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BlackRock Talks … and U.S. Companies Must Listen

Posted by Ed Batts, Orrick, Herrington & Sutcliffe LLP, on Tuesday, February 13, 2018

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In BlackRock CEO and Co-founder Larry Fink's annual letter to companies on January 16, he issued a call to action for companies to have "a clear sense of purpose." To BlackRock, having "a clear sense of purpose" means much more than simply delivering quarterly financial results—companies will be expected to have a strong commitment to evolving Environmental, Social and Governance (ESG) issues.

This letter matters both because BlackRock is an important large investor of actively managed assets and—more importantly—because we are living in a new world order of many fewer public companies with, at the same time, a continued crescendo of passive investment allocation. These changes in the U.S. equities markets have been underway for some time, but with the recent significant bull market run they are being magnified at an accelerated pace.

Below is a quick tour of how we got here. And then we discuss the take-away: For the foreseeable future, companies and their boards need to be in dialogue with passive investors' governance departments. And they need to be prepared for a conversation in which ESG issues are squarely on the agenda.

Part I: The Revolution in U.S. Equity Markets

Pre-Index Investing

In the "old" days (think when EF Hutton was making those "people listen" commercials), a company's stockholders were divided into:

- **Active/Fundamental Mutual Funds** (e.g. Fidelity, T. Rowe, Wellington)
- **Hedge Funds** (e.g. Tiger Management, Bridgewater Associates)
- **Pension Funds** (e.g. CalPERS/CalSTRS, Ontario Teachers' Pension Plan)
- **Labor Funds** (a.k.a. Taft-Hartley multi-employer funds) (e.g. Service Employees International Union or the Sheet Metal Workers International Association)
- **Activist Investors** (essentially a subset of hedge) (e.g. Carl Icahn and Nelson Peltz)
- **Retail Investors**
- **Insiders/Management**

The Ongoing Massive Shift in U.S. Equities Ownership

Two market phenomena have radically altered that landscape.

First, ***the number of actors/companies in which broad-market passive funds may invest has roughly halved, while average market capitalization has more than tripled***.

- The total number of domestic public companies has shrunk from over 8,100 in 1996 to 4,300 today (*World Bank/World Federation of Exchanges*). That essentially eliminates half the domestic (non-foreign listing) investment targets in the U.S. And foreign companies listed in the U.S. add only 900.
- Total U.S. domestic equity market value in that same twenty-year period has doubled, from just over $12 trillion to $27 trillion (held constant in 2017 dollars) *(Credit Suisse)*, going from 105 percent to 147 percent of annual U.S. GDP (*World Bank/World Federation of Exchanges*).
- Commensurately, to balance out fewer companies with greater total value, average domestic public market capitalization of a given public company has increased from $1.7 billion to over $6.9 billion in constant dollars (*Credit Suisse*). Median value is $832 million—and that median value is essentially what market observers would posit is the minimum value necessary for a public company to have scale and liquidity in its public float (*E&Y*).
- The top 1 percent of domestic public companies—roughly 30 companies—account for 29 percent of aggregate market value (*E&Y*).
- The top 4 percent of domestic public companies—roughly 130 companies, each of which is worth more than $50 billion—account for over 50 percent of aggregate market value (*E&Y*).
- To draw further conclusions: Roughly 1,650 domestic public companies are under $832 million in market capitalization. That leaves approximately 1,500 companies "in the middle"—a middle that ranges vastly from roughly $1 billion to $50 billion. And this is the concentrated set of companies on which the broad-based passive index funds by definition must be focused.

Second, as "the market" has decreased in number of actors/companies, ***it has been flooded with allocation to passive vehicles***, whether Exchange Traded Funds (ETFs, whose prices fluctuate intra-day on a securities exchange) or mutual funds (whose prices are calculated once a day after market close):

- *Total Market Value*: More than 40 percent of U.S. equity assets under management (AUM) are in passive vehicles (*Goldman Sachs*) and, out of the entire U.S. equity market (professionally held plus individually invested), 30 percent are in passive vehicles (*Morningstar*).
- *Concurrent Decline in Individual Ownership:* Individual ownership has dropped precipitously from ½ of the market to 1/5 of the market—50 percent in 1976, 27 percent in 1996 and 21.5 percent in 2016 (*Credit Suisse).*
- *Trend*: In 2016, $506 billion flowed into passive funds, while $341 billion was hemorrhaged from active funds (*Morningstar*).

- *Trading Volume*: 25 percent of daily trading volume on U.S. exchanges is in ETFs—not actual stocks (*Goldman Sachs*). There were 2 ETFs in 1996. There were 658 as of 2016, and the number is growing (*Credit Suisse)*.

The three largest passive investment management firms are (with numbers as of September 30, 2017—and no doubt increased since then):

- **BlackRock, New York City:** Out of almost $6 trillion AUM, $1.2 trillion is in the popular iShares equity-based ETFs (which tripled since BlackRock purchased the business from Barclays in 2009); another $1.6 trillion is in institutional passive equity funds. BlackRock, then, holds $2.8 trillion in passive equity strategy vehicles. While BlackRock does not report specific geographic investment mix, a rough approximation would be that some 70 percent of it is likely in U.S. markets (BlackRock 3Q18 Form 10-Q).
- **Vanguard, Valley Forge, Pennsylvania:** $4.5 trillion AUM—the vast majority in U.S. index investing. Its founder, Jack Bogle—after having been fired from active manager Wellington—was the original primary advocate of indexing and created an index giant. In contrast, its large fundamental-based mutual fund competitor, Fidelity, has under $2 trillion AUM. Four of five of the largest U.S. mutual funds are index funds from Vanguard—the fifth is Fidelity's money market fund—an investment in essentially cash, not portfolio management (*Investopedia*). In the past three years, Vanguard received about 85 percent of all new U.S. mutual fund investment money, while the remaining 15 percent went to all of Vanguard's other 4,000 mutual fund competitors <u>all combined</u> (*Morningstar/The New York Times*).
- **State Street Global Advisors (SSgA), Boston:** $2.6 trillion AUM of which 70 percent is in North America, $1.5 trillion in passive equity. State Street, while separately a behemoth in third party securities custodianship, remains the smallest of the passive investment management shops—but has the well-known SPDR ETFs.

The result is that passive investment management firms now hold massive portions (closing in on 1/3) of U.S. equities. And because they are passive, they cannot summarily buy—or sell. Once a passive fund purchases an equity, it is there to stay … forever … unless the company runs into so much trouble as to fall off the particular index. A passive fund's holdings may fluctuate with overall investment levels in U.S. equities; however, a passive fund's ownership level relative to other investors is unlikely to materially change and, in fact, given the seeming march towards greater value, such fluctuations of late have meant only increased ownership levels as "dry powder" continues to aggressively enter the markets.

Part II: Three Ground Rules for Companies Living in a New World Order of Passive Investing

Ground Rule #1: Each of the "Big 3" Passive Shops Has an In-House Governance Function. Get to know them well in advance—to avoid barely getting a short, rushed meeting with them when it is crunch time.

As of January 2018, the heads of these departments (referred to as "Investment Stewardship") were:

- **BlackRock: *Michelle Edkins***, who Larry Fink announced in his message will be supplemented by BlackRock's Vice Chairman and Co-founder, ***Barbara Novick***. Ms. Edkins is a New Zealander who began in investment management in 1997 in the UK and joined BlackRock in 2009.
- **Vanguard: *Glenn Booream***, who joined Vanguard directly from college in 1989.
- **SSgA**: ***Rakhi Kumar***, a former chartered accountant in India who picked up an MBA from Yale and worked for Moody's before spending the last seven years at SSgA.

Ground Rule #2: Passive Investors' Influence Cannot Be Underestimated.

Take, for example, the heated October 2017 proxy contest between Proctor & Gamble and Nelson Peltz's Trian Management. P&G's share ownership falls out as (data from *Proxy Insight*; shares rounded to nearest million):

- Passives: Vanguard (187 million), BlackRock (159 million) and SSgA (113 million): They are #1-3 of the top stockholders—and the next largest holder is Bank of America at a distant 44 million.
- Major Actives (cross-section based on past importance/author experience): Capital, Dimensional, Fidelity, T.Rowe, TIAA-CREF and Wellington, <u>all combined</u>: 106 million.
- Teacher and state/municipal employee pension funds in California, Florida, New York, Ontario and Texas, <u>all combined</u>: 29 million.
- In other words, the most well-known active funds and major pension funds <u>all combined</u> hold 135 million shares in P&G—versus the smallest of the major 3 passive positions, SSgA, at 113 million shares.

All of the intensive proxy solicitation and lobbying effort invested into hitherto major (and still relatively large) funds spread throughout North America can be matched or dwarfed in a single vote from a passive investment management company.

Ground Rule #3: Passive Shops Are Independent Thinkers Who Do Not Necessarily Follow the Herd. Moreover, ISS and Glass Lewis No Longer Are the Undisputed Shepherds of the Herd.

Historically, fundamental/active fund portfolio managers focused almost exclusively on quantitative return of equity value. Beginning in the late 1980s, however, the U.S. Department of Labor's Pension and Welfare Benefits Administration—exercising its jurisdiction for retirement plan investments through ERISA—issued advisory letters in *Avon* (1988) and *Monks* (1990) and then a 1994 Interpretive Bulletin, which cumulatively resulted as a practical matter in forcing investment advisers to vote. From *Avon*: "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock." Rather than each investment adviser devoting the significant resources to establishing individual corporate governance departments to vote on thousands of annual proxies, most instead outsourced the substantive analysis to proxy advisory firms, first ISS and then its later arch rival, Glass Lewis. These outsourced proxy advisory firms for many years reigned supreme, particularly with ISS's near-monolithic dominance of vote recommendations for funds.

Such hegemony has substantially eroded. Using the recent P&G context example, while both ISS and Glass Lewis recommended voting in favor of Mr. Peltz, P&G's single largest shareholder, Vanguard, reportedly ignored those recommendations and voted with P&G management's slate of directors. After a *very*, *very* close vote, Mr. Peltz ultimately was seated on the P&G board. This also shows that while the Big 3 passives matter, if they split—then every vote from non-passive stockholders suddenly becomes mathematically critical. Try hard to avoid ignoring or making an enemy of any institutional stockholder.

BlackRock's 2018 Annual Letter to Companies

Index investing is an interesting commercial environment, since the primary historical factor for investing—seeking individual equity or fund return/Alpha—is stripped from consideration. Instead, fund expenses become key—but there are only so many fractions of a basis point to cut further before the expenses are very similar among competitors—and very, very cheap, at least in contrast to active trader funds or the steep carry and management fees of hedge funds. After two years of steep outflows and sub-market returns, hedge funds have stabilized of late—but even so, *Boston Consulting Group* is forecasting that a reasonable bad case—where hedge returns continue to suffer as they did in the past couple of years—could entail a further 30 percent shrinkage in hedge AUM by 2020. Conversely, keep in mind that, according to *The New York Times*, Vanguard has one employee (in any function …) for every approximately $44 billion of AUM—and that Vanguard's indices have significantly outperformed hedge fund median returns in this bull market.

In recent years, SSgA has increasingly differentiated itself from index fund purchasers by advocating for attention to Environmental, Social and Governance (ESG) issues. And while BlackRock certainly has not avoided the subject, it hitherto did not issue as clear a call to action. Indeed, while many similar themes were raised in last year's annual letter, they were couched in more gentle coaxing, rather than this year's direct call to action:

"Furthermore, the board is essential to helping a company articulate and pursue its purpose, as well as respond to the questions that are increasingly important to its investors, its consumers, and the communities in which it operates. In the current environment, these stakeholders are demanding that companies exercise leadership on a broader range of issues. And they are right to: a company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.

"Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?"

What Does This Mean in Practice?

There undoubtedly is a hypothetical saturation point at which macro-economic headwinds and increasing concentration of equity ownership in passive investment funds will collide—where too much investing dollars could be postulated to be “stranded” in rule-based investing at much more higher levels than indices are now in the aggregate. This potentially could create greater volatility since wholesale rotation out of equities entirely, rather than from one stock to another, seems more likely when dumping an index. Perhaps then, “seeking alpha” (and a bit more of Buffet’s value investing) may return with vengeance.

But don’t bet on it anytime soon. If anything, we appear headed for significant macro-economic tailwinds for the near future. As but one indicator, the new tax bill will likely significantly bolster equity prices, as both lower domestic effective tax rates and repatriation of foreign cash will likely be used to both repurchase stock and provide tidy sums for either dividends or fights over capital allocation strategies with activist investors—buckle up! A rising tide of equity prices raises all ships—and a continuing bull market is unlikely to shake investors’ seemingly unending appetite for smile-inducing returns from low cost, low hassle passive funds—further concentrating voting.

Companies need to expect:

- The continued need to **engage in discussion routinely** with governance departments. In fact, **ask to do so**.
- One or more **independent directors to be part of those discussions**. Depending on the circumstance, it may be necessary to give an investment steward the opportunity to talk without the CEO present for some part of the conversation—still a generally unpopular concept with management.
- **Pointed questions on board diversity**—gender and racial in particular—as well as pay equity.
- To **substantively engage on environmental topics**, such as climate change impact.

The road shows of yesteryear meant relatively narrow lanes of traipsing up and down the Northeastern Corridor—from Baltimore to New York and then Philly to Boston—to perform a pilgrimage to a few portfolio active fund managers and review a financial model. Now management—and importantly, board members—get to add passive shops to their tours. The sooner that boards and, of course, management accept a new reality driven by enormous underlying market dynamics, the sooner they will adapt to a new power structure that increasingly looks far beyond EPS guidance.