FINANCIAL REVIEW

HD **BlackRock fights regulatory threat**

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Optimism was bouncing off the walls this week when the management of BlackRock, the world's largest fund manager, gathered in **Hong Kong** to pitch to Asia's powerful retail distributors and the media.

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No matter where Chanticleer turned at the BlackRock Asia Symposium, there was bullish sentiment. **Chinese** real **estate**, **residential** and **commercial**, emerging market equities and smashed-up Australian resources stocks were all given a ringing endorsement. Even the sick man of Asia, India, was the subject of some boosterism by BlackRock's Australian-born head of Asian equities, Andrew Swan. He says Indian equities will be in a sweet spot over the next three to five years because of improving terms of trade, lower current account deficits, lower inflation and micro-economic reform.

The good vibes in **Hong Kong** were taken to an extreme when Rio Tinto's chief executive Sam Walsh was given the kid glove treatment in an interview by Evy Hambro in front of 220 people. Hambro runs the $US7.6 **billion** ($8.7 **billion**) BlackRock World **Mining** Fund, the world's largest natural resources fund, which is down 38 per cent over the past three years.

He is famous for attacking Rio and BHP Billiton for destroying **billions** of dollars in shareholder funds during the commodities supercycle and failing to share their high cash flows with shareholders

Hambro says despite flooding, in the world of **iron ore**, now is the best time in five years to **buy** Rio and BHP because of the prospect for significant increases in cash returns to shareholders in 2015.

The positive mood was helped by the gradual dissipation during the week of the student democracy protests in **Hong Kong**. Hundreds were still blocking several central **Hong Kong** streets on Monday but by the close of the conference on Wednesday it was back to business as usual in Asia's most vibrant financial centre.

Naturally, the bullishness extended to the outlook for exchange-traded funds or ETFs, which are the fastest growing segment of the BlackRock business and trade under the iShares brand.

But ominously lurking in the background of all this bonhomie are two looming threats to the BlackRock business model from over zealous regulators.

To the absolute dismay of its senior management, BlackRock has been classified by the Financial Stability **Board** as a systemically important financial institution (SIFI) because of its $US4.3 trillion in assets under management. The FSB, chaired by Bank of England governor Mark Carney, is investigating whether to impose a capital charge on BlackRock, similar to the one imposed on the world's SIFI classified banks.

Not only would that be a severe blow to the **company**, it would not make any sense. Fund managers are not leveraged institutions. They are a fiduciaries standing in the middle between investors and their assets.

BlackRock founder and global chief operating officer Rob Kapito told Chanticleer the FSB had got it wrong about posing a systemic risk to the financial system. He says everything the **company** does is on behalf of its clients. "They need to look at us as a stand-alone asset manager. It is not BlackRock's money. It is all our clients' money."

These arguments have fallen on deaf ears. The FSB put a series of questions to the fund manager earlier this year but it was not satisfied with the answers. More questions were put to BlackRock by the FSB two weeks ago. Kapito says his **firm** has answered them and is open to provide as much information as the FSB wants. He is frustrated that because of its size, BlackRock has been included under the umbrella of shadow banking.

Shadow bank assets are expanding as bank balance sheets shrink under the pressure of increased regulation. The FSB's latest Global Shadow Banking Monitoring Report, due to be released soon, shows non-bank financial intermediation grew by $US5 trillion in 2013 to $US75 trillion.

The report shows **equity** funds, fixed income funds and other funds recorded 18 per cent growth in assets in 2013, largely due to rising asset prices.

BlackRock's scrutiny by regulators is not confined to its potential systemic impact on financial markets. The International Monetary Fund and the Reserve Bank of Australia have issued warnings about the potential liquidity problems that could occur if volatile markets led to selling of certain ETFs.

They have not named BlackRock but considering it manages the world's largest high-yield bond fund, the $US13 **billion** iShares iBoxx High Yield Corporate Bond Fund (HYG), the inference is clear that the **firm** is a target. However, a closer look at trading in HYG during periods of turbulence shows it has provided greater liquidity than the primary market.

The International Monetary Fund's latest Global Financial Stability Report warns about fund managers, saying, "Large-scale redemptions in one sector may precipitate losses in unrelated asset classes and indeed across multiple funds of a single asset manager, increasing and magnifying selling pressures across markets."

Earlier in the year the IMF said systemic risks could arise from the use of derivatives in synthetic ETFs and the disproportionate size of some compared with underlying indices could pose risks during periods of heavy trading.

This week, Reserve Bank of Australia assistant governor Guy Debelle, warned of violent disruptions to financial markets because of changes in the structure of trading. Fewer market makers means more likelihood for disruption when buyers head for the exits at once. Ironically, these issues were highlighted by BlackRock more than six months ago. It has made a number of recommendations for reform.

A BlackRock white paper says the low interest rate and low volatility environment coupled with the impact of quantitative easing on the credit markets masks the amount of change that has occurred in corporate bond market as decreased liquidity and the shift from a principal market to an agency market takes hold. "A less friendly market environment will expose the underlying structure as broken, with the potential for even lower liquidity and sharp, discontinuous price deterioration."

It says a move toward product standardisation is needed, accompanied by expanded e-trading venues, new trading protocols, and changes in stakeholder behaviour.

The regulatory threat to BlackRock's business is odd. Market structures have changed as banks have shrunk in response to higher capital charges and measures such as the Volcker rule. ETFs have been a beneficiary of that change by removing bank intermediaries and providing a direct, transparent link between buyers and sellers.

Global growth in ETFs has been staggering. They have doubled to $US2.7 trillion in assets under management over the past two years. This growth is driven by their incredibly low cost: exposure to the S&P500 through an ETF costs seven basis points or 7¢ per $100 invested.

Assets grew 23 per cent in 2013. iShares grew 21 per cent to $US979 **billion**. BlackRock forecasts that assets will grow organically by 11 per cent to $US3.6 trillion by 2017.

Australia is catching the ETF wave but is lagging behind countries of similar size. The obvious reason is that the incumbent financial institutions have favoured more expensive products. The domestically listed ETF market is about $US12 **billion**, while in Canada, an economy with similar sophistication, has about $US40 **billion** in ETFs.

Mark Wiedman, global head of iShares, says Australia will follow other countries where remuneration has shifted from commission or retrocession-based payments to fee-based advice.

A final note on the BlackRock symposium was the phenomenally bullish attitude to **property** investment in **China** and Australia.

John Saunders, head of BlackRock's Asia-Pacific Real **Estate** business, dismissed talk of a crisis in **China**'s real **estate** markets. He said **equity** was ready to replace debt in any troubled developments. Rob Blain, executive chairman of CBRE, Asia-Pacific, and Mark Ebbinghaus, global head of real **estate** at Standard Chartered, said **China**'s demand for **property** in Australia was in its infancy.

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