MARCH 2025

Shareholder engagement in the field of search funds.

A tool in support of culture and performance

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Edition: Caja Alta Edición & Comunicación: www.cajaalta.es
Design: IESE Business School: www.iese.edu

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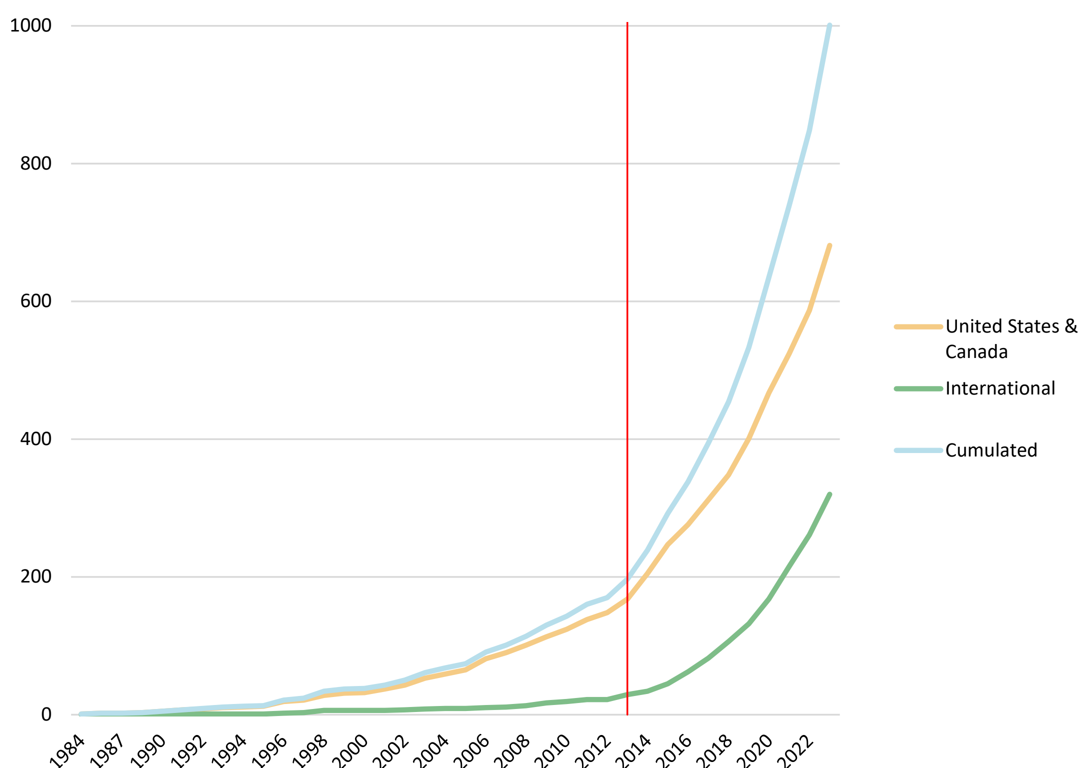
Introduction

Two recurring topics heavily discussed in the search fund community are the accelerating growth of the asset class and its institutionalization. **Figure 1** illustrates the recent exponential growth of the field well: The chart shows the number of core search funds launched annually in North America (in orange), internationally (i.e., all other countries, in green), and cumulatively (in blue) based on the latest IESE and Stanford studies until late 2023 (Kelly and Heston 2024; Kowalewski *et al. 2024*). The inflection point in 2013 indicates a regime change and ever stronger growth globally.

Figure 1. Search funds 1984–2023



Source: Based on Kelly and Heston 2024; Kowalewski et al. 2024.

Related to the increasing number of searches that are being launched is the ongoing institutionalization of search funds, with one supporting the other. This is particularly pertinent in the United States, where the asset class has been around for a longer time and has grown more mature. Indeed, some of the American searchers we recently engaged with had CapTables where individual investors accounted for less than 15%. And while this is typically not the case outside the United States, the trend elsewhere is also for funds of search funds to represent an increasing percentage of CapTables. Institutions tend to have greater capacity and depth when it comes to due diligence, and their networks often provide necessary board expertise.

But what are the dangers of these developments? From what we have observed, the quality of searchers is as good, if not better, as ever (granted, maybe with a higher variance). The number of attractive companies is there. Even in the United States where at present more than half of searches take place, the number of interesting companies for sale dwarfs the number of searches (this does not necessarily mean easy to find or acquire). The capital necessary to fuel this growth is equally present. In turn, board capacity and culture are two major points to be vigilant of.

Following the famous metaphor of the horse (business), the jockey (searcher), and the coach (investors), there is broad consensus that the searchers-turned-CEOs in the model depend on experienced investors for guidance and hands-on support. Curating well-rounded syndicates where a large majority is engaged with the searcher *and* has a good understanding of the search fund culture and tenets, however, gets ever more challenging given the strong influx of new players: both searchers and investors.

With maturity and accelerated growth, institutionalization itself is typically only one of the consequences. So far, the core search fund model and its values, like collaboration and reciprocity, have been transferred from operators to searchers, from investors to CEOs, and vice versa. The field's initial slow growth allowed for personal embedded relationships where high levels of trust almost guaranteed the continuity of the culture initiated by Irv and friends. Now, relationships that were once embedded become arm's length. In arm's length relationships, trust naturally weakens, the focus shifts to the transactional, and distributed learning slows. Both culture and performance dilute.

As widely discussed, the search fund model's strong alliance between CEO and (the other) shareholders helps explain why issues of corporate governance (e.g., principal–agent problems) have predominantly been foreign to this world. In the few cases that these were detected, the experienced boards dealt with them swiftly (typically by removing the CEO and hiring an experienced replacement). Yet, the above-mentioned issues can lead to investor misalignment and cause severe horizontal agency costs (i.e., principal-principal problems), ultimately leading searchers and new CEOs astray from the model and its success factors. While the complexities of scaling-up acquired businesses over time is well understood across the community, we herewith aim to shed light on the easily underestimated challenges of scaling the field.

We propose shareholder engagement (SE) as a promising tool to further the common culture that is present today (but that might change under fast growth), offering a way for knowledge, values, and culture to permeate through the system. Indeed, more open engagement between many shareholders and their boards will fuel a system of situated and community-based learning. As a result, we hope for a greater understanding of the model, a better appreciation of its community, and a humbler awareness of the responsibilities involved—ethical and operational—to spread through the investor network.

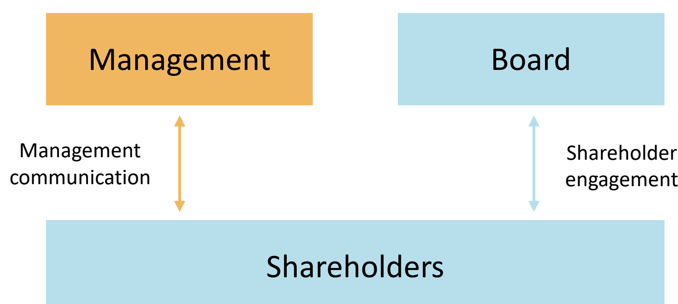
Introducing shareholder engagement

Surveying academic research as well as practitioners' publications, one notices that there is no general agreement on what SE stands for. The following definitions typify the three classes of descriptions under which SE is typically categorized:

- SE enables investors to use their voices as shareholders to support better corporate sustainability policies and practices. (SHARE)
- SE are efforts made by companies to engage with their shareholders on a wide range of topics including executive compensation, strategy, risk management, corporate governance, and other topics falling outside of the usual financial and strategic conversations. (ISS)
- SE refers to all the ways that shareholders can communicate their views to the board and that boards can communicate their perspectives to shareholders (in addition to existing investor relationships activities and processes). (NACD, PWC, CA Institute, ICD)

In line with the latter definition, which is most frequently used (especially in legal and corporate governance documents and by formal institutions), a decisive characteristic of SE is its two-way engagement between the company's board of directors and shareholders. We distinguish it from the communication between management and the company's shareholders that is referred to as management communication (see **Figure 2**).

Figure 2. Flows of communication in corporate entities



Source: Prepared by the authors.

Historic perspective

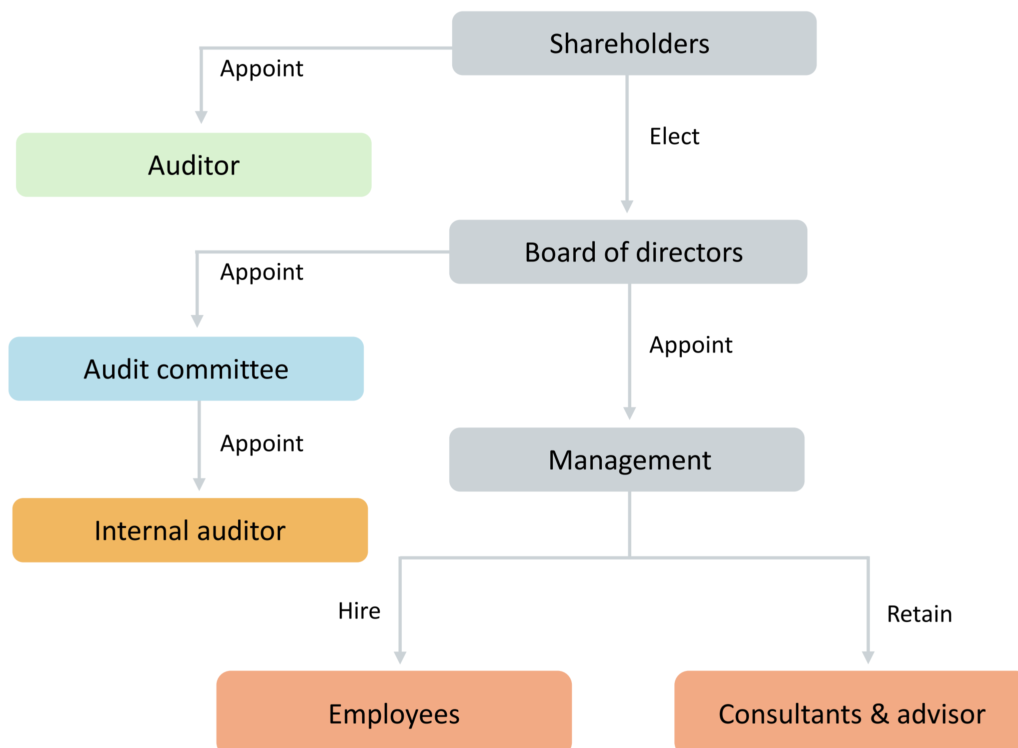
Reviewing history underlines that SE has mainly pertained to the domain of public companies. Joint stock companies were formed in the 16th and 17th centuries to limit the exposure investors were willing to take to risky expedition endeavors. Examples are the Merchant Adventures to New Lands (1553), the Muscovy Company (1555), the East India Company (1600), and the Dutch East India Company (1602). These setups allowed for many an investor to be invested in a common company, liquidity optionality, as well as limited responsibility. What it also did was to separate management from ownership. Adam Smith warned us as early as 1776 of the risk of reduced stewardship.

> The Directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of such a company.
>
> Adam Smith (1776)

In the United States, where companies' management and ownership often (largely) coincided—take Andrew Carnegie, Thomas Edison, John Pierpont Morgan, John Rockefeller, and Cornelius Vanderbilt for illustration—this was originally less of an issue. But things changed when professional managers were attracted to run companies as professional managers, coinciding with the birth of business schools (Harvard being the first university with an MBA program in 1908).

While, historically, there has always been anecdotal evidence of managers not necessarily thinking in the best interest of their owners, it took until 1976 to academically conceptualize this issue. Michael Jensen and William Meckling (1976) coined the concept of the principal–agent problem in their paper "Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure." Arguably, the corporate structure (see **Figure 3**) developed by then safeguarded owners against the risk of management (the agent) exploiting information asymmetries and pursuing their own interests since they were appointed and supervised (and fired!) by a board of directors that was elected by the shareholders (the principals). And just like in a democracy, the shareholders (voters) could replace the board of directors (parliament) when they decided that management (government) was not looking after the shareholders' best interests.

Figure 3. Typical Corporate Governance Structure



Source: Prepared by the authors.

However, in his seminal *Virginia Law* Review paper "The Myth of Shareholder Franchise," Professor Lucian Bebchuk famously stated: that the power of shareholders to replace the board is a central element in the accepted theory of the modern public corporation with dispersed ownership. This power, however, is largely a myth and "shareholders do not in fact have at their disposal those powers of corporate democracy" (2007, 676).

A combination of logics is given for the argument that the powers of corporate democracy are not always effective. A first reason is a legal one: Corporate law typically defines the specific decisions that must be decided by shareholder vote and leaves the others to the directors. The residual powers then rest with the directors, not shareholders.

Second, many (read: an absolute majority of) shareholders are passive investors. Neither do they vote, nor are they sufficiently familiar with the issues that are voted upon. Third, until recently (definitely prevalent in 2007), most director voting happened through slate voting. Management would provide its shareholders with a slate of directors (where the number of directors was equal to the number of director openings) and whereby shareholders could only vote in favor of the candidates or withhold. Hence, technically one vote would suffice for appointments to the board of directors. Given that management would commonly provide shareholders with a slate of 'friendly' directors to vote for, indeed, *this power of corporate democracy was largely a myth.*

Note the date of Bebchuk's publication: May 2007. This is one year before the collapse of Lehman Brothers (September 15, 2008) triggering the Great Recession, but five years after enaction of the Sarbanes-Oxley Act (July 30, 2002), which was a result of the Enron and WorldCom collapses. Back then, congressmen Paul Sarbanes and Michael Oxley had not only been critical of auditing practices but also been vocal about the weak corporate governance of American boards. Similarly, ethical stalwart Paul Volcker called for an urgent separation of oversight between management and independent directors as well as for an independent chairperson. Such criticism and propositions were largely ignored by corporate America and its cozy board practices.

The subprime crisis and its aftermath, congressional hearings included, changed all this. Corporate governance in general and SE in particular became an important topic for boards of publicly traded companies. Premier directors and institutional investors, for example, established the Shareholder-Director-Exchange working group formalizing a 10-point protocol[1] to guide engagement between public company boards and shareholders in 2013. Similarly, *stewardship codes* emerged as industry-led soft regulation from 2010 (Klettner, 2021). Key questions addressed by these efforts mainly dealt with when and how to drive such engagement and concerning which topics.

Implications of SE

Academic research supports positive effects of SE. Some compelling findings include:

- SE leads to an improved risk environment and lessens volatility (Sharfman and Fernando 2008)
- SE improves accounting performance, corporate governance, financial performance, and stock price (Dimson, Karakas, and Li 2015)
- SE and material sustainability are linked to shareholder value (Khan, Serafeim, and Yoon 2016)
- SE boost targets' sales and provides risk-adjusted returns of 2.7% annualized (Barko, Cremers, and Renneboog 2022)

[1] Further details at http://www.sdxprotocol.com/what-is-the-sdx-protocol/.

Other, more practitioner-related studies report:

- Enhanced awareness of shareholders of the company's unique business context and its strategy
- Increased quality of board oversight
- Improved understanding of board perspective on business and governance issues
- Higher valuation and returns for investors that have active SE
- Lower stock volatility
- Higher brand awareness
- Lower probability of bankruptcy, stabler cash flows, and more resilient to external shocks

Overall, evidence supports the assertions of Smith, Jensen, and Meckling: Information asymmetry between principals and agents disadvantages owners, leading to agency risks under conflicted incentives. SE has been effective in mitigating these issues.

In contrast, SE has not been 'a thing' for private companies for various reasons. In many cases, the CEO's percentage stake in the company is far higher than is the case for publicly quoted companies, making for a stronger alignment between management and shareholders. Additionally, oftentimes there is a dominant shareholder with strong representation at the board level. Where this is not the case, a direct line often exists between each shareholder and one or more board members.

The core search fund model was designed with looming agency issues in mind. Both making the operator (potentially) the largest shareholder and choosing board members selectively (e.g., based on complementary skills, capabilities, and character) ensure the alignment of goals and the necessary checks and balances.

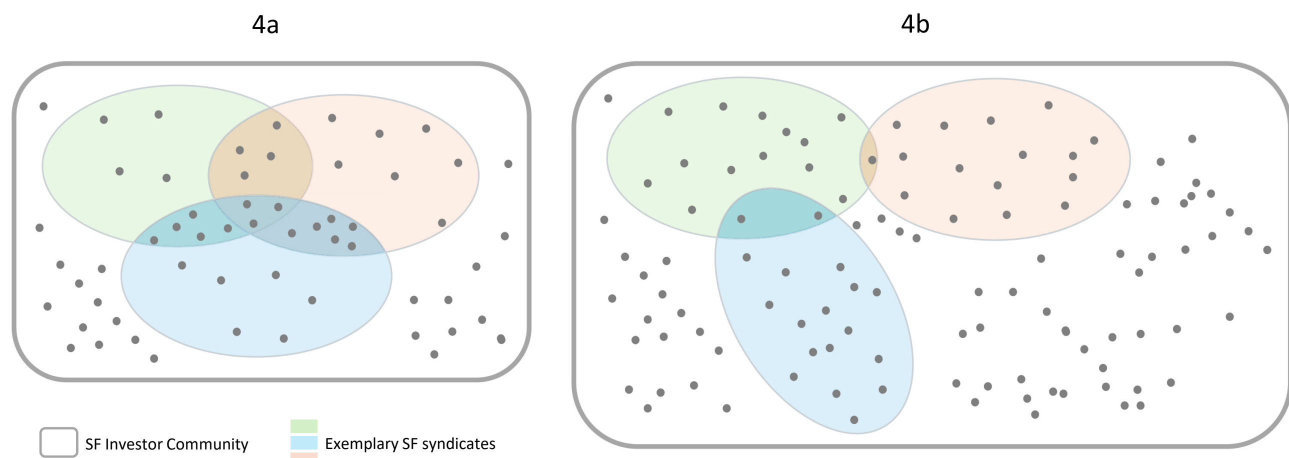
Applying SE to the search fund community

Throughout the emergence of the core search fund model, a diversity of actors in the community and among investors bore great benefits for individual search funds and the field's evolution and maturity overall. Hence, it is exciting to witness the core model's rise globally, which indicates its ability to attract ever more capable individuals. Nonetheless, this rapid expansion risks diluting the shared learning and collective wisdom of those who have shaped the field to date. Search funds—by design—rely on informal governance anchored in trust and collaboration among their investors in general and directors specifically. It is those deep connections that drive the sense of reciprocity and responsibility and motivate close engagement with searcher-CEOs where needed.

The idea of *communities of practice* from institutional theory, defined by the mutual engagement in regular joint activities (Wenger 1998) where members develop their practice through a "shared repertoire of resources, loose organizational structures, significant material and financial investments, and open communication" (Georgiou and Arenas 2023, 7) resonates here. Picture the community of search fund investors as a group of individual actors (see **Figure 4a**) who come together in subgroups to support search funds (colored groups). In a small community, investors naturally coincide frequently with many peers so that they don't just jointly learn from a single company but share their evolving set of experiences and are likely to interact closely enough for such learning—and ultimately, the very *practice* to support young CEOs in their endeavor to create value-adding growth—to permeate throughout.

While the numbers of (potential) searchers and available businesses globally do not indicate an imminent limit to the growth of tickets available as such, it is the decreasing overlap of syndicate members (even less when we focus on board members) that threatens to break established practice. As the wider community grows, repeated investor interactions become ever less frequent and/or no longer capture large parts of the community—i.e., each investor coincides less with the same subgroups and/or knows fewer community members personally (see **Figure 4b**). Even more, separate syndicates with very different sets of values, culture, and approaches are more easily formed. This alienation could have dire consequences for acquired businesses because it weakens the foundation of established informal governance mechanisms and the culture upon which they exist.

Figure 4a. Tightly embedded syndicates **Figure 4b. Decreased syndicate overlap**



Source: Prepared by the authors.

Today, some bifurcation is already observable: Some searchers have very strong CapTables (as in individuals and institutions who are strongly embedded in the community), while others have syndicates with very little connection to it. At large, this trend may entirely separate the investor community as self-selection of well-prepared and networked searchers drives them to investors (funds and private) that take collaboration, engagement, mentorship, and culture seriously. As a result, numerous up-and-coming candidates would face even more extreme challenges in creating a winning board of directors.

It is obvious that these thoughts are very present in the community to date. Issues concerning the field's growth and culture are regularly addressed front and center of the most important forums as well as in personal exchanges. Recent discussions by Rob LeBlanc and A. J. Wasserstein (2023) as well as Rob Johnson (2023) offer sound insight and guidance for novice investors.

Relatedly, principles of SE take on new significance as the search fund community continues to grow while expertise and awareness remain key to avoid cultural dilution. Adopting SE presents a practical opportunity to preserve the community's core values, foster mutual learning, and maintain alignment between searchers, boards, and shareholders. Additionally, historical knowledge, pattern recognition, and sharing will positively contribute to performance. Just as "a potential board member with an outstanding resume who is often unavailable is of little use to a CEO" (Wasserstein and Pananos 2018, 3), a well-intentioned board member with an outstanding resume who is available but disregards the essence of the community's culture, and search fund specificity, can have a devastating effect on an inexperienced CEO and company.

By fostering two-way engagement within syndicates and, by implication, across the broader search fund community, SE offers a way to facilitate and formalize open dialogue and collaborative learning. Two complementary pathways to integrate new entrants seamlessly into the community while maintaining its core principles come to mind: First, by joining balanced syndicates in which experienced and culturally embedded investors take critical director roles, SE can kickstart novices' learning through continuous exchange about key decisions and underlying reasoning. Second, by stepping into board roles themselves but being able to count on the contribution of other (including expert) syndicate members, the pool of actionable board members would multiply. In such settings, the current (and very much necessary) expansion of our community could drive the model's continuous success by benefiting from the valuable impulses of new joiners without losing the winning nature of search fund governance and culture. For this, we propose a set of foundational principles.

Guiding principles

First and foremost, it is critical to stress that SE should be focused on and limited to matters pertaining to the board, not to management. SE is not *en lieu* of management communication but *in addition to* management communication. When boards start to deal with matters that should be left to management to discuss—even with good intentions—it typically undermines management. This is especially true with inexperienced CEOs. Thus, respect for fiduciary duties, legal rights, and obligations is of prime essence.

While a set of topics should be left to management to discuss with shareholders, others lend themselves to more systematic SE (see **Figures 5a** and **5b**). Naturally, some issues will overlap. One way to distinguish management matters from board matters is: Every topic of execution is a matter of management, and every decision that relates to the creation of shareholder value, or avoidance of its destruction, in a meaningful way pertains to the board. Note that in some countries, 'shareholders' is extended to 'all stakeholders,' or even replaced with 'the corporation.'

Figure 5a. Management communication

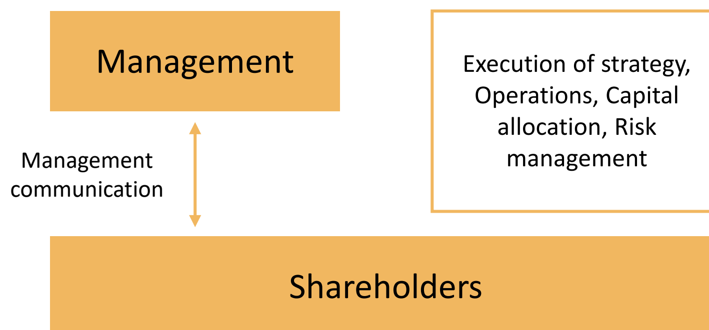
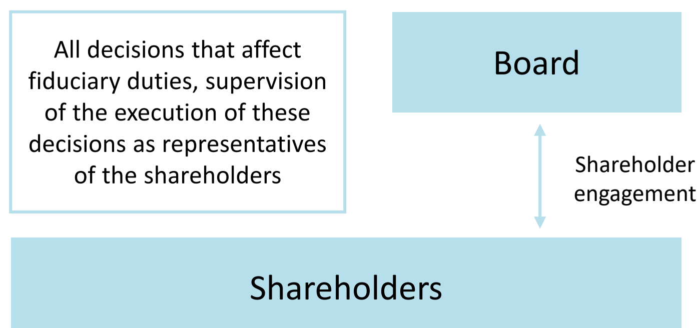


Figure 5b. Shareholder engagement



Source: Prepared by the authors.

Second, SE needs to be **bidirectional,** with communication flowing both ways—from the board to shareholders, but also vice versa. This is not merely provided for by the shareholders' right to engage. Rather, an attentive review of the above-mentioned benefits of SE in corporate settings clearly indicates that much can be learned and won from considering (all) owners' perspectives.

Third, it is important to note that it is good custom for the board to inform management when they will engage with shareholders. Experience suggests that semi-annual meetings work well, but some cases may warrant more frequent meetings. It is good practice to always also have an 'in camera' session, where none of the company's executives are present. At times, other participants might also be excluded from an 'in camera' session, such as a specific board member or a seller-shareholder. We recommend the definition of a clear code of engagement in syndicates early. Such internal policies should lay down such engagement, the approach, and which events or topics warrant discussion. Note that SE does not change any of the fiduciary duties of the board.

Fourth, the focus should always be on long-term value creation and on the shaping of a young professional into a manager and, potentially, a leader.[2] It is a central component of the core search fund model for investors to contribute to and accompany the transformation of the new CEO, and we cannot express its importance enough.

Last, this engagement should always maintain a professional tone, with all actors taking individual responsibility to be collaborative, constructive, and collegial. A learning culture is central therein and, over time, revising the code of engagement and practical approaches may be necessary and is encouraged.

Forming effective boards has always been and remains a critical milestone for search funds, and most seasoned investors are already assisting searcher-CEOs in this critical task. Now, as high growth and institutionalization of the field are colliding, the community's culture must be guarded (though not stalled in its natural development) to ensure access to this support for generations of searchers to come.

In essence, the high performance in search funds is a result of its culture. The discovery of the model by aspiring CEOs and new investors, both in the United States and abroad, has led to accelerated growth. As this note argues, the dilution of culture—and, by extension, a potential decline in performance—is a real risk. We believe that SE can be a way for the community to stay embedded and for the model to keep thriving.

[2] There are very few situations where both are mutually exclusive, but when they are, the board's fiduciary duty is to what is in the best interest of the corporation or shareholders, country depending.

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