors continue to pour dollars into index funds in the gravely mistaken belief they’re enjoying a virtually “free lunch.”

The sad reality is that index funds have turned ordinary investors into the pawns in a game that undermines the integrity of American markets and imposes costs on society that don’t show up in index fund expense ratios. We believe that one consequence of this is that billions of dollars of value created by American companies are being diverted to a select few executives while ordinary investors, distracted by “low fee” hype, are subjected to dangerous risk concentrations in their retirement portfolios.

1 Based on Morningstar estimates
Here’s an unfortunate consequence of Big Index:

- The massive assets of Big Index – Vanguard, BlackRock and State Street – make them the largest block of shareholders in America’s largest publicly traded companies. Wintergreen’s analysis shows that Big Index holds an average of 16% of the shares outstanding of the top 25 companies in the S&P 500.

Figure 1

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ownership %</th>
<th>Company Name</th>
<th>Ownership %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple Inc</td>
<td>15.48%</td>
<td>Home Depot Inc</td>
<td>16.62%</td>
</tr>
<tr>
<td>AT&amp;T Inc</td>
<td>15.45%</td>
<td>Intel Corporation</td>
<td>16.17%</td>
</tr>
<tr>
<td>Bank of America Corp</td>
<td>15.29%</td>
<td>IBM Corp</td>
<td>16.28%</td>
</tr>
<tr>
<td>Berkshire Hathaway Inc Cl B</td>
<td>20.99%</td>
<td>Johnson &amp; Johnson</td>
<td>17.55%</td>
</tr>
<tr>
<td>Chevron Corp</td>
<td>17.90%</td>
<td>JPMorgan Chase &amp; Co</td>
<td>16.73%</td>
</tr>
<tr>
<td>Citigroup Inc</td>
<td>16.57%</td>
<td>Merck &amp; Co Inc</td>
<td>16.70%</td>
</tr>
<tr>
<td>Coca-Cola Co</td>
<td>14.90%</td>
<td>Microsoft Corp</td>
<td>15.40%</td>
</tr>
<tr>
<td>Comcast Corp Class A</td>
<td>17.30%</td>
<td>Pfizer Inc</td>
<td>17.22%</td>
</tr>
<tr>
<td>Exxon Mobil Corp</td>
<td>16.42%</td>
<td>Procter &amp; Gamble Co</td>
<td>16.06%</td>
</tr>
<tr>
<td>Facebook Inc Class A</td>
<td>14.16%</td>
<td>Verizon Communications Inc</td>
<td>16.11%</td>
</tr>
<tr>
<td>General Electric Co</td>
<td>15.28%</td>
<td>Walt Disney Co</td>
<td>14.02%</td>
</tr>
<tr>
<td>Gilead Sciences Inc</td>
<td>15.85%</td>
<td>Wells Fargo &amp; Co</td>
<td>15.11%</td>
</tr>
<tr>
<td>Google Inc</td>
<td>15.36%</td>
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Average: 16.20%

As of 4/22/15

- Wintergreen analyzed the voting histories of the leading S&P 500 index funds run by Vanguard, BlackRock and State Street over the past five years for the 25 largest companies in the S&P 500. We found that over the past five years, these index funds have cast their votes in favor of equity compensation plans 89% of the time, and opposed executives’ pay packages less than 4% of the time. They withheld or cast votes against directors a meager 4% of the time.

Figure 2

<table>
<thead>
<tr>
<th>Equity Plans</th>
<th>Advisory vote to ratify named executive officers’ compensation</th>
<th>Director Votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>For</td>
<td>Against</td>
<td>For</td>
</tr>
<tr>
<td>Vanguard</td>
<td>93% 7% 0%</td>
<td>94% 6% 0%</td>
</tr>
<tr>
<td>BlackRock</td>
<td>88% 12% 0%</td>
<td>97% 3% 0%</td>
</tr>
<tr>
<td>State Street</td>
<td>87% 13% 0%</td>
<td>100% 0% 0%</td>
</tr>
</tbody>
</table>

89% 11% 0% 97% 3% 0% 96% 3% 1%
Meanwhile, index hype creates an illusion of safety and diversification that we believe leads ordinary investors to take on a dangerously high concentration of risk in their investment portfolios. By Wintergreen’s estimate, the top 25 securities by market value in the S&P 500 in 2014 contributed over 33% of the index’s total return, while the top 25 securities by performance contributed 55% of the index’s total return. Apple, Microsoft, Facebook and Intel alone accounted for over 20% to the total return of the S&P 500 in 2014.

Figure 3
Concentration of Returns in 2014

The top 25 best performing stocks accounted for an outsized 55% of the return of the S&P 500 in 2014.

Momentum Investing in Disguise

As indexation takes on mania-like proportions, markets become dominated by the movement of a narrow group of mega-cap stocks. Thousands of companies are overlooked and left by the wayside; they are deemed to be less desirable for no reason other than the fact that they are not included in the index. Business valuations and fundamentals have seemingly ceased to matter, with stock prices largely determined by momentum. Somewhere, Ben Graham, the father of value investing, is rolling over in his grave.

This momentum-driven style of passive investing has worked wonderfully over the past six years, as the U.S. market has been on a nearly relentless upward trajectory. The flood of cash into passive investments without regard for any sort of underlying fundamental analysis of valuation leads to a continued emphasis on companies or sectors that are popular – since they are performing well, as long as the flows into passive funds continue, they must continue to go up.

But what will happen to investors when the music stops and the punch bowl is taken away? We believe that the same small group of companies that have led the markets rise will likely be among the biggest losers, as passive funds are forced to sell the largest and most liquid names in the index.

Being 100% invested and holding zero cash, such as index funds are, has been a great boon to their performance on the way up, but we think will only cause pain on the way down. As many of these passive vehicles are being marketed to ordinary investors as diversified and less risky, they are going to be in for a shock when the momentum trade reverses.
When the market turns investors who were seduced by the illusion of safety and “low fee” hype will discover that they took on far more risk than they realized. At that moment in time the momentum will take a reverse direction and losses incurred will be many multiples times the perceived “savings” on fees. Those looking at retirement in a few years will have little time to recover and considerable pain to bear.

A Driver of Income Disparity

Index mania has been a boon for executives of companies in the index, whether or not these executives are delivering real shareholder value. Flows into Big Index’s fund products that tend to vote with management means a significant block of the shareholders in an S&P 500 company can generally be counted on to support executive compensation packages even when shareholders are receiving meager returns. It’s no coincidence to us that the sharp rise in executive pay in recent years parallels the growth in passive investment products.

Big Index seemingly has little interest in opposing corporate management or tangling with Boards of Directors at S&P 500 companies. The Economic Policy Institute noted:

“From 1978 to 2013, CEO compensation, inflation-adjusted, increased 937 percent, a rise more than double stock market growth and substantially greater than the painfully slow 10.2 percent growth in a typical worker’s compensation over the same period.”

Figure 4

Growth of Index Fund & ETF Net Assets vs. CEO Compensation vs. S&P 500, 2009-2013


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Context is important – successful CEOs who are delivering superior returns for shareholders deserve appropriate compensation. More government rules probably don’t solve the problem and may even create more opportunities to game the system. But it’s clear that underperforming CEOs can reap undeserved and excessive rewards in a governance environment heavily influenced by index fund managers that are unwilling to address problematic pay plans and entrenched boards.

However, it does not have to be this way. In early 2014, after reading Coca-Cola’s proxy statement, we sounded the warning that Coca-Cola was set to pull off a “Big Grab” through a wildly excessive equity compensation plan for top Coca-Cola executives. Even though Coca-Cola shareholders ultimately approved the equity compensation plan, our concerns were heard by many Coca-Cola shareholders, including State Street, which voted its clients’ shares against the plan. Perhaps as a result of this and other factors, Coca-Cola voluntarily modified its equity compensation plan to reduce the plan’s dilutive effects on shareholders. Who can say what else is possible if Big Index took a more active approach to investing its clients’ shares?

What can you do about it?

What can ordinary investors do about Big Index and the threat we think it poses to the markets and their own portfolios?

We believe strongly that ordinary investors should hold the managers of your mutual funds to a high standard when they vote proxies on your behalf. Ask the management company for its proxy-voting record on key issues like executive compensation, board membership and quality of governance. Make your concerns known.

Markets and Wealth for All

A final thought: The social purpose of markets is to provide efficient allocation of resources in the economy and thus promote the growth of businesses and wealth for all. This efficiency relies on the decisions of millions of investors interacting in the marketplace based on their views of the value and integrity of publicly traded companies. Accordingly, we at Wintergreen employ an active, research-driven value style in managing global securities on behalf of our clients.

It is worth considering the social and economic consequences of a market dominated by players who buy and sell stock of the biggest American companies without regard for their valuation, prospects, quality of management, ethics or other important investment characteristics. In such a situation, conflicting interests, misuse of proxy power, inefficient allocation of capital, higher risks and inequitable distribution of the fruits of enterprise loom as critical issues that need to be addressed.
**About Wintergreen Advisers**

Established in 2005, Wintergreen is an independent global money manager that employs a research-driven value style in managing global securities. As of March 31, 2015, Wintergreen Advisers had approximately $1.5 billion under management on behalf of individuals and institutions through its mutual fund and other clients, and is based in Mountain Lakes, New Jersey.

For further information on Wintergreen Advisers, please call 973-263-4500 or visit www.wintergreenadvisers.com. Additional information regarding what we view as the issues at The Coca-Cola Company may be found at www.FixBigSoda.com. For information, forms and documents regarding our U.S. mutual fund, please visit www.wintergreenfund.com.

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**David J. Winters**  
*CEO, Portfolio Manager*

David J. Winters is the Chief Executive Officer of Wintergreen Advisers. Mr. Winters has over 25 years of experience analyzing securities and is responsible for determining general investment advice to be given to clients. He is Portfolio Manager of the Wintergreen Fund, a no-load, Global Value Fund which launched in October 2005. Mr. Winters holds the Chartered Financial Analyst (CFA) designation.

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**Liz Cohernour**  
*Chief Operating Officer*

Liz Cohernour, the Chief Operating Officer of Wintergreen Advisers, has over thirty years of legal experience. Prior to co-founding Wintergreen Advisers in 2005, she served as General Counsel and Senior Vice President at Mutual Series. Ms. Cohernour has responsibility for non-investment operations of Wintergreen. She holds a Juris Doctor degree.
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