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House of fads

Central-bank analysis trumps security analysis in this age of monetary activism. Never mind the 10-Qs, annual reports, proxy statements, conference calls, channel checks, debt-maturity schedules and coverage ratios. Whatever the Federal Reserve and the European Central Bank and the Bank of Japan are going to do, just do it first.

BlackRock, Inc. (BLK on the New York Stock Exchange), the company under the *Grant's* lens, is the central banks' Wall Street doppelganger. Counting its money in the trillions—just like a central bank—BlackRock has positioned itself to profit by the unprecedented monetary manipulations of the post-crisis era. Nonbelievers in the central banks' methods, *Grant's* is bearish on the house that Laurence D. Fink built.

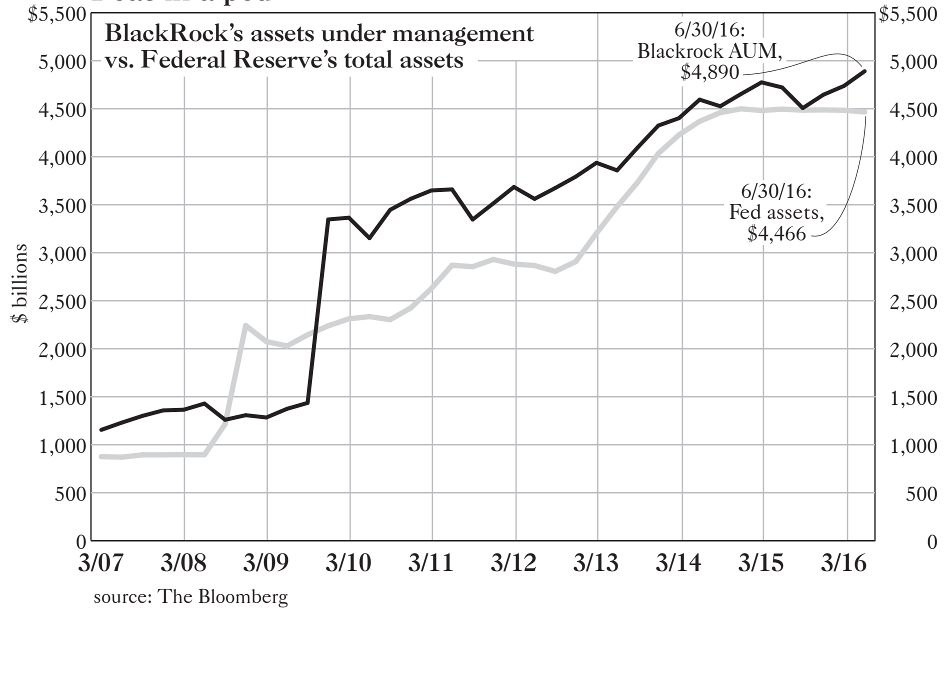
"Built for Change" is how the world's largest asset manager presents itself (the slogan has the cover of the BlackRock 2015 annual report almost all to itself). We would say, a little less pithily, "Built for a Time of Falling Interest Rates and Rising Asset Values, with Resulting Massive Inflows of Client Funds into Index Funds and Exchange Traded Funds."

Just how well BlackRock may adapt to a close of this golden era remains to be seen. Very well, a bull must hope, as the company is capitalized for the success of its recent past. Among its greatest hits was the purchase of the Barclays ETF franchise in December 2009. Not everyone was bullish at or near the March 2009 stock-market bottom. Neither was just anyone prepared to wager $15.2 billion on the proposition that ETFs would garner the investment-market share that they have subsequently, triumphantly done. BlackRock took possession of an iShares universe with around $300 billion under management. Today that universe holds $1.15 trillion and constitutes the most vibrant segment of the vast BlackRock enterprise. Such is its vastness that management is shopping for a new headquarters in not-cheap New York.

Bulls and bears will agree that is not your father's bull market. According to the Sept. 23 edition of Factset's Earnings Insight, the S&P 500 posted a 3.5% year-over-year decline in earnings per share in the second quarter, the fifth consecutive quarter of year-over-year decline. Yet, since earnings peaked in the first quarter of 2015, the S&P 500's price has risen by 4%. Maybe it's no coincidence that, according to S&P Global, 90.2% of U.S. active equity managers underperformed their respective indices in the 12 months ended June 30 (after deducting for fees). The portfolio managers were probably wasting their time reading balance sheets rather than "gaining exposure" to this or that concept or industry grouping by buying ETFs.

Better, too, if the fiduciaries had followed the money-printers. "Yes," colleague Evan Lorenz observes, "the Fed ended its third round of asset purchases on Oct. 29, 2014, and, yes, the Fed implemented a one-quarter-of-1% rate rise, to 0.5% from 0.25%, on Dec. 16, 2015. But the Fed is not the world's only money-spinning central bank. The combined

Peas in a pod



source: The Bloomberg

footings of the Fed, the European Central Bank and the Bank of Japan have swelled by $3.2 trillion to $12.8 trillion since March 31, 2015, the peak of S&P earnings. Monetary uplift has boosted asset prices worldwide."

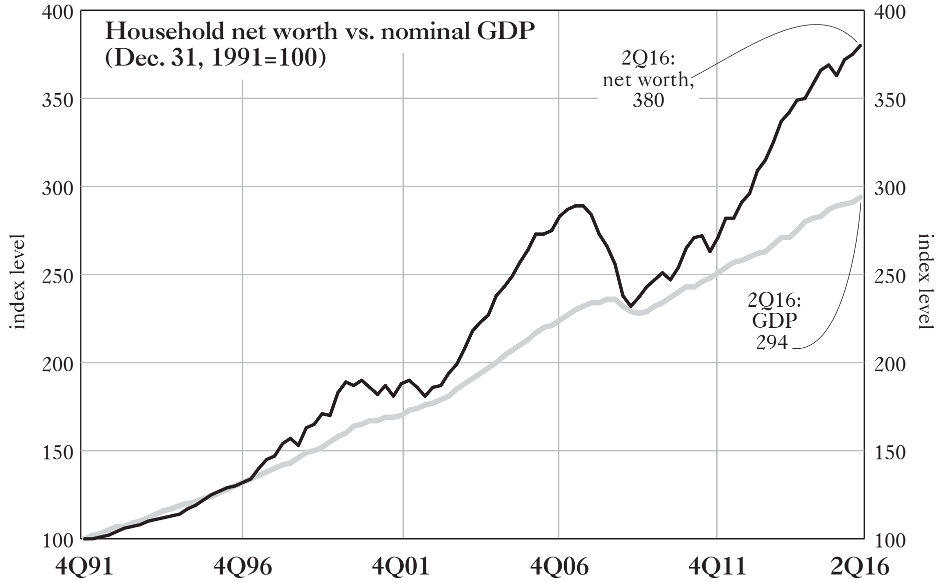
Which is not to say that the central banks favored BlackRock alone, only that BlackRock succeeded best in turning their gifts to account. The company manages $4.89 trillion. It employs more than 13,000 people across 30 countries and 135 investment teams. Its risk-control, risk-management and portfolio-monitoring software—"Aladdin" is its name—is fast becoming the fiduciary standard.

BlackRock's assets under management broadly comprise equities ($2.4 trillion), fixed income ($1.6 trillion), multi-asset ($386.5 billion) and alternatives ($119.2 billion). Institutional investors account for 62% of the assets denoted "long-term." Retail investors contribute 12% and iShares 26%. At BlackRock, 34% of long-term assets are actively managed. The lucrative balance is apportioned to iShares ETFs or index funds. "Short-term" assets, in the sum of $385.2 billion, encompass money-market mutual funds and a smattering of advisory funds.

Maybe the fixed-income and dividend-centered asset businesses ought to be redesignated "Reaching for Yield Solutions." At least $277.4 billion worth of ETF assets would answer the description, including the ones housed in IYR (U.S. real estate), LQD (investment-grade corporate bonds), HYG (high-yield corporate bonds), PFF (preferred stock) and DVY (select common dividends). The five contribute an estimated $298.4 million per annum in management fees. Nothing lasts forever in cyclical markets. When the client reaching stops, the client selling may start.

It wasn't success that brought BlackRock into the world but a $100 million howler. In 1986, the 33-year-old Laurence D. Fink, then a managing director at First Boston, zigged when he should have zagged in the mortgage-backed securities market (of which he was one of the progenitors). It was this blessing in disguise that led to the 1988 departure from First Boston of Fink and a supporting cast to create a new unit at Blackstone, under Stephen A. Schwarzman. When, in 1995, Fink and Schwarzman agreed to disagree over a proposed allocation of Blackstone equity to Fink's department, Fink and team again packed up, this time under the corporate sponsorship of PNC Financial Services

Look familiar?



sources: Federal Reserve, Bureau of Economic Analysis

Group, Inc. Assets under management then totaled $25 billion. By 1999, when BlackRock sold its first shares to the public (PNC has remained a substantial minority owner), AUM had vaulted to $165 billion. As we go to press, BlackRock's AUM is approaching $5 trillion while its market capitalization stands at $59.4 billion, almost exactly double that of Blackstone, the firm that let the prize escape its grasp. "[I]t's a humbling experience to see what you don't do right," Schwarzman rued of the BlackRock sale on Bloomberg radio a few years back.

BlackRock is good at a great many things. It is unsurpassed at asset-gathering. In the 3½ years ended June 30, the firm accounted for 18.2% of all ETF and mutual-fund inflows ($524 billion out of a grand total of $2.9 trillion). Such gatherings are increasingly concentrated in BlackRock's iShares division. In the first six months of 2016, the firm inhaled a net $34.3 billion—in the same half year, excluding iShares, it would have suffered an outflow of $5.6 billion.

Just as BlackRock was born under the cloud of failure, so will it toil in the blaze of success. "With about $4.9 trillion in AUM," observes JPMorgan analyst Kenneth B. Worthington, "BlackRock needs to generate about $37 billion of net new sales each quarter to maintain its 3% organic growth."

That is the Denominator Effect. Then there's the Establishment Effect. You can hardly take the other side of the market when you come close to being the market. Nor can you afford to break from the ruling monetary, fiscal and regulatory powers when you prospered in the slipstream of their policies. The presence on the BlackRock board of Clinton hand Cheryl Mills (and Fink's own ill-disguised ambition to serve as Hillary Clinton's secretary of the Treasury) flags the firm's vulnerability to a possible Trump administration.

Fink, like many another investment manager, will tell you that the future is about technology—though Fink, to his credit, might have said the same thing 30 years ago. He introduced computers to the trading floor of First Boston in 1982. He installed a Sun Microsystem workstation into his Blackstone offices in 1988. Today 2,300 BlackRock employees work not at gathering or investing assets but in programming and maintaining BlackRock's immense Asset Liability and Debt and Derivatives Investment Network, the system called Aladdin.

What, exactly, is it? The BlackRock website tries to explain: "The Aladdin platform combines sophisticated risk analytics with comprehensive portfolio management, trading and operations tools on a single platform to power informed decision-making, effective risk management, efficient trading and operational scale. More than just technology, Aladdin powers Collective Intelligence by providing tools to help your organization communicate effectively, address problems quickly, and make informed decisions at every step of the investment process."

To judge by its success in the marketplace, Aladdin is all that and more. During the financial crisis, the Federal

Reserve Bank of New York engaged BlackRock to manage the risks embedded in the assets which it had carted from the wrecks of American International Group and Bear Stearns. Nowadays, some $15 trillion of investment assets ($5 trillion or so at BlackRock, another $10 trillion outside the firm) are, as they say, "Aladdinized." The BlackRock system has become a kind of risk-and-portfolio-analysis category killer.

"For our part," Lorenz notes, "we wonder how Aladdin thinks, what it knows and how overconfident it might be. The bull market in interest rates began 35 years ago. Aladdin's world is that of falling yields and of inverse correlation between bond prices and stock prices. There have been other investment worlds. In the 1970s, stock prices fell in tandem with bond prices. We do not, of course, have access to Aladdin's millions of lines of code, but it would come as no surprise if the system were wired to assume that bonds and stocks are inherently negatively correlated. Such is a principle of risk parity, a portfolio-management technique in which, to hedge your stocks, you lever up your bonds. Risk parity wouldn't have worked in the inflationary 1970s, and it wouldn't have worked in the deflationary crisis of 1920–21 (*Grant's*, May 29, 2015). Maybe Aladdin won't work in some future unscripted event. Or maybe someone, leaving the office one night, will trip over a plug, turn off the lights and bring down software chaos. Things happen."

For now, BlackRock's digital genie is humming—and, in the process, colonizing much of the world of risk measurement and risk management. "Models track relationships from historical data to project future risks and returns," Lorenz notes. "If too many people use the same model, they might behave in ways that invalidate the model's assumptions. The risk of a BlackRock monoculture is growing."

In 2008, the hedge-fund investor David Einhorn attacked Value at Risk, the prevalent statistical template for controlling and measuring financial risk. He compared it to "an airbag that works all the time, except when you have a car accident." We wonder if a similar false sense of security has settled over the stewards of low- and negative-yielding bonds. No doubt, BlackRock's quant corps is nonpareil. Still, the risks that may accompany negative nominal bond yields would seem to defy mathematical modeling. According to *A History of Interest Rates* by Sidney Homer and Richard Sylla, today's are the first substantially negative yields in at least 5,000 years.

Clients are anxious and confused, Fink told dialers-in on the July 14 call: "[They] do not know what to do with their money. They are afraid, and they are pulling back. . . ." A careful fiduciary might well pull back from unprecedented monetary meddling, high prices and rich valuations.

What does this mean for BlackRock? One of Fink's right-hand men, Robert S. Kapito, came up with an answer two months later at a Barclays Global Financial Services Conference: "I think that today is the greatest opportunity in the history of mankind in the asset-management industry. And the simple reason is because there is north of $50 trillion and some would say $70 trillion in cash. $10 trillion of that probably has a negative yield. . . . Where is that money going to go? So I would tell that it could be the greatest opportunity in the history of asset management."

Jack Bogle founded Vanguard in 1975 near the bottom of an especially rugged bear market, which reciprocally proved to be near the start of a titanic bull market: a generation-long (and counting) updraft in stock and bond prices. That was, arguably, "the greatest opportunity in the history of asset management," which Bogle duly seized. Today's market setup features a 10-year trailing, inflation-adjusted S&P 500 price-to-earnings ratio of 27, highest since October 2007, and a junk-bond market (on the authority of Martin Fridson) trading at eight-year extremes of overvaluation. It isn't the backdrop in which Bogle made his start or, for that matter, in which Fink did.

Economic growth can explain only so much of America's pan-asset-class bull market. The rising tide of money (the falling rate of interest) must also share in the glory. Active managers, futilely trying to pick stocks and bonds, have failed to match the performance of the passive managers who merely "seek exposure." Perhaps it's no coincidence that, since 2007, BlackRock's assets under management have grown in tandem with the Fed's balance sheet.

Thus, it should give pause that radically EZ money is coming under growing scrutiny, both inside and outside the walls of the central banks. According to the European think tank GEFIRA, the European Central Bank spent €18.48 in bond-buying to generate €1 of marginal European GDP. "The question is where this money from the QE goes and who benefits from it," GEFIRA asked on its website last Friday. "Clearly it is not the real sector, the so-called Main Street of French, Italian or Portuguese cities (Greece is not under the QE program). European stocks are still weak, too, while stock exchanges in the USA are hitting their records. So, is the ECB serving Europeans?"

Is the Fed serving Americans? The Bank of Yellen, observes TCW Group fixed-income CIO Tad Rivelle, is trying to replace economic cycles with asset-price cycles. "The Fed's playbook on this is well worn. First, policy rates are lowered," Rivelle relates. "This triggers a daisy chain of events: Low or zero rates promote a reach for yield; the reach for yield lowers capitalization rates across a variety of asset classes, which, in turn, spurs a rise in asset prices. Rising asset prices—the so-called wealth effect—'rescues' [sic] the economy by rebuilding balance sheets and restoring the animal spirits. And voilà! Aggregate demand rises, businesses invest, and a virtuous growth process is launched."

It does not seem so virtuous that net household wealth in relation to GDP appears more distended than at even the peak of the housing bubble. By placing the cart of asset prices ahead of the horse of enterprise, governments (and their central banks) have failed to deliver the promised macroeconomic goods.

As for the microeconomics of the situation, BlackRock isn't the low-cost fund provider of the passive investment vehicles that have displaced so much old-fashioned security analysis. Compare and contrast the BlackRock emerging market ETF with its Vanguard counterpart, suggests Kevin Duffy, a principal at Bearing Asset Management (and a short-seller of BlackRock shares). Each weighs in at more than $30 billion of assets; each tracks a slightly different set of prices. The BlackRock offering—iShares MSCI Emerging Markets ETF (EEM)—charges a 0.69% expense ratio. The Vanguard alternative—Vanguard FTSE Emerging Markets ETF (VWO on NYSE Arca)—charges a 0.15% expense ratio.

"I went to BlackRock's website and looked at the top 20 ETFs by assets," Duffy tells Lorenz. "Those funds had $533 billion [in assets] and generate $1.22 billion in annual revenue based on expense ratios. . . . It just seems to me that there is a fair amount of room for compression on these expenses. I haircutted those funds to get it more in line with Vanguard. The fees from those 20 funds I get down to $800 million or

$900 million from $1.22 billion." Let us say that competition forced down BlackRock's fees to $850 million from $1.22 billion. The pre-tax loss would amount to $370 million, or $1.53 per share. Nor is this an entirely theoretical risk. In the second quarter, BlackRock's base fees fell by 2% even as assets under management grew by 4%. The clients migrated to lower-cost assets, like cash.

Self-evidently bad ideas don't cause financial panics. It's the good ideas turned bad—pushed beyond their reasonable limits—that do the damage. Might ETFs fill that bill? On Aug. 24 last year, trading halts in eight S&P stocks "cascaded into stoppages of 42% of all U.S. equity ETFs." The quoted words belong to Bob Rice, New York-based Tangent Capital managing director, author of an article in the June 15 edition of *InvestmentNews*. "On the same day, fully one-fifth of all equity ETFs experienced price movements of 20% or more, even though just 4% of individual stocks did," Rice continued. "Case in point: the very popular iShares Select Dividend ETF (DVY) experienced losses at much greater percentage price swings than any of the individual stocks it held."

You wonder who has the ball. In particular, surveying the junk-bond exchange-traded funds, you ask what drives the high-yield market. Is it the bonds? Or the ETFs?

The two big high-yield ETFs are called HYG (the BlackRock edition) and JNK (managed by State Street Global Advisors). Together, they house $28.6 billion of assets, a small fraction of the $1.4 trillion junk market. "Despite their relatively small size," observes Bloomberg reporter Lisa Abramowicz, "they have become a node of activity in a market that's still struggling with an outdated infrastructure [i.e., placing bond buys and sells through a broker over the phone]. And that means they can set prices for the rest of the market, which is an amazing amount of power—especially considering [that] the pool of high-yield debt has never been bigger."

Trading in HYG and JNK amounts to 20%-plus of all high-yield bonds in a typical day, according to James A. Bianco, president and eponym of Bianco Research. For those who wish to know the reason, Bianco pinpoints a feature called delivery in kind.

"What that means," Bianco explains, "is that BlackRock has been running around to high-yield managers and saying, 'You are best committing to me if you want to get long or short high yield.'"

In the old days, said portfolio manager might buy or sell the desired bonds piecemeal. It might have taken days. Better, the voice at the BlackRock end of the telephone goes on (this is Bianco playing the role of the BLK salesperson), "Buy $200 million worth of HYG ETF, and then call us up and give us some parameters and we will put together an index of bonds out of HYG and we will present it to you for delivery. If you are accepting of it, we will give you the $200 million worth of bonds and cancel your $200 million worth of ETF, or if you want to trade it the other way, vice versa."

"The trade mechanism is now becoming the ETF with delivery in kind that they go back and forth with all the time," Bianco continues. "BlackRock will say that the marketplace can self-arbitrage it. If the pricing gets out of line, you can buy the ETF or sell the ETF and then do a delivery in kind and get the underlying bonds because you think they are worth more or less. Because the market prices itself to the ETF, it becomes somewhat self-fulfilling, too."

What could possibly go wrong? Bianco and we can think of plenty. Recalling the 2015 "flash crash," anyone can. As it is, two ETFs with a value of approximately 2% of the junk-bond market now effectively price all junk bonds.

To be clear, a bet against BlackRock is a bet on discontinuity—on a break in the central bank–induced asset levitation or on the fad for passive investment vehicles or on the malfunction of the technology about which BlackRock is so prone to boast.

"To the extent that central banks pare back intervention or central-bank action fails to boost asset prices, BlackRock would face two problems," Lorenz points out. "First is mark-to-market declines. As noted, 66% of BlackRock's long-term AUM is invested in index funds or iShares ETFs, and BlackRock's funds excluding iShares have already seen outflows in the first six months of 2016. If index funds and ETFs fall out of favor, BlackRock would likely face investor outflows, too. The combination of falling asset prices plus outflows would pressure base management fees, which contributed 83% of second-quarter revenues."

BlackRock trades at 19.4 times trailing earnings vs. 15.2 times for the asset-management field. It's a premium that's contingent on perceptions and events. Franklin Resources, Inc. has a well-regarded franchise in emerging markets, and it commanded a price-earnings multiple of 16.3 times before the EM troubles of 2015 struck (*Grant's*, July 11, 2014). Now it trades at 13 times.

In the second quarter, BlackRock repurchased $275 million of its own common stock. Contrapuntally, over the past 12 months, BlackRock executives and board members sold $153 million of common stock (they made no recorded purchases). Fink sold $27.4 million worth. Kapito, the super bull, unloaded $39.1 million worth.

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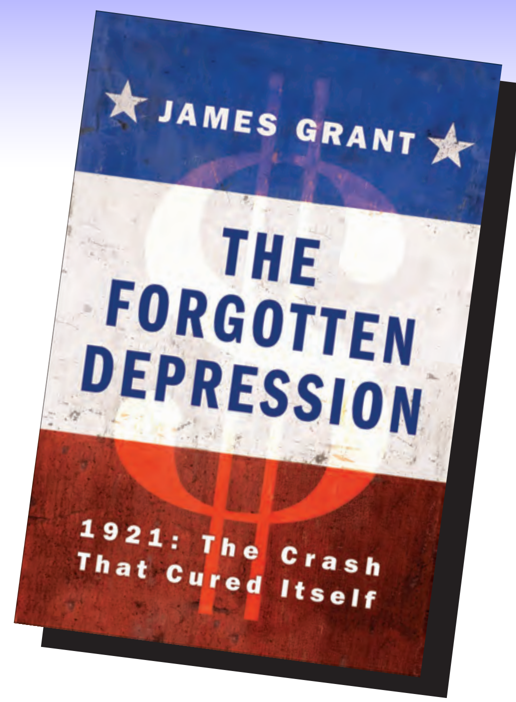

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