1. The purported conflict of interest mentioned in the article relies on Fidelity’s level of board / management support as evidenced by its proxy voting behavior. Therefore, a strategic shift towards a more activist stance on Fidelity’s part could help to dispel concerns about conflicts with its benefits management plans. Furthermore, such activities could enhance returns in the company’s funds. Given the current high level of shareholder activism, it could be argued that if a money manager abstains from such activity, it is operating at a competitive disadvantage to those investors who agitate for value-creating management decisions. Furthermore, a low-cost solution to Fidelity’s lack of shareholder activism is contained in the article. In the case of VNU, Fidelity “effectively outsourced its shareholder advocacy.”

By adopting such a “following” strategy with regard to shareholder activism, Fidelity can, at a reduced cost to direct activism, achieve the following:

a) Display independence from the interests of the benefit management business (hopefully avoiding regulatory interference)

b) Increase fund returns through enhanced shareholder value

c) Utilize its size to create effective collaborations with activist money (generally hedge funds)

d) Mitigate the loss of company management goodwill by letting traditional activists engage in the activities that typically cause consternation among executives (harassing phone calls, press releases, and other forms of pressure)

A concern with this strategy would be the extent to which it may cause Fidelity to lose benefits management clients.

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1 “Fidelity’s Divided Loyalties”, Businessweek, October 16, 2006
http://www.businessweek.com/magazine/content/06_42/b4005060.htm?campaign_id=rss_daily
Davis and Kim (2004) maintain that “mutual funds with large ownership are in a position to internalize more of the benefits from governance activism”\(^2\). However, unlike pension funds, large mutual fund companies have been loathe to agitate for improved corporate governance. Even when compared to its large mutual fund brethren, Fidelity is notably pro-management. To the extent that support of shareholder initiatives increases value, Fidelity’s reluctance to cast its proxy votes against management may have hurt returns for its investors. One way in which this hypothesis could be tested would be to analyze fund returns for the effects of proxy voting tendencies. A controlled comparison between funds with the same benchmark which are differentiated in their level of shareholder activism could provide illumination on the relationship between voting against management and superior returns. Perhaps a comparison of Fidelity and Vanguard, could provide some clues in this direction, as the latter has shown itself more willing to vote for shareholder proposals.

The phenomenon of Fidelity’s recent underperformance is likely the result of a number of factors, and evidence that Fidelity’s conflict of interest regarding benefits management clients is harming shareholders is largely anecdotal and somewhat murky. The Businessweek article, “Fidelity’s Divided Loyalties,” is unable to provide clear evidence that Fidelity’s shareholders would have been better served had they voted differently. For example, in the case of United Health, the article relates that Fidelity’s competitors, T. Rowe Price and Vanguard, withheld votes from a director over governance issues related to an options backdating issue. The article does not explain how this vote would enhance shareholder value, since the options problems go back to 1994, while the vote was in May of this year. As the article notes, United Health Shares have more than tripled over the past ten years.

The existing literature, however, is fairly clear that this underperformance is unlikely to be due to a conflict of interest arising from benefit management relationships. The study by Davis and Kim shows that “levels of ownership are essentially independent of client relationships between mutual funds and

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firms, and funds are no less likely to vote against management in client firms than non-clients. Thus even if voting with management destroys value, this tendency cannot be said to be caused by client relations with the companies in question. A study by Rothberg and Lilien further discounts the “mutual fund conflict of interest argument”:

We compare the voting records of fund companies that are primarily mutual funds to the voting records of fund companies that are a small part of larger financial services companies. We do not find a difference in how often they vote against management.

As to the general tendency of Fidelity to vote with managements, two explanations seem most likely. First, as a matter of corporate control, Fidelity has constructed proxy voting guidelines which are generally conservative and putatively pro-management. Because part of Fidelity’s business is finding companies and directors in which it believes, it is not surprising that the firm’s default position is to support incumbent directors. Thus Fidelity’s assessment of management can be viewed through the firm’s investments. That is, it will “vote with its feet” if it no longer believes in the company. Conversely, continued ownership could be viewed as support of management, thus voting with this management would simply be an effect of Fidelity’s investment decisions.

Second, Fidelity since 1996 has pursued a somewhat conservative strategy which is dependent upon marketing and benefits management. As assets under management have ballooned, the firm became more focused on protecting principal than attaining superior returns through a performance-based pattern of accountability. While this does not represent a conscious choice of “relationships over shareholders”, the organizational inertia of the last 10 years has perhaps prevented Fidelity from taking a more visible role in shareholder advocacy.

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