WHY FINK WILL TRIUMPH WITH BGI

BLACKROCK WINS RACE FOR BARCLAYS GLOBAL INVESTORS

Archive photo of Laurence Fink, chairman and chief executive of BlackRock, speaking to reporters during a news conference following a meeting of the Governor's Commission to modernise the regulation of financial services Friday, January 18th 2008 in New York. Photograph by Mary Altaffer, for the Associated Press, supplied by PA Photos, August 2009.

Laurence Fink, chairman and chief executive of BlackRock, long coveted Barclays Global Investors and its iShares family of exchange-traded funds. When the financial storm of the past year threatened Barclays PLC, Fink bid $13.5bn for BGI, an offer the bank could not refuse. After the deal closes later this year, BlackRock will become the world's largest manager of investment assets. Art Detman describes why BlackRock will likely grow and thrive, and how this acquisition may affect the money-management business.

LARRY FINK IS a man in a hurry. When, in 1988, he founded what today is BlackRock, it was a money management operation that occupied a single room in New York City. In less than 10 years he had more than $100bn under management, mostly fixed-income securities. In 2005 Fink bought State Street Research Management, which put BlackRock deeply into equities. A year later the acquisition of Merrill Lynch Investment Managers pushed BlackRock's assets under management over the trillion-dollar mark. And when BlackRock completes its acquisition of Barclay Global Investors, it will have $2.8trn under management, as much as the next two largest US firms—State Street and Vanguard—combined. By one estimate, BlackRock Global Investors (as it will be named) will have more than 3% of the world's investable assets under management. In most industries, a 3% market share would be unremarkable; in the money-management business, it is breathtaking.

"Astounding, isn't it?" comments John Dutton, head of GHS-Dutton, a wealth adviser in Northern California. "I used to run an investment management firm back in the 1980s and we charged a fee of six-tenths of 1%. Imagine that fee on $2.8trn." As for Fink, we can assume he long ago computed the potential income from the combined asset base. In any event, his media people say he's not talking to the press until after the acquisition closes, which might not be until nearly the year's end.

By itself, San Francisco-based Barclays Global Investors is one of the larger money managers. At 30th June it had £1.02trn under management, about $1.7trn, even more than BlackRock's $1.37trn (which, tellingly, grew by $15.2bn in net new money in the second quarter alone). For the six months to end-June, BGI had pre-tax profits of £276m, about $469m. BlackRock's after-tax income was $349m for the same period.

BGI contributed about 15% of last year's pre-tax income at fabled Barclays, the eminently British bank that has operations worldwide and assets of £1.5trn ($2.6trn). When the global financial meltdown began last year, Barclays twice refused government aid and was told by the UK's Financial Services Authority that it must improve its Core Tier 1 ratio, which was an anaemic 5.6% at year's end. Six months later—thanks to the turnaround in the banking industry—it was 7.1%. Once the BGI sale is completed, it will be 8.8%, perhaps not robust but high enough to satisfy the regulators. Because BGI is carried on Barclays' balance sheet at only £1.5bn, roughly $2.6bn, everything above this amount flows through to its paid-in capital.

BGI has three main lines of business—indexed accounts (64% of assets under management), iShares (23%), and actively managed accounts (13%)—and selling all of them wasn't the bank's first choice. Barclays chief executive John Varley and president Robert Diamond (who also is chairman of the executive committee of BGI, which is managed as a standalone business) reluctantly concluded that the best way to raise capital was to sell the iShares operation. It was not a core business of Barclays, which Varley and Diamond ambitiously intend to build into the world's pre-eminent investment bank. Serendipitously, iShares is a highly profitable operation, generating 44% of BGI's operating profit in 2008. As the industry's most successful family of exchange-traded funds (ETFs), iShares accounts for 54% of ETF sales to the world's 100 largest pension plans, 47% of all US ETF volume, and 39% of European volume.

Little wonder that Barclays soon had a reported 27 inquiries. Some experts expected bids from the likes of Fidelity, the big mutual fund company, Northern Trust, and even Charles Schwab Corporation (whose headquarters is within walking distance of BGI's). Instead, the interested parties were firms such as Goldman Sachs, Bank of New York Mellon, Bain Capital, Colony Capital, BC Partners, and Apax Partners.

In the end, Barclays accepted a bid from CVC Capital Partners, a private equity firm. The amount was $4.2bn, much less than the $6.5-$7bn some observers had expected. Did the low price mean that Varley and Diamond were growing a bit desperate? Perhaps so, but they had given themselves a second chance by insisting on a 45-day go-shop clause. Armed with a firm price from CVC, they looked for someone to top it. That someone was Larry Fink, who had long admired BGI and very much wanted it. But Fink wanted not just iShares but nearly all of BGI (except for one small, money-losing operation). He reportedly offered $12bn. When negotiations ended, the price was $13.5bn—13 times BGI's projected 2009 earnings before interest, taxes, depreciation and amortization. "BlackRock paid a generous price," says Kim Arthur, president of Main Management in San Francisco and a long-time user of iShare ETFs, who adds: "But it is buying the market leader, and typically you do have to pay a premium for that, especially in a fast-growing market."

With the clock ticking, Fink rounded up the money from PNC Financial Services Group (a long-time BlackRock investor); sovereign-wealth funds from Singapore, China and Kuwait; and Highfields Capital Management, a hedge fund. He did this within a 24-hour period, a classic demonstration of Fink's clout and determination.

As for CVC, it will have to content itself with a break-up fee from Barclays of $175m, a tidy sum for being a stalking horse.

Fink is paying $6.6bn in borrowed cash, which includes $3.8bn from Barclays, and the balance in stock. When the deal goes through, Barclays will own 19.9% of BlackRock and Varley and Diamond will be board members. For a while, it appeared that Fink wouldn't be able to raise the remaining $2.8bn in cash. He had engaged PCP Capital Partners, which has a track record of raising money from Middle Eastern investors, including a $5.77bn investment last year by Abu Dhabi in Barclays itself. But, according to press reports, as the deal was ready to go down, Amanda Staveley, head of PCP, did not produce commitment letters from the actual investors themselves but rather from a special-purpose vehicle she managed. Fink and his advisers at Citigroup felt this wasn't good enough. With the clock ticking, Fink rounded up the money from PNC Financial Services Group (a long-time BlackRock investor); sovereign-wealth funds from Singapore, China and Kuwait; and Highfields Capital Management, a hedge fund. He did this within a 24-hour period, a classic demonstration of Fink's clout and determination.

Although the object of Fink's ambitions is the largest sponsor of ETFs—funds comprising of a basket of securities that trade throughout the day like individual stocks—BGI was not the first to offer them. In fact, it wasn't until 1996 that it created some ETFs which were strictly for institutional investors. This was three years after State Street Global Advisors and the American Stock Exchange had created the first ETF, the Standard & Poor's Depository Receipt, known as SPDR. State Street and Amex followed up with an S&P mid-cap index fund and then another to track the Dow Jones 30 Industrials. Sales were modest until the introduction of the ETF that tracks the Nasdaq 100, the famous QQQQ. It was tech-heavy and highly volatile, just what many investors wanted in the go-go 1990s.

Lee Kranefuss, who joined BGI in 1997 from the Boston Consulting Group, was eventually put in charge of BGI's small and struggling band of ETFs, all country funds then known as World Equity Benchmark Shares (WEBS). He simplified the technical aspects of managing them, rebranded them as iShares, made them exchange-listed, and began marketing them to institutional investors as well as individuals. In May 2000, BGI had only 17 iShares ETFs, accounting for less than $2bn in assets and perhaps 3% of the market. Today, BGI has more than 380 ETFs with a market value of roughly $425bn. (See "BGI: The Dominator Factor," FTSE Global Markets, March/April 2007.)

Notably, all iShares ETFs track established, third-party indices. Some, like those for an emerging market country, might be obscure but they are legitimate, recognised indices, not one contrived by BGI for marketing purposes. Nor does BGI sponsor any leveraged ETFs or inverse ETFs, both of which have come under increasing criticism recently. "I think they're very dangerous," says Mark Wilson, a vice president at The Tarbox Group, which manages just over $300m from its office in Newport Beach, California. "Leveraged ETFs allow you to make a good call and still end up with bad performance." The reason, as Wilson notes, is the ratchet effect. If a fund drops in value by 1%, it has to gain 1.11% to break even. In a fund leveraged three times, that 1% loss requires a 3.33% offsetting gain. "On a daily basis, this dynamic gets really bad. The fund is doing exactly what the sponsor said it would. It's just that when things go up and down again, you can have negative performance."

Inverse funds, which are designed to rise in a falling market, can also be treacherous. "Real estate ETFs are a perfect example," Wilson says. "On a daily basis, one leveraged fund did exactly what the sponsor said. So you would expect an 80% return because that's two times the inverse of the underlying index, which went down 40%. But instead the ETF was down something like 20% and that's why I worry about these leveraged and inverse funds. They are very dangerous to people's financial health."

True enough, but with payments due on $6.6bn in loans, will Fink be tempted to offer leveraged and inverse ETFs? What about tweaking some indices to soften or eliminate their bias towards big-cap funds? Some sponsors offer funds whose indices are weighted by dividends or even revenue growth rates. Here Fink might find some support among professional investors.

"A given ETF may not be as diversified as investors might think," explains Jim Tierney, head of Argus Investors' Counsel of Stamford, Connecticut. He notes that in some industries the top one or two companies dominate an index weighted by market capitalisation. Thus, an investment in an index comprising a dozen or more stocks is essentially an investment in just one or two stocks.

Another problem Fink faces is growing competition. At one time, iShares had 70% of the market. That's below 50% now, and it's almost certain to continue to fall as existing sponsors introduce new ETFs and newcomers enter the market. For example, Pacific Investment Management, which managed about $760bn and is a unit of Allianz SE, is launching a family of fixed-income ETFs. The first is the Pimco 1-3 Year US Treasure Index Fund, which competes directly with a $71bn iShares ETF. The Pimco fund has an annual expense ratio of 0.09% of assets compared with 0.15% for the iShares fund.

Fink can expect many more new competitors like this simply because the demand for ETFs is growing, evidently at the expense of traditional mutual funds. Although mutual funds are still far larger than ETFs—$10trn in combined assets at 20th June versus only $590bn for ETFs—the flow of funds pattern is clear. Mutual fund assets are declining and ETF assets are rising, and in some months it appears to be a roughly one-to-one ratio.

It's too soon to say that this indicates the ascendancy of indexing. But a definite trend is under way, although most professional investors warn against overstating the case. "The purchase of BGI by BlackRock is not a validation that passive investing has trumped active investing," says Dennis Clark, president of Advisor Partners, a San Francisco firm that manages $250m. "The validation is really threefold. One is that indexing will likely remain a key component of portfolios in the wealth-management arena as well as for large institutional accounts. Two, ETFs are a superior indexing vehicle. That's a huge trend and it will continue. Three, BlackRock with BGI will become a serious, dominant player with scale."

Chances are Fink would agree with all three points. He's already said that he doesn't believe indexing will supplant active management. Instead of managing a portfolio of 200 or 300 stocks, managers will limit themselves to fewer than 100 individual issues and use ETFs as a foundation—the beta, if you will, for their value-added alpha. That ETFs are a superior indexing vehicle is still debatable. Some managers use indexed mutual funds for certain asset classes because they are cheaper, and some institutional investors, such as the giant California Public Employees' Pension System (CalPERS), create their own basket of stocks to track specific indices. As for BlackRock Global Investors becoming "a serious, dominant player with scale", well, that will happen the day BlackRock folds BGI into its operations. Despite the debt burden and the growing competition, as long as Larry Fink is running BlackRock it will grow and prosper.

If a fund drops in value by 1%, it has to gain 1.11% to break even. In a fund leveraged three times, that 1% loss requires a 3.33% offsetting gain. On a daily basis, this dynamic gets really bad. The fund is doing exactly what the sponsor said it would. It's just that when things go up and down again, you can have negative performance.