

# UNIVERSITY OF ROCHESTER

William E. Simon Graduate School of Business Administration

**Finance 423**  
Corporate Financial Policy & Control

**Professor G. William Schwert**  
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**Quiz # 2: Take-home**  
**due at the beginning of class on Monday, November 27, 2006**

Write a brief answer to the following questions. Relate your answers to the information in the attached article from *Business Week* and to the readings and class discussion in FIN 423. Limit your answers to no more than three (3) double-spaced (11 point fonts or larger and 1" margins on all sides) pages. ***This is an individual assignment. If you collaborate, you risk failing the entire course.***

1. This article stresses the conflict of interest Fidelity might face in running its mutual funds and voting its common stock holdings on behalf of mutual fund shareholders when it is also running 401K plans for many corporations. Other than prohibiting firms like Fidelity from doing both types of business (an approach that might appeal to Governor-elect Spitzer, for example), can you suggest business practices that Fidelity could use to avoid this problem?
2. Fidelity claims that this conflict of interest is not a problem even using its current business practices. What kinds of evidence would you look for to see whether Fidelity's mutual fund shareholders suffer from this problem?
3. Is there any evidence that you can find that supports the premise that the recent performance of Fidelity's mutual funds is related to its management-friendly voting practices?



OCTOBER 16, 2006

## SPECIAL REPORT

### Fidelity's Divided Loyalties

It could be the king of shareholder rights. But do its corporate interests get in the way?

Amid all the recent turmoil over corporate deceit, excessive CEO pay, and out-to-lunch company boards, one voice has been conspicuously quiet: that of Fidelity Investments, the world's largest mutual fund firm. Fidelity holds a 10% or greater stake in at least 100 of the nation's largest 1,000 companies and, all told, controls at least \$1.3 trillion, more than all hedge funds combined. But Fidelity rarely exercises its unprecedented muscle to push for improved corporate governance.

Traditionally, most mutual fund companies have backed the management of the companies whose shares they hold. But during the past five years of tumult over corporate leadership, some of Fidelity's rivals have been more aggressive in challenging the behavior of CEOs in the name of seeking better corporate performance and improved results for mutual fund customers. Fidelity's hands-off strategy now sets it apart.

So does the evolution of its overall business strategy. No longer mainly a mutual fund provider serving individual investors, Fidelity also serves corporations as a manager of both retirement plans and, increasingly, a whole host of business outsourcing services, from payroll to health and welfare.

In theory, at least, these two distinct lines of business can come into conflict: Does Fidelity primarily serve its corporate customers, whom it would be loath to challenge over governance issues? Or does it stick up for its individual customers, whose interests might be better served by a more activist stance toward corporate management? The evidence shows that in recent years, Fidelity has forgone the opportunity to join other large mutual fund companies--even ones that offer corporate 401(k) plans--in pushing for better governance.

Fidelity's behavior as a shareholder probably wouldn't merit much attention were it not for one other development: the deterioration of its funds' performance. Once an overachiever, Fidelity has descended to mediocrity. Only 39% of its actively managed stock funds beat their category averages through the first eight months of 2006, according to fund tracker Lipper Inc. Over the past five years, fewer than half of Fidelity equity portfolios have beaten the average of their peer groups. The performance has been so poor that the company says it is significantly increasing its spending on stock research.

#### **PRO-COMPANY**

Fidelity says its investment management and corporate benefits units run entirely independently of one another and that there is no conflict, theoretical or actual, that could harm individual customers. But the decline of Fidelity's mutual fund returns during an era of sharply increased skepticism about corporate management naturally raises the question of whether Fidelity's big lines of business now clash. A close look at recent corporate controversies illustrates that Fidelity has frequently declined to join its rivals and other investors in confronting dubious company management.

Because of a 2003 Securities & Exchange Commission rule that Fidelity and others opposed, mutual fund firms now must disclose their proxy voting records by Aug. 31 of each year. Taken in isolation, Fidelity's record doesn't illuminate much; the act of buying a stock, and holding on to it, is inherently a vote of confidence. But in the context of its peers, Fidelity's votes seem disproportionately pro-company.

Case in point: semiconductor maker Analog Devices Inc. (ADI), which is embroiled in the options backdating scandal that has hit more than 130 companies this year. In February the company revealed that its CEO was granted \$145 million in unconventional deferred compensation; it's also facing SEC and U.S. Attorney probes into its options practices. Analog says the compensation number is a long-term cumulative total that includes, among other things, exercised stock options. The stock has shed 37% since the news broke. Fidelity and T. Rowe Price tied for top share ownership--8% each--when they cast their proxy votes at the company's March annual meeting. T. Rowe withheld its vote for the only compensation committee member up for reelection. It also went against management to back a shareholder proposal that would require a majority vote for directors. (Shareholders can vote for or against proposals, but for director candidates, they can either vote for a candidate or, to protest, withhold their vote.)

In contrast, Fidelity voted for all directors and against shareholders across all of its actively managed portfolios. According to government filings from the most recent period, Fidelity manages Analog Devices' 401(k) plan. Notably, two Fidelity-branded index funds did oppose management on two proposals, but those funds are actually run by an outside company with its own proxy voting system. Fidelity declined to comment on any company-specific votes.

Fidelity's management-friendly voting pattern goes back many years. Consider Tyco International (TYC), a famous example of corporate misgovernance. In 1998, before vote disclosure was required of mutual fund firms, Fidelity was Tyco's largest shareholder, with a 14% stake. According to government filings, it also earned \$1.8 million on Tyco employee benefits administration. A shareholder proposal called for a majority of Tyco directors to be financially and personally independent from executives--something that 15 other institutional investors voted for. Fidelity instead sided with management, later disclosing its vote in a survey taken by a labor group. Tyco subsequently lost \$80 billion of market value in the controversy over executives using millions of dollars of shareholder money for personal expenses. The SEC sued three directors, two of whom were executives.

Fidelity lays out its proxy voting guidelines, which are approved and overseen by the funds' board of trustees, in a carefully worded document that's available on its Web site. It acknowledges the issue of corporate governance explicitly: "Fidelity believes that there is a strong correlation between enhancing shareholder value and sound corporate governance." But it also makes its predilection to side with management crystal clear. It says it "will generally vote in favor of incumbent and nominee directors except where a director has failed to exercise reasonable judgment."

Fidelity never promised to be a crusader, and it isn't about to start now. "The notion that we should be governance activists is not a leap we'll make," says Stephen P. Jonas, executive director of Fidelity Management & Research Co., the investment management arm. "The sole beneficiaries of publicly disclosed proxy votes are special interest groups with axes to grind with companies." Fidelity says it votes with its feet--meaning it simply sells shares when it strongly disagrees with decisions a company has made.

Fidelity does, however, draw a distinction on compensation matters. It says it voted against management proposals on one narrow subset of executive pay, stock compensation proposals, 54% of the time between 2005 and 2006, and notes that the number would have been 65% had it not been successful in negotiating with companies to conform to its proxy guidelines. The policy reads: "Fidelity encourages the use of reasonably designed stock-related compensation plans that align the interests of corporate management with those of shareholders by providing officers and employees with incentives to increase shareholder value."

In some cases, it's hard to reconcile that policy with Fidelity's voting record. In 2003, Home Depot's (HD) board changed CEO Robert L. Nardelli's compensation structure to weaken its link to stock performance. By the May, 2006, shareholder meeting, some were furious that Nardelli had received more than \$200 million in compensation in the five and a half years since he joined the company--a period during which the stock lost \$23 billion in market value.

#### **BOARD TIES**

T. Rowe Price, Home Depot's ninth-largest shareholder, withheld votes from 10 of 11 board members, and voted for shareholder proposals seven out of eight times. "We were not happy with some of their corporate governance...and

the company changing its compensation policy midstream," says portfolio manager Anna M. Dopkin, who co-chairs T. Rowe's proxy committee. Similarly, Putnam Investments, the No. 10 shareholder, withheld votes from all of management's candidates and voted for seven of eight shareholder proposals.

In contrast, Fidelity, which among mutual fund firms had the largest ownership of Home Depot's shares, at 5%, voted with management and against every shareholder resolution. Fidelity would not disclose outside business ties to Home Depot. The retailer says none of the board relationships influence Fidelity's decisions.

But it is public record that Home Depot's board includes many directors who handle the purse strings at other companies that are Fidelity clients. Director and compensation committee member Angelo R. Mozilo is also CEO of Countrywide Financial Corp. (CFC), a Fidelity client, according to government filings. John L. Clendenin, the chair of Home Depot's audit committee and a member of its compensation and executive committees, is lead director at Powerwave Technologies, a Fidelity client. There are at least two other such cross-management relationships involving members of Home Depot's board. Says a former Fidelity fund manager: "The last thing they're going to do is vote against a director who helps hire another company's next benefits manager."

Still, Fidelity insists there's no conflict whatsoever between the fund management and benefits groups. "I don't pay any attention to who the [corporate] clients are," says Jonas. "I don't know who they are. I don't care who they are." Others doubt there's any coordinated link between votes and corporate clients. "There's no way a portfolio manager will vote for something that's bad for [his or her] fund so that another department's client isn't annoyed," says Robert McCormick, a former director of investment proxy research at Fidelity who is now vice-president of proxy research and operations at advisory firm Glass, Lewis & Co. in San Francisco.

But Fidelity's pro-director voting pattern persists even when there's reason to suspect egregious governance abuses. Consider UnitedHealth Group (UNH), which, like Analog, is mired in an options-backdating scandal. In March, questions arose about the timing of the CEO's options grants over several years. In May, upon revealing an SEC inquiry, the company conceded a "significant deficiency" in its options program, an acknowledgement that could potentially result in its having to restate earnings from the past several years, marking them down by as much as \$286 million. Multiple shareholder lawsuits followed. UnitedHealth denies any impropriety.

Fidelity was UnitedHealth's largest holder as of March, with 128 million shares, 9.5% of the total. The company's stock fell by as much as 31% at one point--erasing \$20 billion in value. Fidelity sided with management on all proposals and director candidates at UnitedHealth's May 2 meeting and voted against a shareholder proposal requiring future board members to be elected by a majority vote.

By comparison, T. Rowe Price withheld a vote for a board member from the fund that held its biggest position, 7 million shares. Vanguard, the ninth-largest shareholder, withheld votes from a director who sat on both the audit and compensation committees, and another who sat on the board's nominating committee.

Again, Fidelity has outside business ties to key directors. James A. Johnson sits on United's audit and compensation committees; he also sits on the board of KB Home, (KBH) a Fidelity benefits client that also counts Fidelity as its second-largest shareholder among mutual fund firms. Compensation committee member Gail R. Wilensky sits on the board of Quest Diagnostics (DGX), a Fidelity client. All told, UnitedHealth board members were affiliated with at least nine Fidelity clients.

### **AVOIDING THE SUBJECT**

Of course, Fidelity may simply have been voting in favor of a board that has performed well for fundholders over time. Despite the recent sell-off, UnitedHealth shares have more than tripled in 10 years. "If we don't like the stock, we're gone," says Eric D. Roiter, general counsel for Fidelity's investment arm. "Withholding votes is a moot point." Yet Fidelity was still UnitedHealth's top shareholder as of June, the most recent date for which data are available. On the subject of options backdating, Roiter says: "Some [of it] could be illegal. Some could be legal. We're against illegal backdating."

Fidelity could, of course, withhold votes from a company's directors while still holding its stock. Roiter points to the

withholding guidelines in Fidelity's proxy policy, which cite specific cases of poison pill plans, the repricing of underwater stock options, and failing to act "in the best interest of shareholders when approving executive compensation." By and large, Fidelity would rather avoid the subject altogether. "We have more discreet ways to convey unhappiness over compensation," says Roiter. "Deciding to withhold is a big weapon."

Fidelity is somewhat more willing to take on companies in Europe, where its controlling family owns just under half of Fidelity International. But even on the other side of the Atlantic, Fidelity seems reluctant to make too much noise.

In one case it decided to jump on the back of a smaller investor rather than raise a ruckus itself, effectively outsourcing its shareholder advocacy. When Netherlands-based media firm VNU waffled on making a big acquisition, Fidelity, whose Boston and International operations were amassing a 15% share position, took action--sort of. It contacted Knight Vinke Asset Management, a hedge fund that held a 2% stake in VNU. Fidelity "suggested we take a look at it," says Knight Chief Investment Officer Eric Knight.

Knight did, incurring what he estimates were 4,000 man hours of labor and other high expenses, including the cost of hiring a consulting firm to analyze VNU's operations. "We paid for everything," he says. Knight aggressively confronted VNU with press releases and letters to management, cajoling it to buy back stock or put itself up for sale. Fidelity International chimed in three months later with a short statement opposing VNU's plans to buy a company. VNU was ultimately sold to a private equity group.

Could Fidelity, with its many resources, have gone it alone? Fidelity International declined to comment. Knight's explanation: "They could in theory. But that's not their business. We're not managing corporate pensions, so we don't have the conflicts."

All told, Fidelity says it withheld votes from at least one director at 73 companies in the 2005-2006 season, out of a total of about 6,000 company meetings. It says it withheld votes for directors of "key clients" more frequently than for directors of "non key clients."

Fidelity is more likely to vote with shareholders on other matters, but only marginally so in many cases. A 2005 study in the *Journal of Financial Economics* showed Fidelity voting in favor of key shareholder proposals and against management recommendations at the nation's largest 1,000 companies 33% of the time between 2003 and 2004--the lowest of two dozen institutions analyzed. That compares with 51% for Vanguard, 67% for T. Rowe Price, and 70% for American Funds--all big 401(k) players.

Similarly, a March, 2006, study of mutual fund voting patterns from July 1, 2004, to June 30, 2005, by the Corporate Library and two labor groups found that Fidelity voted for shareholder proposals involving executive compensation at a rate less than 1/12th the average of the 18 funds examined. Fidelity voted for stock options expensing measures 5.3% of the time, compared with the peer average of 74.8%. It never voted to tie options pay more closely to company-specific performance. And only one other firm was less likely to vote to cap severance and golden parachutes for executives.

Fidelity says that for the 2005-2006 proxy voting season it voted contrary to one or more management proposals at 31% of all U.S. company meetings at which it voted. That percentage held for what it calls "key clients" and "not key clients" alike.

Some former Fidelity employees say the firm's general reluctance to take on companies is emblematic of a bigger, longer-term problem: the decline of a performance-driven culture. One former manager recalls how in its early-1990s heyday, star managers such as Peter Lynch would take aside cub analysts to dispense variations of one overriding theme: "If you can't find two or three great stocks in your universe of coverage, you're not doing your job."

### **MARKETING EMPHASIS**

But a leadership change and the ouster of a risk-taking fund manager in 1996--combined with Fidelity's growing corporate benefits business--sent a new message. Fidelity turned into "a marketing organization that was about

where it would get the next 401(k) customer," says one former insider. "That chased away performance[-oriented] people and left the people who just wanted a big, safe place to work." Fidelity now caters to individuals who seek out its funds and others who are there strictly because Fidelity manages their company's 401(k).

"Defensiveness crept into the place the larger it got," says a former manager. "Now they just want to be close to the benchmark. Performance doesn't matter as much as babysitting assets."

Fidelity's Jonas, who took over the fund business a year and a half ago, doesn't deny the mid-'90s emphasis on stability, which he says was industrywide. Now he says boosting returns is Job One. "We frankly were not happy with domestic equity [performance], which was mediocre," he says. "We came in to make serious investments to get performance on par." He says the firm is plowing \$100 million into equity research, much of it for U.S. staff.

But \$100 million isn't much compared with the enormous fees Fidelity collects even on underperforming funds. Take the \$45 billion behemoth, Magellan. The fund is no longer open to outside investors but still accepts money from 401(k) participants. It has lagged the benchmark Standard & Poor's 500-stock index in 8 of the past 12 years. Yet Magellan holders have paid about \$5.2 billion in fees since 1996. "There's certainly a lot more Fidelity could be doing for its money," says Jeffrey M. Cohn, managing partner at New York-based Bench Strength Advisors, which advises institutions on performance.

Fidelity's Jonas says Magellan is a work in progress. A spokeswoman says that if Fidelity's fundholders don't believe in the firm, they, too, can vote with their feet by taking their money elsewhere. Of course, many can't--all they have are their corporate retirement accounts.

And more such customers are coming down the pike. In August, President George W. Bush signed into law a pension reform bill that will channel great sums to the retirement benefits industry by making enrollment in corporate 401(k) savings plans automatic, with customers required to opt out if they don't want to participate. As a result of the new law, the Investment Company Institute projects that 401(k) participation will increase from its current level of 66% of employees at businesses that offer them to 92% over the next several years, dramatically boosting assets from the current \$2.4 trillion. Like it or not, Fidelity is about to get even bigger.

By Roben Farzad