A Unique Money Manager with Unique Challenges

By Dan Culloton
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BlackRock's great scale comes with great responsibility.

Morningstar recently issued a new Stewardship Grade for BlackRock. The firm's overall grade--which considers corporate culture, fund board quality, fund manager incentives, fees, and regulatory history--is a C. What follows is Morningstar's analysis of the firm's corporate culture, for which BlackRock receives a B. This text, as well as analytical text on the other four Stewardship Grade criteria, is available to subscribers of Morningstar's software for advisors and institutions: Morningstar Advisor Workstation(SM), Morningstar Office(SM), and Morningstar Direct(SM).

There has never been a money management firm like BlackRock. In fewer than 30 years the former unit of private equity firm Blackstone has used acquisitions and operational savvy to become the largest asset manager in the world, with $4.6 trillion in assets as of Dec. 31, 2015, and style-, vehicle-, strategy-, asset-class-, and globe-spanning capabilities. Its scale, breadth, expertise, and ambitions place it at the epicenter of most financial industry trends and debates. Local and national governments, sovereign wealth funds, and other institutional investors seek its input and advice and often use its risk-management tools. Achieving such prominence and influence through multiple transformational mergers when one such deal often has been enough to trip up rivals is, in itself, enough to signal a positive and resilient corporate character.

With great size and complexity, however, come great challenges and responsibilities. To be sure, BlackRock is endowed with the resources and will to satisfy many of them. There clearly are areas that need improvement, though. Its mutual funds, for example, still have below-average manager-retention rates and poor success ratios (the percentage of funds that survive and outperform their peers over three-, five-, and 10-year periods). Its investment management fees could be lower and manager ownership levels higher. A 2015 settlement of the Securities and Exchange Commission charges that the firm mishandled a former portfolio manager's conflict of interest also demonstrates the challenges of inculcating a fiduciary culture throughout an organization as large and complex as BlackRock.

Merger Master

Operational prowess is BlackRock's biggest asset. Nothing signifies that skill more than the way it has handled the mergers that have made it. Acquisitions have been the downfall of many money managers, but BlackRock has successfully navigated several--

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including buying Merrill Lynch Investment Management in 2006 and Barclays Global Investors and iShares in 2009. Insisting the combined entities conform to BlackRock's information technology platform and philosophy smoothed the bumps. The firm also has developed tools to bind its 12,000 employees in more than 70 offices around the globe.

BlackRock's Aladdin risk- and portfolio-management system serves as its central nervous system, and the BlackRock Investment Institute brings stylistically and geographically disparate investment teams together to share ideas. In early 2016, the firm also announced an executive reorganization designed to enhance global communication and collaboration; among other changes, it named new global fixed-income and multiasset heads and brought its quantitative and fundamental equity teams together in one active equity group.

Despite those changes, leadership at the top has been consistent. Chairman and CEO Larry Fink and president Rob Kapito were among the firm's eight founding partners. They are acutely aware that BlackRock's funds must perform for their institutional and retail clients if they want to flourish as a publicly traded company. Virtually every BlackRock executive Morningstar has met has emphasized the firm's fiduciary duty to clients and have listed faltering performance for clients among the worst of problems.

Tech Savvy

BlackRock leaders also stress the need to innovate and invest in technology. The firm has packaged for advisors some of the vaunted BlackRock Solutions asset-allocation and risk-management tools it sells to institutions and uses as its own IT backbone. In 2015, it rolled out a web-based iRetire tool harnessed to its Aladdin platform and bought FutureAdvisor, a "roboadvisor" that uses algorithms to deliver investing advice via the Internet. The firm also continues to spend on its quantitative and qualitative capabilities. It recruited academic Andrew Ang of Columbia University to help its factor-based investing efforts and data scientist Bill MacCartney from Alphabet GOOG to assist predictive computer model development, and it has lured other experienced fundamental managers and analysts to join its active equity and fixed-income teams.

The firm works hard to get its message across, and its voluminous reports, market commentaries, policy papers, and marketing materials are, for the most part, responsible. They draw on and emphasize BlackRock's range of abilities, global reach, institutional experience, and longer-term investment themes rather than specific products or short-term results. Fink and other executives have used the firm's market-leader status as a bully pulpit, weighing in on a wide variety of financial, fiscal, policy, and governance issues.

Maturing Market Leader

Although BlackRock is at the top of the heap, not all of it is at the top of its game. It is still a young firm; more than half of its employees have joined the company since 2008, just before its last transformational merger. As one former executive said, BlackRock is an adolescent in an industry of 55-year-old white males. That infuses it with energy and ideas, but that also means it is still developing.

Indeed, it can be hard for outsiders, and even insiders, to know what is going on across planet BlackRock. Early in 2016, for example, it announced its third leadership reshuffling since 2012. Among other moves, the firm said the former chief product officer and head of strategic product management, Rich Kushel, would replace Ken Kroner as the firm’s head of multiasset strategies and scientific active equity when Kroner retires this year. The announcement came about two months after Kroner met with Morningstar analysts and gave no indication of his intent to step down. The reorganization, which also includes naming prominent bond-fund manager Rick Rieder as global CIO of fixed income and combining the firm’s quantitative SAE team and bottom-up stock-picking crews into one active equity group, does not appear to have any immediate impact on individual investment squads and processes. Only time will tell, however, if the promotions and reassignments really enhance global integration or end up imposing change on particular investment approaches.

Lingering Concerns

In addition to relatively frequent corporate-organization-chart changes, investment personnel tenure and turnover remain a concern. In the United States, the firm’s average manager tenure and retention ratios have improved in recent years but still rank in the lower half of the top 20 U.S. mutual fund families. Its one-year retention rate of 91% and five-year retention rates of 88% rank 18th and 19th, respectively. The firm’s average manager tenure of 5.7 years is below the 8.3-year average for the top 20 U.S. firms, ranking 18th. It has attracted talented people but also has seen some notable departures, including former head of alpha strategies, Quentin Price, who announced his retirement in 2015 only to resurface later at Deutsche Asset Management. BlackRock’s emerging-markets long/short, Indian equity, U.S. stock, and London-based commodity, energy, and natural-resources teams also have seen turnover in the past year or so.

The performance of the firm’s active strategies also remains spotty. There are pockets of excellence, such as Nigel Bolton’s European equity team in London, Dennis Stattman’s Global Allocation group in Princeton, New Jersey, and Rieder’s fixed-income squad in New York, but it is not uniform. While a nearly seven-year-old revamp of the firm’s active fixed-income operations has begun to pay off, the firm’s active equity funds remain a work in progress. Fewer than half of the firm’s U.S. funds across all asset classes survived and outperformed their Morningstar Category peers on an absolute and risk-adjusted basis over the three-, five-, and 10-year periods ended December 2015. Nearly half of BlackRock funds sold around the globe that have Morningstar Analyst Ratings get Neutral or Negative Performance Pillar ratings.

Earnings Pressure

While aware of its duty to existing clients, the firm also is driven to acquire more of them, particularly in its wider margin retail business. The family is gradually changing the compensation structure of its wholesalers to reward those selling portfolio solutions rather than individual funds and strategies. Yet BlackRock remains a huge asset-gathering operation. It doesn't jump on every passing investment fad, yet there are few asset management trends it is not involved in. Its Strategic Product Management group that keeps tabs on the performance and investment and business rationale of its constantly evolving fund lineup, curbs strategy proliferation somewhat. Still, the firm launched dozens of new mutual funds globally in 2015, according to Morningstar's database, and when asked if anything is outside of the firm's circle of competence, BlackRock personnel often respond with a half-joking, "of course not, we're BlackRock." That could indicate can-do spirit or show hubris.

BlackRock has been more cost-conscious, continuing to cut fees on its core series of broadly diversified iShares funds and traditional index mutual fund lineup and waiving expenses on select active mutual funds. The firm does not aspire and is not likely to be a low cost leader, though. The pressure to increase sales and hold the line on fees point to BlackRock's ever-present challenge: balancing the interests of its fundowners and clients with those of its equity shareholders. Nearly all asset-management firms wrestle with this, including privately held ones. BlackRock's rapid growth and strong corporate execution, however, have conditioned public shareholders to expect industry-leading margins, and consistent dividend growth and share-price returns.

BlackRock is one of a kind but is still working on being the best of all kinds of money managers.