THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

MOVING BEYOND MODERN PORTFOLIO THEORY

WITH FIONA REYNOLDS, PRI CEO, JON LUKOMNIK, MANAGING DIRECTOR, SINCLAIR CAPITAL, AND JAMES P. HAWLEY, SENIOR ESG ADVISOR, FACTSET

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Fiona Reynolds

So, welcome everyone to this episode of the PRI podcast. I hope that wherever you are tuning in from, that you're all safe and well. My name is Fiona Reynolds and I'm the CEO of the PRI.

And today I'm really delighted to be joined by our special guests, Jon Lukomnik and James P Hawley, who are the co-authors of the recently published book, Moving Beyond Modern Portfolio Theory: Investing That Matters. So, their book is really the first coherent finance theory to explain why investors should devote resources to fight climate change, encourage diversity, combat issues, such as anti-microbial resistance and many, many other real-world systemic issues. Jon is the founder and managing partner at Sinclair Capital, a strategic consultancy to institutional investors. And he's also a senior fellow at the High Meadows Institute.

And James is senior ESG advisor at FactSet and professor emeritus of economics and business at St. Mary's college in California. He also serves importantly as an academic fellow at the PRI.

So today we're discussing the book Moving Beyond Modern Portfolio Theory, which provides a new and necessary reframing of finance theory that breaks down the barriers between capital markets and the real world.

So, I want to start by asking, how did this book come about? What are the origins of your thinking about these issues, particularly the redefinition of investing. That's first with you, John.

Jon Lukomnik

Thank you, Fiona, for inviting us. That was a very gracious introduction, so thank you for that as well.

I guess for me, the origins of this go back more than a quarter century. I was running the New York City pension funds at the time, the fourth largest pool of asset owner capital in the United States and the 10th largest in the world. And I realised one day when I had a break, as you can imagine, it's a very busy position…you're dealing with trustees and you're dealing with investment managers. You're dealing with negotiating agreements and who knows what else. And someone canceled the meeting. And so, I had a rare break in the middle of the day and I was just trying to get my bearings. I had a sudden epiphany that all this motion that I was doing was secondary, that what I really needed was some place to put $80 billion, turn a rate of return above inflation forever.

Now on the one hand, that's a very comforting epiphany, because it simplifies your task, but on the other, finance theory provides no way to do that. You have lots of ways to try to extract the best possible risk-return from the market, but if the market isn't healthy, it doesn't suggest any way to make it healthy.

And I realised that what I needed was a healthy economy and then healthy capital markets to provide investment opportunities related to the economy. And so that started me thinking, is there a way to think about investing that is much more holistic than just staying within the capital markets?

James P Hawley

And I think for me, I came at it in a complementary and overlapping way because some 25 years ago now with a colleague, we developed the theory of universal ownership and looking at what it means for financial markets to be dominated by institutions of different sorts. New York City combined pensions was one. And indeed, I interviewed Jon in his capacity at that point as part of the research on the book. And once on the earlier book, that is to say on universal owners.

And once I began thinking about what that means in terms of the structure of both institutions and institutional impact on markets, it became very clear that MPT, as we develop in the book, was really speaking to a different time and place. And so Jon and I developed a working friendship from there. And about five years ago, we started talking about MPT and the book emerged out of that.

Fiona Reynolds

Well, that's amazing, obviously we all need more meetings to be canceled so that we can have less time in meetings and more time thinking, I think is my takeaway from that.

Now both Professor Frank, Partnoy at the University of California, Berkeley, and the very positive review that, of the book that scene capital monitor use the same phrase. And they say that you've written a takedown of modern portfolio theory or MPT yet you are also really respectful of MPT. So, which is it, what do you really think about MPT?

Jon Lukomnik

The problem is it's MPT, it’s modern portfolio theory, which is a limited portion of what should be MIT, modern investment theory. Modern portfolio theory: everyone thinks about it as diversification. Diversification is not new. We actually trace it back to Miguel Cervantes writing “Don't put all your eggs in one basket” for Don Quixote in 1609. So, a couple of, you know, half a millennia ago, people knew that, but what MPT did was provide the math to enable you to create the least mean variance portfolio, the most efficient risk-return portfolio from the extent markets. The problem is what we call the MPT paradox. MPT works on diversifiable risk, on idiosyncratic risk security A versus security B, company A versus company B. Unfortunately, as we know, from a series of academic studies, depending on which one you look at, non-diversifiable risk, the movement of the markets, actually accounts for between 75% and 94% of your return.

And there's not much you can do about it using MPT because diversification doesn't work on systematic risk. And so we are very respectful of MPT for what it does, but also very aware that the investment community has treated it almost like a Maslow's Hammer problem, where we have this one tool and we tend to think everything looks like a nail. And just as one quick example, the 2008-09 global financial crisis, you know, we all thought while we were diversified with thousands of individual mortgages or pieces of individual mortgages. And no one went and said, wait, diversification doesn't work. If the underlying underwriting is bad, that's a real-world systemic risk that one has to deal with by dealing with it in the real world, not by diversifying ever worse mortgages.

James P Hawley

I think the other element here, which is somewhat historical and I mentioned briefly before, is that when Marco was developing his theories, you had a market which was highly decentralised in the US market in the mid-fifties. Well into the sixties, 80% to 90% was basically individually owned institutions, they played a marginal role that shifted beginning in the late sixties, seventies, eighties. So that, at the moment, is completely flipped. The better part of 85% to 90% of US and much of global markets too, are institutionally dominated. So the respect out of MPT was for the context in which it was written. And from that perspective, there were very few market participants who could actually affect issues of systemic risk of different kinds. That obviously has changed.

Fiona Reynolds

Okay. Can you talk a bit about your views on materiality and how it informs your research and how it relates to some of the other concepts that we've just talked about?

James P Hawley

Sure. I think the notion of materiality, which in part we talk about in our book, which is the notion of dual materiality that has been developed in the EU and elsewhere in terms of moving it into regulatory disclosure mandates. And we have some criticism of that, but basically it's hugely important because it recognises again, the power of institutions in markets. And indeed, the PRI was formed very much with that in mind, some 15-plus years ago. So, the notion of materiality in an institutional framework is a much broader, but also deeper, notion. Then the notion again, of what materiality might be in a market dominated by individual investors, even though some of them may be quite wealthy at large, they are all basically whole tiny fractions of a percent of shares outstanding.

Jon Lukomnik

Additionally, we tend to think about the process of becoming material. Materiality changes as humans evolve, not just in terms of one's moral or social view, but also in terms of scientific understanding. Climate change is material because we now understand what climate change is. We didn't understand it 15, 20 years ago. When I, when I say this, people go, oh, that's political, whatever, but let me give you a classic example.

A vast portion of the collateral of the loan market in London in the early 19th century was the lives of Black American slaves in the south. Now there may be modern slavery and we, the PRI, has done a good job combating it. And clearly there are investors who are combating modern slavery, but basically it does not exist as the basis for collateralised loan markets. Certainly. And we basically have said, this is against all moral and ethical constructs. It wasn't in 1820. And so, materiality definitely changes as the operating principles of a company or a capital market get farther away from where society's values are or society-scientific knowledge is eventually those things become material. And either laws change, regulations change, or investors tend to view them as material, therefore take action.

Fiona Reynolds

Yeah. Good. All good points. You also stated in the book that we're in the third stage of corporate governance in which we're just starting to get our heads around how to deal with systemic risks. So, continuing on from what you were just saying. Can you briefly explain how we got here and how you see this third stage evolving? From what I read it coincides almost exactly with the PRI Stewardship 2.0 programme and the papers that we've put out.

Jon Lukomnik

Okay. Let me try to summarise 350 years of corporate governance history in two minutes. We were going to trace Western corporate governance at least to the founding of the Dutch East India corporation generally considered by most people to be the first modern company. And what we point out is that while things obviously changed for 300 years, in reality, the locus of power in terms of corporate governance was set when shareowners revolted and the executives of the Dutch East India Corporation did the corporation basically won. Shareholders for instance, complained about capital structure. They wanted dividends and either the company didn't pay them or they paid them in nutmeg or in black pepper, as opposed to gold gilders, which is what everyone wanted back then.

Let's move ahead 300 years to the 1980s, the 1980s were an interesting era for those of us who lived through it. It sparked the OECD principles and the United States Council of Institutional Investors, the Cadbury Commission report in the UK.

And really what happened was it was a dystopian world. There were things like raiders and white Knights and goodbye kisses and deadhead pills. And it was about parties seeking to extract rents from the public markets in particular and disadvantaging, the broad shareholders and stakeholders of those companies. And so you had this reaction. So, it was about fixing the alignment of economic interest in individual companies. Fast forward to 2005, the PRI is formed and it extends from governance, also environmental and social, and it wasn't that environmental and social didn't exist before, the series of principles had been done before.

There have been issues around apartheid that investors were used in, but broadly speaking, it drew on into everyone’s views to a much more holistic view of corporate value, but it was still around individual corporations, post-global financial crisis, I think what has happened, what Jim and I call the third stage of corporate governance is it builds on the first two, but it adds this systemic world risk issue that we became aware that we couldn't deal with systemic risk merely through diversification of the capital markets and that investors who, as Jim said, have institutionalised and therefore have the wherewithal to do this, started taking on real world risks, deliberately, climate change, income inequality, gender diversity.

And so you see what we call beta activism, which we use to distinguish it from individual company activism. Beta activism around these issues, particularly in coalitions of investors, trying to get the markets to rerate because they're mitigating those risks.

James P Hawley

And perhaps to underline the obvious here is that this is a fundamental change, not necessarily from how financial markets and institutions work, but from the theory that in part informs how they work. And there's a real disjuncture going on, which is why we think moving beyond MPT is critical.

And it's the feedback loops that Jon was talking about, which in financial theory, essentially close to don't exist. Intermediation, which is another way to put the same thing, is basically assumed. That is, it assumes financial markets work, capital is put quote “to good use”. Our notion is that all investment is impact investment. The question is, what's the nature of the impact and are there gaps that are critical in those impacts? And so MPT much more broadly, much received financial theory simply does not address the real-world element here so that we take the notion of intermediation as one of the critical functions of financial markets. And essentially say that must be traced to the feedback loops and symbiotic relationship between financial markets and the nonfinancial quote “real economy”.

Fiona Reynolds

Yeah. So, a lot of the work that we're doing at the PRI right now really touches on all of this. So how do you move beyond thinking about ESG issues in terms of what are the ESG risks to my portfolio and start thinking about, well, what are the risks of my portfolio in the real world, and how do we deal with both of those issues? What is the impact of my investments and what is the feedback loop between the two?

There's a lot of work as you, as was mentioned before, happening in Europe about double materiality, but I do have to say, and I've be interested in your views since you're both in the United States that we, I would say in general, we get more pushback about some of these theories and some of that sort of work that we're doing within the United States. Do you think there is sort of a divide in thinking?

James P Hawley

I’m not sure it’s a divide in thinking, I think in general, on ESG issues, sustainability, even though there's been massive developments in the US in the last three to four years, that the US has lagged historically looking at those issues. And so, I'm not in the least surprised that the notion of dual materiality, I should say notions of dual materiality because they're not all the same has been somewhat lagging in the US. That said, it's a current agenda item on the SEC, for example, so that there is lag, but I'm fairly cautiously optimistic that there will also be a catch up. And I would hesitate to say necessarily breakthroughs, but potentially.

Jon Lukomnik

I also think it's one reason this book has gotten the reaction it's gotten, because as you said at the beginning, it is a finance book. It gets to, we therefore have to deal with people and planet as a way of improving the risk-return of the market, but it doesn't start with, “we have to deal with people and planet”. And I think one of the distinguishing factors of the United States type of capitalism has been this artificial bifurcation of unilateral materiality. And what this book does, and one reason that it has been cited so often, I believe is it squares that circle. It provides a financial basis on which to consider these issues because they prove to be material risk to the market. And, and so my hope is that eventually all this merges into an accepted body of academic wisdom that if not coalesces globally, at least is directionally aligned globally.

Fiona Reynolds

As you say, the reaction to the book has been dramatic. And I think you've done, you know, 25 or so presentations, including private ones to some of the largest investors in the world. The CFA Institute has done both a blog and a podcast about it. Forbes has run a review and everyone from Responsible Investor to Barron's has asked you to write something about the book. So where do you think we're going from here with this thinking? Why do you think that you've got this reaction and where do you think we go to next?

James P Hawley

Well, it seems to me in part, our book was written because we saw practice outrunning theory, and I think there are many, many examples of that. Jon mentioned a few, BlackRock would be an example of an obviously massive institution, while heavily criticised in many cases, nevertheless, in my view has been taking significant steps over the years in terms of moving beyond modern portfolio theory. That is, to say involved in engagement, increasingly under pressure, perhaps involved in following those black boxes of engagement with votes that back that up. And you have some significant breakthroughs in terms of what happened. ExxonMobil, I think would be a very good example, so that I think our book, as Jon said, really tries to say, let's begin to put into practice, which is run ahead of the theory. Let's try to bring the theory in, in line with, and to create a deeper understanding both of existing practice or practices, but also where those practices might develop too. And we have a number of very specific examples

Jon Lukomnik

Of the work about, and Fiona, if I, if I may, I think I'm going to politely chide you because you noted that Jim was the academic fellow at the PRI, but you didn't note that I was a judge of the past two years for the PRI Stewardship of 2.0 awards. And I think what Jim has said is true and I will take my chide and turn it into a compliment. I think the PRI has done a great job at in fact, of recognising and leading the fact that practice has led theory and what those awards are all about is on the stewardship side, at least, is dealing with systemic risk of the real world and dealing with it in terms of stakeholder and other investor coalitions. And so, I think what the book does is provide, not that we need to provide financial legitimacy, but it provides an easily cited source of financial legitimacy for those that I expect that sort of beta activism, third stage corporate governance activism to continue.

The question is how much will the academic community adopt and embrace this? And I think we are starting to see not just about our work, but for instance the paper by [inaudible dialogue] out about coordinated engagement and the impact of that.

There are papers out about the fact that investors have helped with gender diversity in the boardroom, even more so than the #MeToo movement or the California state laws. And so I think the question becomes how much of this gets a court incorporated into academia, and that is perhaps a slower process but a very important process. And that's where I would like to see it go.

Fiona Reynolds

Well, thank you, Jon, for pointing out about the awards and also thank you for judging. That's really important. They're really important awards. And in actual fact, we just announced the shortlist and we will have the winners in October at our Digital Conference. So, I just want to come back very quickly before we wrap up just on this issue about practice and theory, is it usual that practice is out in front of theory in finance, or is this sort of an anomaly? I'm just interested in that because I don't know the answer to it.

James P Hawley

Yeah. That's a really interesting question. And I, I'm not prepared to make a total generalisation. That said, one of the fascinating things which we do talk about in our book about MPT and others have made this point too, is that we use the term, which we have borrowed and cited of "performative", meaning that the creation of MPT actually facilitated critical and transformative developments in financial markets.

So that was a classic case of finance theory heavily driven by very sophisticated mathematics driving changes with albeit with a lag of a number of decades, for a number of reasons in how financial markets worked and in that regard was revolutionary. And that's one of the things we think is hugely important about MPT. So, I'm not suggesting that therefore all finance theory is performative and drives markets, but in the MPT case, it certainly was. And did.

Fiona Reynolds

Okay. Well, I think we could talk about this subject for hours. It's endlessly fascinating, something that we've definitely worked on through our Academic Network. And we've had call for papers on these issues in the past as well. And it's going to be really interesting to see how it all develops, but we need to wrap up.

So, I want to thank you both for really, what's been a fascinating discussion about the evolution of modern portfolio theory and you know, your desire to change what the world considers investing to be. I think this is something that we share at the PRI. So, Moving Beyond Modern Theory, Jon and James's new book is available at major book retailers. I encourage you all to rush out and buy it. Please don't forget, you can stay informed with all of our work via our social media channels. So, we're on Twitter, we're on LinkedIn, Facebook, YouTube, WeChat and Weibo. You can also keep up to date with our blog series, webinars, and of course our podcasts. So, if you enjoyed this episode, please do subscribe and rate our podcast.

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