BEHIND BLACKROCK'S ESG SHIFT

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EXECUTIVE SUMMARY

Over the past two years, BlackRock has taken steps to reorient and redefine its identity, shifting from a brand deeply rooted in the concept of index investing to a brand whose foundation is ESG, or environmental, social, and governance investing.

This paper examines the consequences of BlackRock's shift, especially for public pension funds. Our major conclusions are these:

- **High-Fee Forecaster** – BlackRock's shift toward ESG investing imperils returns for its clients, which include many public pension funds. Over time, BlackRock will look less like a low-fee, efficient index provider and more like a higher-fee forecaster of economic and social trends, with a bias toward stocks and bonds that meet its new ESG bias.
- **Adversely Affecting Public Pension Funds** – Making ESG investing the very foundation of its investing strategy, BlackRock repudiates the Efficient Market Hypothesis that is the core of its index investing franchise. Instead, BlackRock takes the position that the pricing of many stocks does not properly reflect the risks of climate change. Following such a strategy may be fine for some asset managers, but managers of public pension funds will have to explain to retirees that their money is being wagered on a particular ideological and social view rather than invested according to an established, time-proven methodology.
- **Inevitable Consequence: Lower Returns** – By increasing the importance of social and environmental investing in its clients' portfolios, BlackRock has created a major distraction from the focus of achieving the highest risk-adjusted returns for its client. The inevitable consequence will be lower long-term returns. Research has consistently indicated that conventional index portfolios outperform ESG portfolios.
- **Outsized Influence on Corporate Policy** – The shift also indicates that BlackRock will try to take a more active role in influencing corporate policy through proxy voting and direct advocacy. That, too, is bad news for pension funds. BlackRock is among the top five shareholders in most large corporations, so it has a lot of clout. Businesses run best when they are run by their own managers rather than being pressured in their governance by investment funds.
- **BlackRock's ESG Strategy: A Marketing Ploy with Higher Fees** – Because the shift puts BlackRock's own franchise at risk, why the change? A major reason is that index investing has become intensely competitive, putting the firm's returns in jeopardy. ESG investing permits much higher fees. (BlackRock's iShares Global Clean Energy ETF, one of the largest ESG funds in the world, carries an expense ratio 11 ½ times as great as the expense ratio for BlackRock's S&P 500 ETF.) In addition, BlackRock may see an emphasis on ESG as beneficial in drawing new customers by differentiating the firm from other index-portfolio specialists such as State Street and Vanguard.
- **Pension Officials Should Think Twice about BlackRock** – While BlackRock may perceive the shift in its own interests, pension fund leaders must consider whether the shift is in the best interests of its own current and future retirees.

BACKGROUND

BlackRock, founded in 1988 by Larry Fink, a mortgage-bond trader, is the world's largest private asset manager. The company went public in 1999 and currently holds about $6.5 trillion in assets for its global clients. Some of BlackRock's most important clients are public, union, and private pension funds. The firm manages about $4 trillion in assets for these and other institutional clients, which include governments, sovereign wealth funds, foundations and family offices.[1]

> "BlackRock is among the top five owners in nearly every major global company – and thus holds among the top five voting blocs of shares in those companies."

Through its sheer size, BlackRock has an enormous influence on the governance of U.S. and global business, an influence exerted both through proxy voting and direct intervention. For example, BlackRock is the third-largest shareholder in Apple, with roughly $60 billion worth of the tech company's shares,[2] and in Chevron, with about $10 billion in holdings. In fact, BlackRock is among the top five owners in nearly every major global company – and thus holds among the top five voting blocs of shares in those companies.

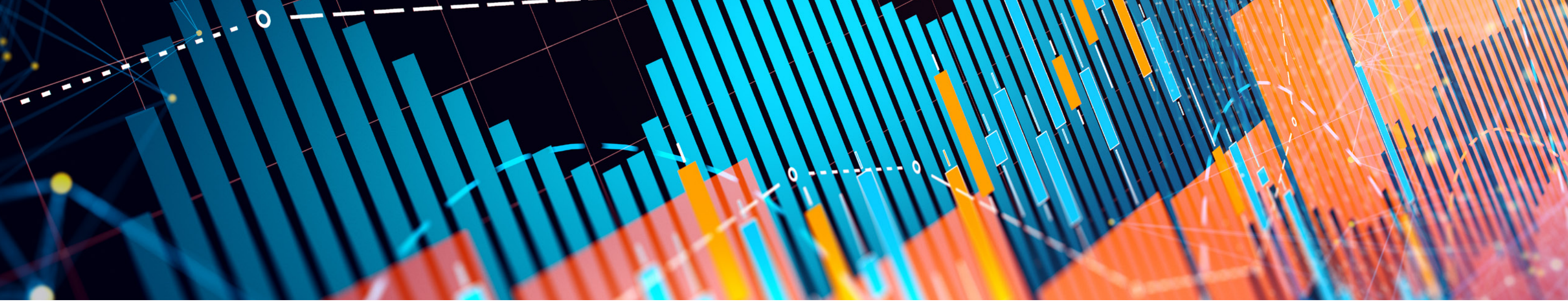
ESG INVESTING

In January 2018, Fink drew wide attention with a letter telling CEOs they must do more than just make profits. "Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."[3]

Despite all the attention it gained, the 2018 letter was short on specifics. A separate letter published by Fink in 2020, however, focused more directly on sustainability and climate change, which, he wrote, are creating a "fundamental reshaping of finance."[4] In a separate letter to clients this year, the BlackRock Global Executive Committee, headed by Fink, argued that "sustainability" is the very foundation of the company's investment strategy.[5]

BlackRock defines sustainability as "understanding and incorporating environmental, social and governance (ESG) factors into investment analysis and decision-making." As the headline to that letter stated, "Sustainability is BlackRock's New Standard for Investing."

1 https://www.blackrock.com/institutions/en-axj/our-client
2 https://money.cnn.com/quote/shareholders/shareholders.html?symb=AAPL&subView=institutional
3 http://www.corporance.es/wp-content/uploads/2018/01/Larry-Fink-letter-to-CEOs-2018-1.pdf
4 https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter
5 https://www.blackrock.com/corporate/investor-relations/blackrock-client-letter



STEPS TO PROMOTE SUSTAINABILITY

The 2020 client letter and an accompanying fact sheet laid out several promises:

- First, BlackRock will make "ESG funds the standard building blocks in multi-asset solutions such as model portfolios."
- Second, the firm will reduce the supposed ESG risk in actively managed portfolios. Analysts who determine the composition of active portfolios will consider "ESG risk with the same rigor" they use in analyzing "traditional measures such as credit and liquidity risk."
- Third, BlackRock says it is "in the process of removing from our discretionary active investment portfolios" stocks and bonds of "companies that generate more than 25% of their revenues from thermal coal production." The goal is to complete this purge by mid-2020.
- Fourth, BlackRock will launch "new ESG-oriented investment products, as well as those that screen fossil fuels."
- Finally, BlackRock promised to strengthen its "commitment to sustainability and transparency" in the firm's "investment stewardship activities," an apparent reference to proxy voting and other kinds of pressure.

ESG FUNDS AS THE STANDARD

BlackRock is a packager and marketer of index portfolios. It does not determine their contents, which are calculated by other companies such as Standard & Poor's, Russell, or MSCI. In addition to its index business, BlackRock also has a smaller business in retail actively managed funds, where human managers make decisions on what to buy and sell. Total managed-fund assets sold to the public as of March 31 were $609 billion.[6] In addition, BlackRock manages non-public portfolios for institutions, the majority of its business. Those portfolios are not transparent; as we noted, they are overwhelmingly index portfolios, but include managed portfolios as well.

Currently, minimal BlackRock assets are invested in ESG portfolios. Although BlackRock does not reveal the make-up of its institutional portfolios, for its public funds (mainly iShares exchange-traded index funds, or ETFs) ESG assets amount to approximately 1% of the total. There are only six ESG ETFs with more than $1 billion in assets, and five are iShares products.[7]

BlackRock says it wants to double the number of ESG products it offers worldwide and make those portfolios the "building blocks" of client asset holdings. The firm also wants to establish new models that "will use environmental, social, and governance (ESG)-optimized index exposures in place of traditional market cap-weighted index exposures. Over time, we expect these sustainability-focused models to become the flagships themselves."[8]

In other words, rather than weighting stocks in a portfolio by market capitalization (the biggest companies carry the most influence), BlackRock will somehow weight them by ESG factors or a combination of ESG and size. How this will work is unknown. Owning a cap-weighted index of the German market is something that managers of pension funds can understand and can deploy in their portfolios; owning an index of the German market weighted by ESG factors is much less transparent.

6 https://s24.q4cdn.com/856567660/files/doc_financials/2020/Q1/BLK-1Q20-Earnings-Release.pdf
7 https://www.marketwatch.com/story/doubling-down-on-sustainability-blackrock-ishares-planning-major-esg-etf-expansion-2020-01-15?mod=investing
8 https://www.blackrock.com/us/individual/blackrock-client-letter

SHORTFALLS OF ESG INVESTING

Research has consistently indicated that conventional index portfolios outperform ESG portfolios, partly because ESG portfolios charge higher fees. A Pacific Research Institute study last year, for example, analyzed 18 public ESG funds with a 10-year track record and concluded that a $10,000 ESG portfolio would be 43.9% smaller compared to an investment in a broader S&P 500 index fund. Just two ESG funds beat the S&P fund over a 10-year period.[9]

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Public pension funds that are focused – as they should be – on achieving the best risk-adjusted returns for their members should be wary of BlackRock’s new emphasis.

In a 2016 paper, Alicia Munnell, a former Treasury Department official under President Clinton and now director of the Center for Retirement Research at Boston College, and her colleague Anqi Chen, concluded: “While social investing raises complex issues, public pension funds are not suited for this activity. The effectiveness of social investing is limited, and it distracts plan sponsors from the primary purpose of pension funds – providing retirement security for their employment.”[10]

BlackRock, by contrast, is now trying to increase the importance of social and environmental investing in its clients’ portfolios. The inevitable consequence is the distraction to which Munnell refers. Retirement security will no longer be the sole, or perhaps even the primary, purpose of pension funds that invest with BlackRock.

ACTIVE AND PASSIVE PORTFOLIOS

Actively managed (that is, non-index) portfolios represent about one-fourth of BlackRock’s total assets. If active portfolios were concentrated in a separate firm, it would still be one of the top ten asset managers in the world.[11]

BlackRock’s focus on ESG risk will not directly affect its current index investments, which are automatic components of portfolios by virtue of their size, home country, or sector. Still, by making dramatic divestments and other changes to its active portfolios, BlackRock will gain attention as an ESG-oriented firm, differentiating it from competitors. BlackRock will also be increasing the number of its ESG portfolios, both active and passive.

In its client letter, BlackRock makes reference to portfolios that screen (that is, bar) companies involved in fossil fuels. Environmental groups in the past have urged BlackRock to use its clout to have fossil-fuel producers and users eliminated from indexes. Eli Kasargod-Staub, executive director of the climate advocacy group Majority Action, was quoted by Bloomberg as saying that BlackRock needs “to pressurize index providers to remove producers from the indexes.”[12]

Can BlackRock convince research firms to adjust their primary indexes? There does exist a mutual fund that offers the market benchmark minus energy companies, but it has only $16 million in assets. ProShares S&P 500 Ex-Energy, founded in 2016, owns the entire S&P 500 without its two dozen or so energy companies.[13] Such an approach could become a model for BlackRock.

9 https://www.pacificresearch.org/new-study-finds-esg-funds-underperform-broader-investment-funds-over-long-term/
10 http://crr.bc.edu/wp-content/uploads/2016/11/slp_53.pdf
11 https://www.valuewalk.com/2019/07/top-10-largest-asset-management-companies/
12 https://www.bloomberg.com/news/articles/2020-01-14/blackrock-s-holdings-in-thermal-coal-companies-table
13 https://www.morningstar.com/etfs/arcx/spxe/quote

INVESTMENT STEWARDSHIP

Although the stocks it manages are owned by others, BlackRock decides proxy votes for most of the shares. The firm has tremendous clout, and it can probably gain more attention and perhaps have more influence through proxy voting than through divestment of certain energy holdings and other steps it proposes. On Jan. 28, shortly after BlackRock issued its client letter, State Street Global Advisors, a giant competing asset manager that stresses index investing, said it was "prepared to take voting action against board members at companies in the major stock-market indexes that have been 'consistently underperforming' peers in the asset manager's ESG performance scoring system."[14]

In its client letter for 2020, BlackRock's management noted that the firm "recently joined Climate Action 100+," which is a group of investors that seek "to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change."[15]

This prospect of increased ESG activism does not bode well for public pension funds because it means companies will be under pressure to meet an ideological and social agenda that may divert them from their main goals and thus suppress their returns. Businesses run best when they are run by their own managers rather than succumbing to pressure in their governance by large investment funds. This is especially true for funds that own shares in thousands of companies and thus have to make their proxy-voting decisions through one-size-fits-all policies rather than firm-specific considerations.

THE MOTIVATING FACTOR

These changes represent a reorientation of BlackRock's investment philosophy. That philosophy today is based on a simple, broadly accepted foundation, the Efficient Market Hypothesis (EMH), which holds that today's share price reflects all possible information and that, "because of the randomness of the market, investors could do better by investing in a low-cost, passive portfolio."[16]

That is BlackRock's current business. Its reputation is based not on its ability to pick stocks or see the future but to provide low-cost index investments efficiently. Unfortunately, index investing is a commodity business, with competition from firms like State Street and Vanguard, which also offer undifferentiated funds at wafer-thin margins. For example, BlackRock's S&P 500 exchange-traded fund (ETF) charges 0.04% in expenses; Vanguard's S&P 500 ETF charges 0.03%. Both funds have exactly the same components.

> "BlackRock is saying, in effect, that the market does not recognize the threat of climate change in its pricing; therefore, BlackRock will make investments that correct this "mistake." This is an approach we see frequently in markets, but rarely from a firm so dependent on index investing."

14 https://www.bloomberg.com/news/articles/2020-01-28/state-street-tells-companies-esg-moves-are-no-longer-optional
15 http://www.climateaction100.org/
16 https://www.investopedia.com/terms/e/efficientmarkethypothesis.asp

The firm is now proposing to take steps completely counter to the EMH, which is blind to the policies and practices of individual companies. BlackRock is saying, in effect, that the market does not recognize the threat of climate change in its pricing; therefore, BlackRock will make investments that correct this "mistake." This is an approach we see frequently in markets, but rarely from a firm so dependent on index investing.

One likely explanation for Fink's shift is to increase profitability. ESG portfolios – even ESG index portfolios -- traditionally carry higher expense ratios than other funds. We do not have access to BlackRock's fee schedules for its institutional clients, which are proprietary, but anyone can see the difference in BlackRock's public funds. For example, BlackRock's iShares Global Clean Energy ETF, one of the largest ESG funds in the world, carries an expense ratio of 0.46%[17] - 11 ½ times as great as the expense ratio for BlackRock's iShares Core S&P 500 ETF, which is linked to the popular large-cap benchmark. BlackRock's iShares MSCI KLD 400 Social ETF, based on one of the oldest social indexes, carries an expense ratio of 0.25%,[18] more than eight times that of the BlackRock's S&P 500 ETF.[19] For the 10 years ending May 8, the S&P 500 ETF outperformed the Clean Energy ETF by an annual average of more than 13 percentage points and the KLD 400 ETF by 0.7 percentage points. Because of compounding over time, even that small difference becomes significant. An investment of $10,000 became $30,423 invested in the KLD 400 ETF but $32,352 in the S&P 500 ETF, according to Morningstar.[20]

An ESG shift would both allow BlackRock to charge higher fees and, from a marketing perspective, distinguish it from competitors like Vanguard, State Street, and Fidelity. The shift may be BlackRock's only palatable choice. Right now, the large indexers are in a race to the bottom. BlackRock's quarterly earnings fell for four quarters in a row on a year-by-year basis between the fourth quarter of 2018 and the third quarter of 2019.[21]

SIGNIFICANCE FOR PUBLIC PENSION FUNDS

Judging from Fink's letters, we can only conclude that the world's largest asset manager wants the public to view it as a firm deeply concerned with climate change and ESG investing. Those may be admirable pursuits, but for public pension funds, the BlackRock shift is a red flag. It is an indication that BlackRock is adopting a goal for its investing decisions outside of the goal of the best returns for shareholders.

Maximizing two such goals is impossible, but BlackRock argues that ESG investing recognizes risks that the market as a whole does not. This is a hubristic notion that runs directly counter to the philosophy and strategy of index investing, which has been BlackRock's franchise.

> "BlackRock, over time, will look less like a low-fee, efficient index provider and more like a higher-fee forecaster of economic and social trends."

What is the reason for BlackRock's shift? It could be a sincere recognition that the market does not know how to price the prospects of climate change and the policy changes that may jeopardize earnings or the very existence of some businesses in the future. It could be that Fink sees a market niche that is so far not being adequately filled by large asset managers. Or, it could be that he has to respond in some way to the race to the bottom among similar firms. Cutting fees lower and lower is not a good way to boost returns for stockholders, but finding a way to increase those fees may be.

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17 https://www.morningstar.com/etfs/xnas/icln/quote
18 https://www.morningstar.com/etfs/arcx/dsi/quote
19 https://www.morningstar.com/etfs/arcx/ivv/performance
20 https://www.morningstar.com/etfs/arcx/dsi/quote
21 https://ir.blackrock.com/financials/quarterly-results/default.aspx

In the end, the motivation is less important than the result, which is that BlackRock, over time, will look less like a low-fee, efficient index provider and more like a higher-fee forecaster of economic and social trends. There is a place for such asset managers, to be sure. But if you are running a public pension fund, how comfortable are you explaining to current and future retirees that their money is being wagered on a particular ideological and social view rather than invested according to an established, time-proven methodology?

CONCLUSION

BlackRock is a phenomenon in the investing world. In little more than 30 years since its founding, it has become the largest asset manager by developing an efficient, low-fee index-investing business. However, BlackRock is in a highly competitive niche. While the median equity mutual fund carries an expense ratio of 1.15%,[22] BlackRock can charge only 0.03% for its most popular exchange-traded fund, linked to the S&P 500 index. It makes sense for BlackRock to shift its strategy toward a sector where fees are traditionally much higher: ESG investing.

> “While ESG investing may be more advantageous for BlackRock, it is dangerous for BlackRock’s clients, especially public pension funds - many of which are suffering shortfalls from long-term underfunding and the recent challenges of COVID-19 and volatile global markets. The shift to ESG will inevitably raise fees, and it will distract BlackRock from contributing to the main goal of every pension fund: securing the highest risk-adjusted returns for its members.”

While ESG investing may be more advantageous for BlackRock, it is dangerous for BlackRock’s clients, especially public pension funds - many of which are suffering shortfalls from long-term underfunding and the recent challenges of COVID-19 and volatile global markets.[23] The shift to ESG will inevitably raise fees, and it will distract BlackRock from contributing to the main goal of every pension fund: securing the highest risk-adjusted returns for its members.

Furthermore, BlackRock, which is typically the second-, third-, or fourth-largest shareholder in most large corporations (number-two, for example, in Amazon and Microsoft; number-three in Procter & Gamble and Walmart),[24] has enormous clout in voting proxies, and its latest letters to clients and CEOs indicate that it will use that power to influence corporate governance in an ESG direction. The pressure will almost certainly lead to management decisions that are biased more toward meeting BlackRock’s ideology than meeting the appropriate business objectives of the corporations whose stock the firm owns on behalf of pension funds and other institutions.

Pension funds should consider seriously whether BlackRock’s shift is in the best interests of their own current and future retirees.

22 https://www.ici.org/pdf/per26-01.pdf
23 https://www.pewtrusts.org/en/research-and-analysis/articles/2020/04/23/how-the-market-downturn-could-affect-public-pension-funds
24 https://money.cnn.com/quote/shareholders/shareholders.html?symb=WMT&subView=institutional

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