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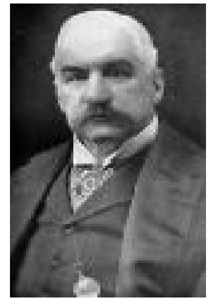
Finance Capitalism 2.0:
How BlackRock became the new JP Morgan

Jerry Davis
LERA Conference
January 7, 2012

Changes in US corporate ownership

Or, how did we get from here…



J. Pierpont Morgan

…to here…

Abigail Pierrepont Johnson

…to here…

?????

…and how does it matter?

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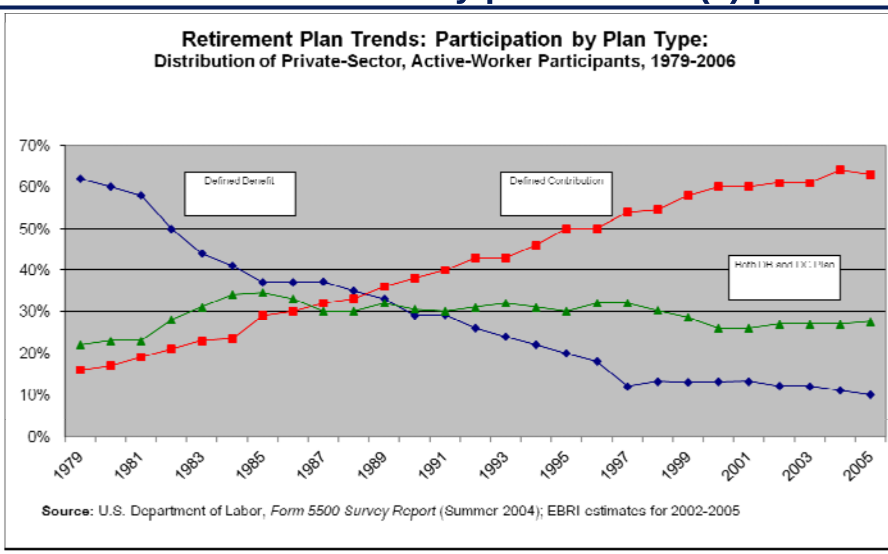
Most employers abandoned traditional company pensions in favor of relatively portable 401(k) plans



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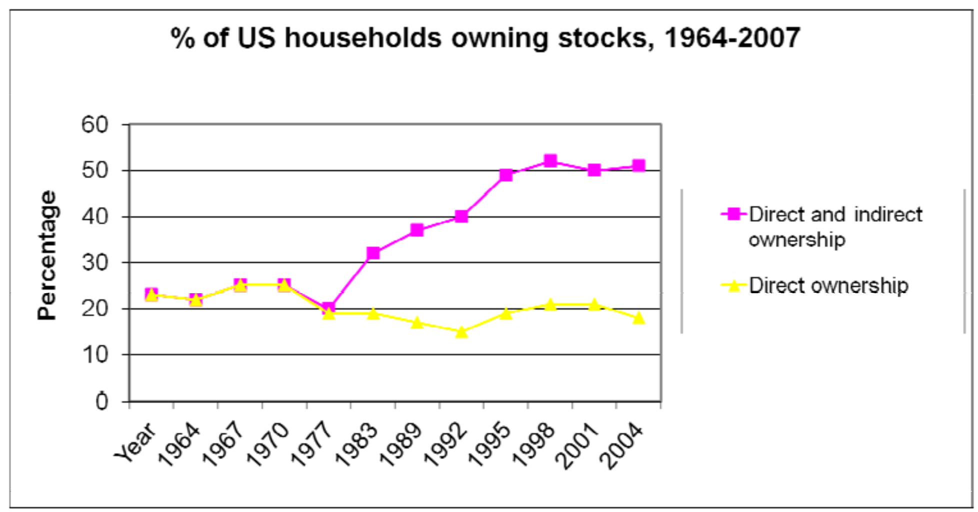
As a result, households became increasingly invested in the stock market during the 1980s and 1990s



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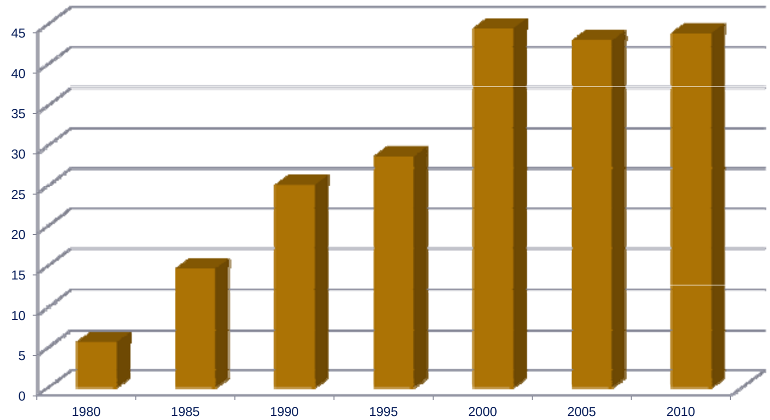
Source: Federal Reserve *Survey of Consumer Finances* (various years)

Specifically: investors in mutual funds



Proportion of US households owning mutual funds

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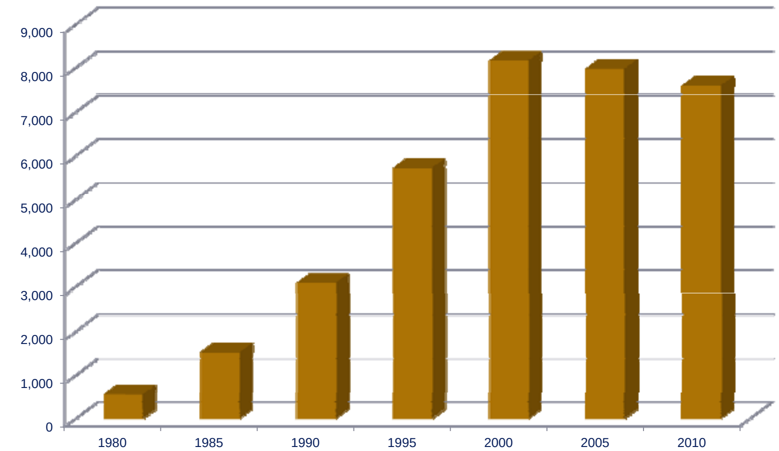
Source: Investment Company Institute 2011 *Investment Company Fact Book*

There are many more US mutual funds now



Number of US mutual funds

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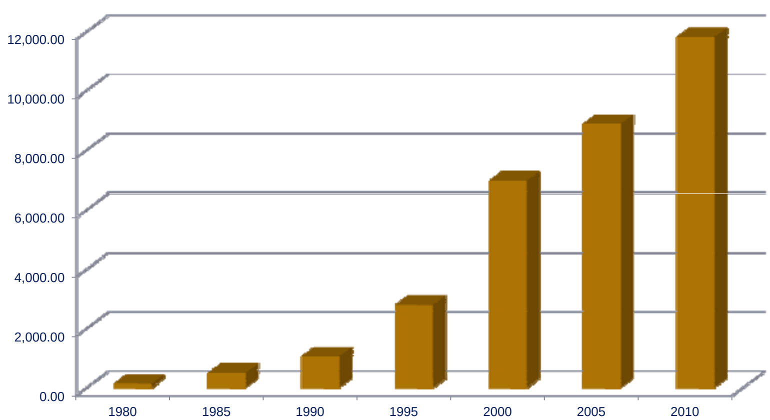
Source: Investment Company Institute 2011 *Investment Company Fact Book*

And they gathered a lot of assets



Billions of dollars in assets held by US mutual funds

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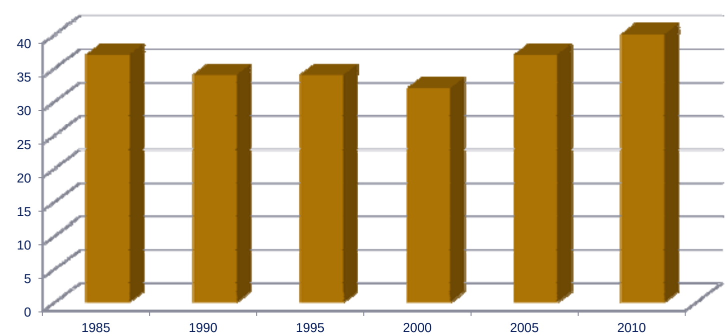
Source: Investment Company Institute 2011 *Investment Company Fact Book*

But name brand funds got most of the benefit

Fidelity Investments · Vanguard · American Funds · T.RowePrice Invest with Confidence · Janus

Market share of top 5 fund complexes



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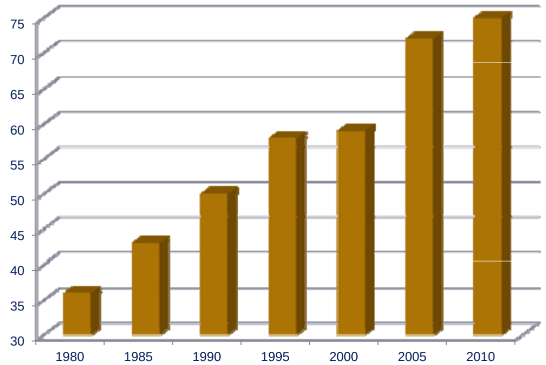
Source: Investment Company Institute 2011 *Investment Company Fact Book*

Leaving US corporate ownership largely “intermediated” by a few mutual funds



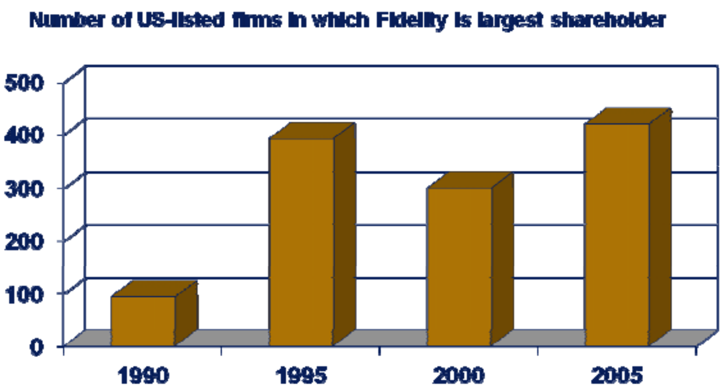
Mean ownership by institutional investors of 1000 largest US corporations

Corporate ownership by mutual funds

- 1950: 3%
- 1990: 8%
- 2005: 28%

Source: Spectrum 13F database, various years

Fidelity is now the largest shareholder of one in ten US corporations

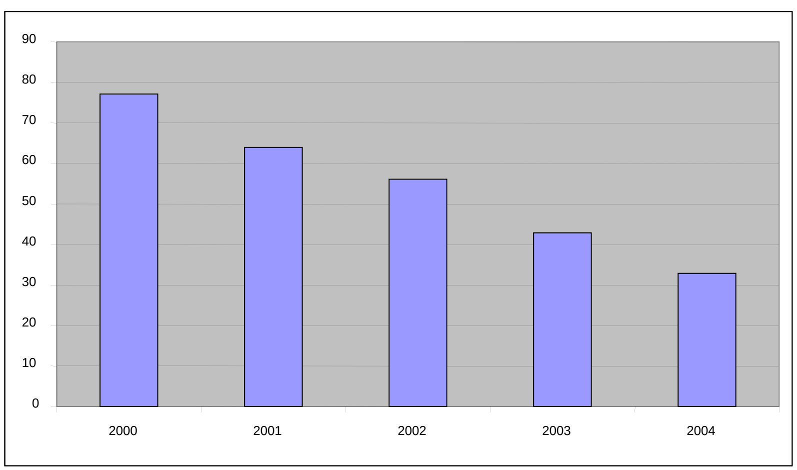


# of listed firms in US	3833	5187	5828	4423

Source: *Spectrum* 13F and 13G databases, various years

How long does Fidelity hold on to “large” blocks?

Of those firms in which FMR owned 5% or more at the end of 1999, how many did it still hold in…



Q: How do funds vote on shareholder governance proposals?

FUND FAMILY	For Independent Board Chair	Require Vote on Pill	Expense Options	Declassify Board	Vote on Parachute	Allow Cumulative Voting	TOTAL
Fidelity	No (0)	Split (73)	No (0)	Yes(93)	No (8)	Abstain (0)	33
Vanguard	No (0)	Split(45)	Yes (100)	Yes (100)	Split (50)	No (0)	51
Putnam	No (0)	Yes (94)	Split (22)	Yes (92)	Split (80)	No (0)	47
AIM	No (10)	Split (80)	Split (22)	Yes (88)	Split (26)	Split (82)	54
T. Rowe	Split (54)	Split (84)	No (2)	Yes (100)	Split (82)	Split (70)	67
American	No (7)	Yes (100)	Yes (100)	Yes (100)	Split (30)	Yes (98)	70
Franklin	Split (77)	Yes (94)	Split (76)	Yes (100)	Split (41)	Yes (88)	78
Janus	Split (62)	Split (83)	Split (71)	Split (75)	Split (68)	Yes (91)	74
Morgan Stanley	No (0)	Split (82)	Yes (95)	No (7)	Split (44)	No (11)	43
Oppenheimer	No (12)	Yes (90)	Yes (86)	Yes (100)	No (0)	No (13)	53
CalPERS	Yes (100)	Yes (100)	Abstain (0)	Yes (100)	Yes (100)	Yes (100)	86
CREF	No (8)	Yes (100)	Yes (100)	Yes (100)	Split (41)	No (0)	62

A: The more pension business they do with companies, the more likely they are to vote with management on shareholder-sponsored proposals

Source: Davis and Kim, *Journal of Financial Economics* 2007

Top 5 blockholders of NYSE-listed firms, 2000-2005

2000	2001	2002	2003	2004	2005
Fidelity (320)	Fidelity (369)	Fidelity (416)	Fidelity (427)	Fidelity (434)	Fidelity (464)
DFA (299)	DFA (277)	DFA (260)	Barclays (264)	Barclays (307)	Barclays (345)
Capital Res. (224)	Capital Res. (161)	Capital Res. (207)	DFA (228)	DFA (211)	DFA (209)
AXA (134)	AXA 135)	Wellington (163)	Capital Res. (201)	Wellington (183)	Capital Res. (185)
Wellington (126)	Wellington (155)	AXA (142)	Wellington (187)	Capital Res. (175)	Wellington (166)

Fast forward: Who were the biggest blockholders in 2011?

Owner	# of 5% stakes in US-listed companies
BlackRock	1803
Fidelity	677
Vanguard	524
Dimensional Fund Advisors	428
T. Rowe Price	362

WTF?

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The composition of American equity markets has changed radically over the past decade

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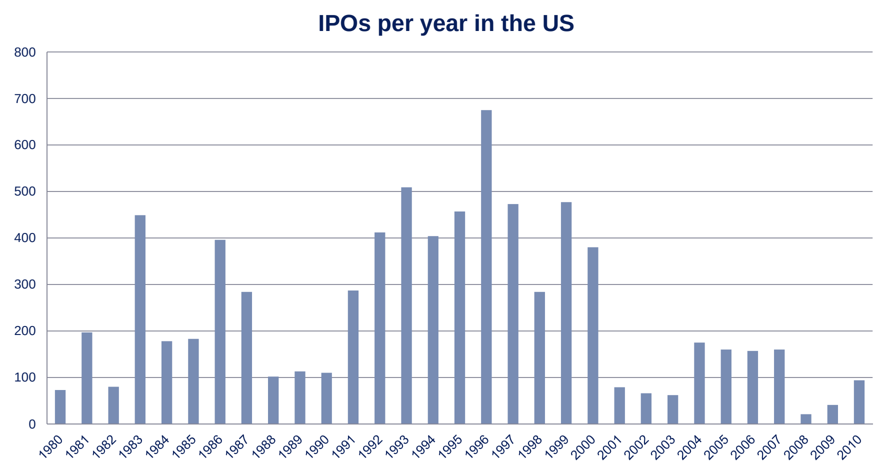
The “going public” fad of the 1990s is long gone



Source: Jay Ritter, University of Florida

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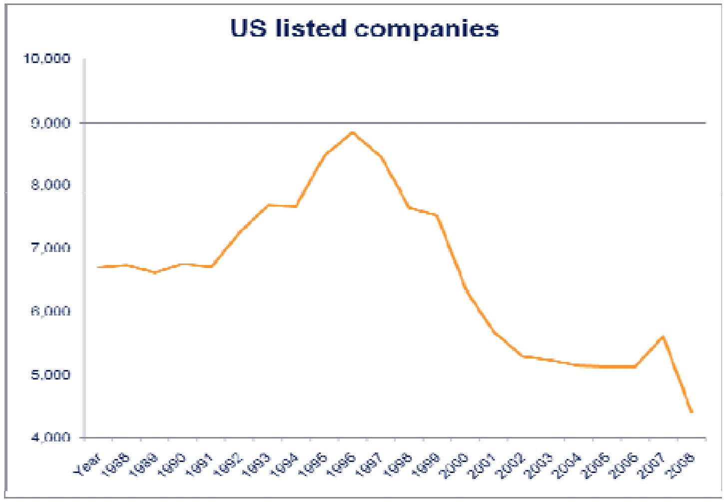
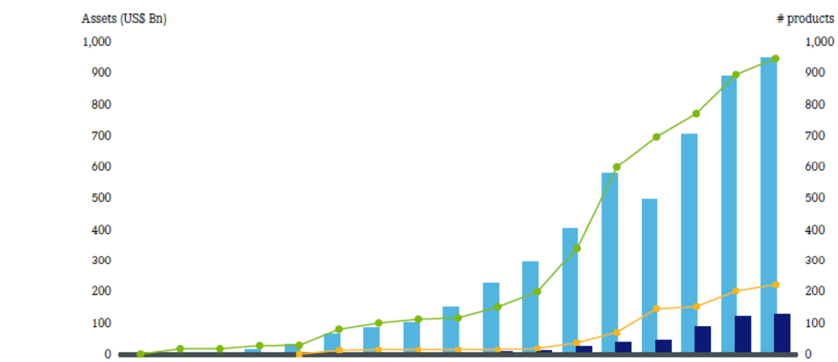
As a result, the number of public corporations in the US has dropped by over *half* since 1997…



Source: World Bank *World Development Indicators 2010*

…while the number of Exchange Traded Funds (ETFs) has increased 50 fold

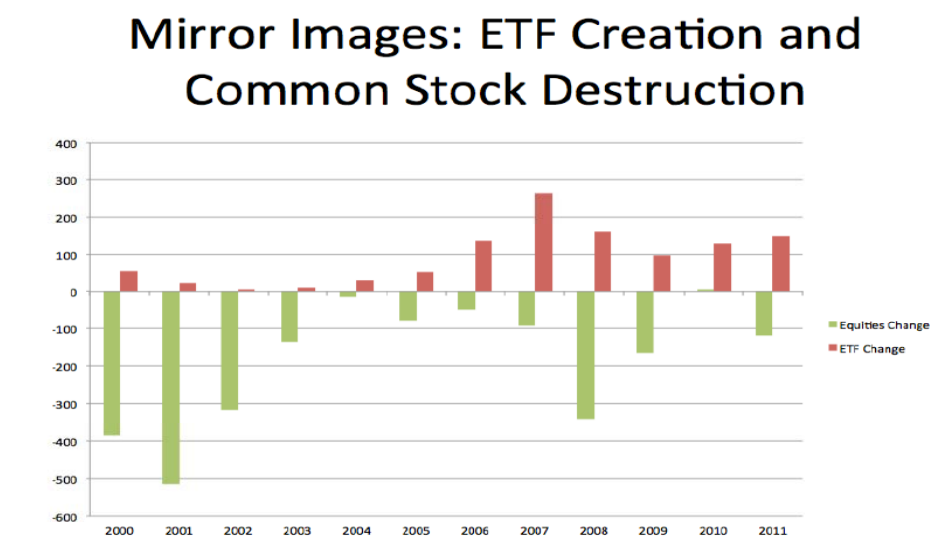
Figure 55: United States listed ETF and ETP asset growth



Assets (US$ Bn)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1-11
ETF assets	$1.1	$2.4	$6.7	$15.6	$33.9	$65.6	$84.6	$102.3	$150.7	$227.7	$299.4	$406.8	$580.7	$497.1	$705.5	$891.0	$950.0
ETP assets	–	–	–	–	$2.0	$5.0	$3.8	$4.0	$6.1	$8.9	$14.4	$25.9	$40.5	$45.3	$88.1	$120.8	$129.8
ETF/ETP total	**$1.1**	**$2.4**	**$6.7**	**$15.6**	**$35.8**	**$70.6**	**$88.4**	**$106.3**	**$156.8**	**$236.6**	**$313.8**	**$432.8**	**$621.2**	**$542.5**	**$793.6**	**$1,011.9**	**$1,079.8**
# ETFs	2	19	19	29	30	81	101	113	117	152	201	343	601	698	772	896	949
# ETPs					2	14	17	17	17	17	20	38	72	146	153	203	224

Source: BlackRock *ETF Landscape Industry Review, Q1 2011*

Chart 1: U.S. Exchange Listed Companies and U.S. Exchange Listed ETF Growth



Source: Congressional testimony of Harold Bradley, 10/19/11

Should we worry about ETFs?

- ETFs account for roughly *half* of all trading in US equities markets today
- With ~4300 listed domestic companies and 1100 ETFs comprised of indices of these stocks, price movements have become increasingly correlated:
  - "**Stocks move together today more than at any time in modern market history**…When individual common stocks increasingly behave as if they are derivatives of frequently traded and interlinked ETF baskets, then it is trading in the ETFs that is driving the prices of the underlying stocks rather than the other way around" (Bradley and Litan, 2011)
  - In short: stock prices are highly volatile and often detached from fundamentals

The New York Times Reprints

December 30, 2011

When Investors Rush In, and Out, Together

By GRAHAM BOWLEY

It seems that anxious investors in these troubled economic times are seeking safety in crowds.

The prices of stocks, bonds and a host of other financial assets, which in normal conditions more often than not move in a diversity of unpredictable directions, are increasingly surging up or down in lockstep.

The rise in correlation between individual stocks, but also between completely separate asset classes like stocks and gold or stocks and oil, "has been one of the big themes of the investment climate this year," said Marc Chandler, a market strategist at Brown Brothers Harriman in New York.

The chief explanation for the correlation is the great uncertainty facing investors — mainly over the crisis in Europe, which has raised the specter of the potential bankruptcy of governments and a collapse of the banking system.

With every bit of bad news, nervous investors around the globe have been selling many of their positions across all asset classes, no matter what they are, driving prices down, and rushing into perceived safe havens like cash and United States bonds. But sometimes just a day or so later, with a glimmer of hope that Europe is pulling away from the abyss or that the United States is picking up steam, newly optimistic investors turn around and rush back from cash into harder assets, like stocks, foreign bonds or commodities, pushing prices higher together.

"When things are less stressed, stocks and other investments move according to other more fundamental factors like a company's earnings or its balance sheet," said Maneesh Deshpande, managing director for global equity derivatives strategy at Barclays Capital. "But when macro fears take over, they move in flocks."

The new king of the hill: BlackRock

- BlackRock has $3.5 trillion in assets under management
- BlackRock's iShares funds have a 47.4% market share of ETF AUM in the US
- As of 2011, BlackRock owns 5% or more of over 1800 US corporations (i.e., 42% of all traded companies)
- BlackRock is the **single largest shareholder** of **one in five** US corporations, including
  - ExxonMobil, Chevron, GE, IBM, AT&T, Verizon, JP Morgan Chase, Marathon…and over 800 others

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U.S. Securities and Exchange Commission

SEC Adopts New Measures to Facilitate Director Nominations by Shareholders

FOR IMMEDIATE RELEASE
2010-155

Washington, D.C., Aug. 25, 2010 — The Securities and Exchange Commission today adopted changes to the federal proxy and other rules to facilitate the rights of shareholders to nominate directors to a company's board.

Video: Open Meeting

Chairman Schapiro discusses proxy access: Windows Media Player QuickTime

Text of Chairman's statement

Additional Materials

- Adopting Release

The new rules require companies to include the nominees of significant, long-term shareholders in their proxy materials, alongside the nominees of management. This "proxy access" is designed to facilitate the ability of shareholders to exercise their traditional rights under state law to nominate and elect members to company boards of directors.

Under the rules, shareholders will be eligible to have their nominees included in the proxy materials if they own at least 3 percent of the company's shares continuously for at least the prior three years.

"As a matter of fairness and accountability, long-term significant shareholders should have a means of nominating candidates to the boards of the companies that they own," said SEC Chairman Mary L. Schapiro. "Nominating a director candidate is not the same as electing a candidate to the board. I have great faith in the collective wisdom of shareholders to determine which competing candidates will best fulfill the responsibilities of serving as a director. The critical point is that shareholders have the ability to make this choice."

Under the new proxy rules, BlackRock would have been eligible to nominate directors at well over *half* of all public corporations in the US by 2013…

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United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued April 7, 2011 Decided July 22, 2011

No. 10-1305

BUSINESS ROUNDTABLE AND CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA,
PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION,
RESPONDENT

On Petition for Review of an Order
of the Securities & Exchange Commission

…but the Business Roundtable and the Chamber of Commerce got the rule vacated…

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2. Shareholders with Special Interests

The petitioners next argue the Commission acted arbitrarily and capriciously by "entirely fail[ing] to consider an important aspect of the problem," *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43, to wit, how union and state pension funds might use Rule 14a-11. Commenters expressed concern that these employee benefit funds would impose costs upon companies by using Rule 14a-11 as leverage to gain concessions, such as additional benefits for unionized employees, unrelated to shareholder value. The Commission insists it did consider this problem, albeit not *in haec verba*, along the way to its conclusion that "the totality of the evidence and economic theory" both indicate the rule "has the potential of creating the benefit of improved board performance and enhanced shareholder value." 75 Fed. Reg. at 56,761/1. Specifically, the Commission recognized "companies could be negatively affected if shareholders use the new rules to promote their narrow interests at the expense of other shareholders," *id.* at 56,772/3, but reasoned these potential costs "may be limited" because the ownership and holding requirements would "allow the use of the rule by only holders who demonstrated a significant, long-term commitment to the company," *id.* at 56,766/3, and who would therefore be less likely to act in a way that would diminish shareholder value. The Commission also noted costs may be limited because other shareholders may be alerted, through the disclosure requirements, "to the narrow interests of the nominating shareholder." *Id.*

…in part because unions and state pension funds could misuse it to pursue their "narrow interests"

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Conclusion: Everything we thought we knew about American stock markets is no longer true

- Markets are less informationally efficient because co-movements in prices of firms in the same indices obscure individual differences
- Due to ETF-induced price volatility, US stock markets are no longer inviting to new issues
- Ownership of individual corporations is no longer highly dispersed
- Prospects for control of corporations by financial institutions has never been this high in a century
- **Stay tuned for Finance Capitalism 2.0!**

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Our Stockholders

Thankfully, markets always go up eventually…

S&P500
1/3/00:
$1469.25
Yesterday:
$1277.81