

Session I: 'The Impact of the Financial Crisis on Responsible Investing'
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Respondent Comments

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I have been asked to comment on three excellent papers that move the research agenda on responsible and sustainable investment forward from the vantage point of a position I no longer hold, that of a trustee to a large institutional investor. In my case, the large institutional investor was the New York City Employees Retirement System (NYCERS), which has long had a reputation for being an activist investor promoting the cause of responsible investment. It is also a fund, like many others throughout the world, which has been on a nerve wracking roller coaster ride as the financial markets have reached amazing highs and very troublesome lows, especially over the last decade.

Indeed, it is one of my most profound disappointments that when I left NYCERS earlier this year it was in an arguably worse financial position than when I started as a trustee nearly 14 years before. There are, clearly, a number of reasons that so many institutional investors, especially pension plans, find themselves in similar circumstances, but one common theme is the volatility within the financial markets, spawned, in large part, by a series of speculative frenzies that have exposed the flaws in many of the working assumptions that pension fund trustees and their advisors have accepted as gospel for many, many years.

Each of the papers speaks to these common working assumptions and demonstrates the need to formulate a new paradigm for how institutional investors actually invest other people's money, whether those funds are retirement, health or education savings accounts, or the holdings of endowments and other institutions. Robins, Krosinsky, and Viederman, for instance, in reviewing the relative outperformance of sustainable investment vehicles versus their more traditional peers in

the past few years rightfully conclude that relative outperformance “cannot hide an absolute loss for sustainable investors over the course of 2008”, leading them to suggest that the efficient frontier thesis and the strict notions of fiduciary duty need be replaced with the “market resilience hypothesis” and the “reasonable investor hypothesis”. Similarly, Urwin and Woods suggest that the current legal interpretations of fiduciary duty “make pension funds understandably reluctant to adopt any model of sustainable investment”, and argues for legislative and governance reforms to facilitate a sea-change in how such funds invest money. Likewise, Hawley while focusing less on fiduciary duty per se suggests that a misguided “search for alpha” among institutional investors may have fit with current notions of fiduciary duty, but failed to lead institutional investors to try and ascertain what each individual fund’s foray into alternative investments was having on the larger markets they invested in and the risks the investors incurred as a result.

As a former trustee who spent all too many hours wrestling with the dragon of fiduciary duty (on my good days, the match ended as a draw), the emphasis of all the authors regarding the fundamental shift that much take place if institutional investors are ever to get off the boom to bust roller coaster ride are welcome additions to the literature. Moreover, each of the authors emphasizes different aspects of a sustainable investing agenda that merit further discussion and research. Before doing so, however, I want to credit Roger Urwin and Claire Woods with wading into the definitional debate around responsible investing and sustainable investing and providing a basis for establishing a common language for people working in the field. Responsible investment does, as Urwin and Woods hold, stem from a set of values that seeks to control “the negative externalities of their investments.” While sustainable investment “is an investment strategy derived predominantly from investment beliefs” that see “an investment strategy with greater breadth and depth...will produce stronger investment performance both now and in the future.”

Let me start with the paper by Krosinsky, Robins, and Viederman. Perhaps it is my training as an historian, but the extended trip into the experience and thinking of Keynes as an investor was particularly welcome. Keynes’ attempt, the authors suggest, to develop an investment strategy for himself lead him to become an early

adherent of behavioral finance, and to differentiate between investors and speculators, holding that true investors sought long-term returns versus the speculative mania of the short-term investor, and that investment actually had a social purpose, which I am assuming could be both good and bad. Using these three aspects of Keynes' thinking derived from his experience as an investor, the authors rightfully hold that Keynes thought helps lay a foundation for sustainable investing. I find little to argue with here, but would suggest that the authors pay closer attention to aspects of Keynes' work that is most often associated with him and speaks to the unsustainable nature of the current economic order. Keynes, I believe, understood that how much the average worker earned and how secure he/she was in the labor market greatly mattered when discussing the overall health of an economy. In the U.S. (and elsewhere in the mature economies to greater or lesser degrees) over the last 30 years there has been a steady erosion of wages for the median wage earner, and one of the principal reasons why workers became addicted to credit is that their wages no longer allowed for the maintenance of their lifestyle (this is true even after, in two-income households, both adults went into the full-time labor employment). The availability of cheap money allowed, for a time, a lifestyle that most U.S. citizens were not really able to afford. This is the definition of unsustainable, and the financial geniuses in the investment industry not only missed this, but actively created the sham that just fell apart. Hence, I would like to see the authors pay closer attention to the role the growth in inequality played in the current debacle, and what sorts of changes need to happen to create a more sustainable economic order. This might mean a thorough re-examination of "shareholder value" as the be all and end all in investor discussions about long-term value. So be it.

"The End of Neo-Classical Finance" is the section of the Krosinsky, Robins, Viederman paper that I most enjoyed (and this is not solely for the reference to the Monty Python Dead Parrot Sketch). While I am not necessarily as sanguine as the authors seem to me about the demise of the efficient market hypothesis (it may well be stunned), I do concur that we are at a moment where a countervailing view could rise to a position of dominance, and that such a view would need to incorporate the intangibles most offered associated with ESG issues, and the reality of a power shift in the global

economic order as a result of the rise of the emerging market countries that, as Mohammed El-Erian argues convincingly, has just begun.

Krosinsky, Robins, and Viederman offer the “reasonable person hypothesis” to replace the more constrictive definition of fiduciary duty that has dominated pension boards over the years and the “resilient market hypothesis” to replace the dogma of the efficient market theory. Both contributions are sensible additions to the dialogue, and I would agree with the authors that there has been some recognition in the larger world, as at General Electric, of rise of sustainability investment into the mainstream. Yet, as the authors note, recognition of the issue does not mean that investors have actually begun to change how they invest the assets in their charge. Outdated or not, the traditional definitions of fiduciary duty still dominate in most places, leading prudent men and women to often adopt policies and strategies that perpetuate short-term actions that have helped to propel the boom and bust cycle we seem to keep repeating. In addition, the hard and present reality of balancing the need for annual rates of return often blind trustees to considerations of anything but short-term considerations.

Indeed an area that all of the authors might want to explore a bit more is how the need to reduce employer contributions to pension plans led trustees to pursue investment strategies that have contributed to the boom and bust cycles of the last two decades. Part of the pension funding equation, we should all remember, is the contribution stream, from employers and workers alike in most public pension plans in the United States. Plan sponsors (and, at times, members) have all too often taken the position that investment gains alone can lead to the adequate funding of pension plans. That is not, nor has it ever been the case. Moreover, acting in such a manner can lead to the pursuit of dangerous investment policies that put the fund at great risk.

Krosinsky, Robins, and Viederman conclude their paper with a compilation of key elements they view as necessary for creating a strategy for sustainable investment, including revamping financial education and re-writing the tax code to change investor behavior. Their list is a pretty thorough one, but I would urge them to focus some more attention on the role that government can play in effectuating changes in behavior among trustees that will help drive that behavior forward.

The role that government can play in fostering the development of sustainable investment and the need for improved governance of funds is a central component of the papers by Roger Urwin and Claire Woods. Urwin and Woods quite convincingly demonstrate that the primary factors accounting for the failure of fiduciaries to embrace sustainable investment rests with narrow and outmoded interpretations of fiduciary duty and poor governance of the pension funds themselves. This analysis combined with a nuanced approach to how one would fashion a sustainable investment strategy that takes a broad and deep view and a longer-term framework for evaluation is a compelling one. Urwin and Woods also speak to the importance of the principle of inter-generational equity in pension funding---this is what I took their argument regarding an institutional investor social responsibility mandate analogous to a corporate social responsibility mandate to mean--- to the equation of how funds invest the assets, and certainly some research that would buttress their contention that sustainable investment is the more “efficient and fair” manner for doing so would be welcome.

I want to stay on this issue of an institutional investor social mandate notion for a moment. I have long held that institutional investors had to own up to their responsibility for how they invest the assets of their funds, and, in the current moment, their measure of responsibility for the current financial debacle. I believe Urwin and Woods are on the right track with having government setting standards that would mandate institutional investors demonstrate how their investment policies and actions meet the goal of providing pension benefits to their beneficiaries as well as meet some larger societal objectives, as well as the need for trustees to be better prepared to do their jobs. What I found missing in the Urwin and Woods paper was the reality that achieving such changes in law and regulation is a political one, and will take, both on the part of trustees and elected political leaders, a measure of political will that I have not often seen. Having been told often when I was a trustee that my forays into acting responsibly, whether that be to file a shareholder resolution on a social issue, like insuring that a major multinational corporation should commit to a policy which recognized the right of workers to form unions and collectively bargain over the terms and conditions of employment or establish a policy that sought to measure a money managers ability to incorporate ESG issues into their decision-making process, were

beyond the scope of that responsibility, the road to achieving a mandate that will allow for trustees to behave in such a manner is not going to be an easy one to navigate.

This might be one of the reasons that Urwin and Woods make the sharp distinction between sovereign wealth funds and pension plans, which allowed for them to argue that sovereign wealth funds are, because of their different mandate, in a better position to implement a sustainable investment mandate. The distinction is an important one, and Urwin and Woods are correct in my view for suggesting such is the case. Yet, here too I would argue that not all sovereign funds are alike, and that differences in political culture and the political aspirations of any one nation could temper how sovereign funds actually act in the world. Given the global imbalances that currently exist, one does not have to stretch too far to see that a sovereign wealth fund could act in a short-term manner quite at odds with what I perceive are the goals and aspirations of Urwin and Woods.

I do not want to appear too critical of Urwin and Woods. I actually found myself making notes in the margins of their paper that reflected their understanding of the sometimes countervailing forces trustees often face, and the wisdom of their arguments that institutional investors need adopt sustainable investing policies and practices because such practices better promote the goal of inter-generational equity. I applaud them, also, for focusing the need for trustees and policy makers of actually thinking through the investment policy and the asset allocation, and what flows from such policy. In the short-term amount of time I have, I fear that I am doing a disservice to the second paper submitted under Roger Urwin's name that does a good job of drawing a road map for putting sustainable investment into practice. I wanted, however, to underscore that in discussing how to move a sustainable investment agenda forward that we understand that these are, in very concrete ways, discussions about power in society, and we certainly should not expect the needed changes in the investment industry to come easily, or without great changes in the ways the various actors in the investment chain behave.

James Hawley's paper focuses squarely on the question of what role institutional investors played in the financial crisis, and asks how behaviors would have to change going forward. Hawley's paper is instructive for both its somber tones and insightful

portrayals of exactly the types of changes that must go on the investor side of the table if the current transformative moment is actually going to yield an outcome that puts sustainable investment policies and practices in the mainstream of the investment universe. I was struck by Hawley giving central stage to the negative outcomes that sprang from the “search for alpha” that dominated boardroom discussions after the collapse of the public equity markets in 2001. And I want to say loud and clear that this was not just a result of the dot.com bust, but a corruption scandal, primarily in the United States, that **should have** led to a thorough re-examination of how institutional investors acted, especially around issues of financial risk that Hawley discusses at length. What is sadly true is that this transformative moment passed without much changing in how institutional investors behaved, and this was only eight years ago. It is not as if we hadn’t been warned. Moreover, if I read Hawley right, institutional investors did not seek to alter the way they did business as they directed larger portions of their assets to alternative assets.

Hawley needs to be applauded for noting how the “search for alpha” led institutional investors to pour billions into private equity, real estate, and hedge funds, and other alternative investments in the years after 2001 that helped create dominant players in the financial sector in the span of a few years. The eagerness that institutional investors had for alternatives was akin, in my experience, to people chasing movie stars for autographs. Pension funds vied with each other to make sure they could have the privilege of paying “2% and 20%” to the “best” private equity and hedge fund practitioners in a quest to enhance returns, diversify their funds and reduce risk. General partners and consultants advised that pension fund trustees should not ask for great transparency, or heaven forbid, lower fees, because doing so would result in the general partner going to the pension fund down the street. This led to a number of spirited discussions—read screaming matches--- at my former board about why the actors with the money to investment should not be making the rules. There was, I kid you not, a long debate because some fool of a trustee demanded that NYCERS adopt a policy specifying that all private equity firms agree to abide by all local, state, and federal labor, anti-discrimination, and environmental laws and regulations (and, yes, I played the role of the foolish trustee).

The desire to “get into the best funds” meant, as Hawley notes, that institutional investors, in the US especially, did not ask elemental questions about what the risks were of so much money going into certain sectors of the economy (especially in a low interest rate environment) at one time. Nor, since the institutional investors didn’t demand transparency in the investments were institutional investors able to fully appreciate what risks were present in their own portfolios. I cannot agree enough with Hawley’s comments that even the most active and responsible institutional investors on corporate governance in the public equity space failed to apply such scrutiny to the alternative investments they made. Indeed, Hawley’s comments need to be fully examined by the academic community:

We hypothesize that these gaps and failures to adequately monitor occurred because institutions did not take into account and apply across the investment spectrum basic corporate governance principles: specifically transparency, monitoring, and accountability. In turn this contributed, albeit unknowingly, to the financial crisis when combined with large capital flows into (some or many, depending on the specific institutional investor) alternative investment vehicles, along with the indirect investment in various structured investment products by (equity investment in) the financial sector itself (e.g. Citigroup, GE, page 7).

The failure of institutional investors to police themselves suggests to me (and I believe Hawley) that until institutional investors actually develop the ability to control the actors they hire to invest assets, or take control of the process themselves---as has been the case with some Canadian pension funds regarding private equity and infrastructure---there will be other quixotic “search for alpha” chases by institutional investors that could wind up with equally disastrous results. Hawley goes one step further by asking, “On a broader level, it is worth considering the difficult question of whether institutional owners are actually able to know well (or even if) financial firms are understanding their own risks and if so, can this be tracked, how and by whom.” I agree with Hawley that part of the answer here is the development of a strong regulatory regime at the national and international levels. Yet, an equally important component of

the answer lies in the development by the institutional investors of the capabilities to ascertain at least some of the answers themselves.

The final pages of Hawley's paper, with the aid of work by Steve Lydenberg and others, suggests that a fundamental re-ordering of the governmental regulatory regime and of how institutional investors do business is in order if institutional investors are ever to get off the roller coaster they have been riding, for at least the decade and a half that I have been involved in the institutional investor universe, and create something like the sustainable investment world that Krosinsky, Robins, Viederman, Urwin and Woods write so eloquently about. For me this means that institutional investors of like mind need to build collaborative investment vehicles that will enable them to both directly invest across the investment horizon, and establish a new set of rules for those they hire to invest on their behalf. Part of these vehicles will have to include ways to that are beyond my scope to fathom of identifying the risk that comes from moving these great amounts of capital into and out of various markets. This brings me back to an earlier comment. There is power in how these assets get invested and despite all the obstacles to the creation of such collaborative vehicles such seems indispensable if institutional investors are going to both meet their responsibilities to beneficiaries and the larger society we all live in.