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Why Investors Might be Climate Allies: Corporate Governance Today

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These comments were adapted from Mr. Lukomnik's recent Adam Smith Lecture at Pembroke College, Cambridge.

Twenty-five years ago, I had an epiphany. I was, at the time, the New York City official in charge of investing the City's own cash, as well as the five defined benefit pension funds. At the time, the mid-1990s, those pension funds were the fourth largest pool of institutional assets in the United States, totaling more than $80 billion. I was responsible, in large part, for the retirement security of more than half a million active and retired teachers, clerks, police, firefighters, sanitation workers, mechanics, bus drivers and other city workers and retirees.

I had a staff of almost 60. I reported to five boards of trustees of the funds. I hired, fired and oversaw scores of outside money managers, managed billions of dollars internally, dealt with custodian banks, actuaries, lawyers, accountants, NGOs, etc. And, of course, I was supposed to be abreast (or preferably ahead) of the markets, new developments in asset management, academic research. It was incredibly rewarding, but also a bit frenetic.

One afternoon I had some time to just think. I was sitting in my office, staring out at the trading desk, when it occurred to me that there was a lot of wasted activity trying to meet and beat relative return benchmarks like the S&P 500. Instead, there actually was a remarkably simple formulation of the task I faced: I needed to find somewhere to invest $80 billion to earn a rate of return above inflation forever. And that had very little to do with benchmarks, bond math, derivatives, repo contracts or any of the other myriad details I dealt with daily.

As with most "aha" moments, it was the simplicity of it that stunned me. But, so did the magnitude of the challenge, because it meant that I was facing what investors call a beta problem, not an alpha one. Investors call the systematic risk and return of the capital markets beta, whereas alpha represents returns above or below the market caused by an investor's skill. (As an aside, I note that over the years, I have noticed that investment managers claim all returns above benchmark are skill-based alpha, and all returns below benchmark are simply the manifestation of risk.)

Simply put, the overall return of the markets affected our returns – and any large investor's returns – much more than does the ability to correctly pick stocks, bonds or other securities. Depending on the study, systematic risk issues account for between 75-95% of the variability in return.

Now that's a bloodless way of thinking and talking: "systematic risk." The reason it's bloodless is that Modern Portfolio Theory or "MPT" does not care about the causes of risk. It doesn't care if the cause of systematic risk is the normal to and fro of the economy, or the global financial crisis, or income inequality, or lack of diversity on the Boards and in the executive suites of the companies in which we invest, or country risk such as apartheid in South Africa or the troubles in Northern Ireland or insurrections in the Middle East. Or, as the title of this talk suggests, climate change.

Now, as human beings, we may care. I certainly hope that we care: for the workers who suffer in stressed economies; for the societal fraying that comes from high levels of income inequality; for the essential unfairness of gender, racial, ethnic and sexual orientation discrimination; for the lives lost and ruined in conflict areas. But MPT is, in fact, bloodless. For MPT, the only thing that matters is that those risks create volatility – variability in price, both realized (ex poste) and expected (ex ante). MPT suggests that you diversify your holdings to deal with *idiosyncratic* risks, such as those created

by any individual portfolio company succeeding or failing. In that way, MPT's advice is a quantification of Cervantes' 1615 caution in Don Quixote: don't put all your eggs in one basket.

But when it comes to the *systematic* risks that shape the overall market risk and return profile, MPT basically says you have to accept it. MPT – which dominates investment theory – provides no insight or tool as to how to solve this beta problem.

My co-author, Jim Hawley, and I call this the MPT paradox: by ignoring the systematic risks that shape beta, MPT focuses us on that aspect of investing that we can control, but which matters least: security selection and portfolio construction. Now, let me be clear. Harry Markowitz is a genius and the Nobel Prize he received, largely for developing MPT, was well deserved. A full review of MPT is far beyond the scope of this talk, but suffice it to say that without MPT, we would be stuck in a much poorer world, because portfolio theory allowed us to make investments in areas and through a set of securities that might have been considered too risky if not considered in a portfolio context. That enhanced both the private function of asset management – creating a desirable risk-adjusted return for individuals – and the societal role of intermediation, or, as the third Lord Rothschild once said, taking money from point A, where it is, to point B, where it is needed.

The fact that MPT improved the efficiency of those functions is not a hypothetical conclusion: until 1996, three state pension funds in the United States were not allowed to invest in stocks, or venture capital, or real estate, or almost anything else, but only in bonds, and primarily in those issued by the US government. That was because the laws on the books in those states reflected how risk was managed pre-MPT.

But MPT does not provide a tool to affect the challenge I faced 25 years ago of finding a place to put $80 billion to earn a rate of return above inflation forever.

The tool I turned to was corporate governance.

At first, corporate governance was defensive and focused on abuses like greenmail. In economics language, we saw corporate governance as protecting our economic interests from rent-seeking behaviors by corporate insiders and changing the structures and processes which enabled such rent-seeking. The defensive posture of stage one corporate governance began to change following a speech at a Council of Institutional Investors meeting by Ira Millstein, who urged us to focus on underperforming companies.

That made sense. If we could improve the underperformers, we could improve the market returns. It was like going after the slowest zebra to get the herd to run faster. However, the focus remained on governance, the "G" in the popular acronym ESG, Environmental, Social and Governance factors. It's not that the E&S of ESG were ignored. The South Africa apartheid battle was an "S" issue. As to the "E," the CERES Principles, a set of environmental principles that were developed in what would later be my office, were set into place by the crash of the Exxon Valdez. In 1989, that oil tanker crashed into Prince William Sound in Alaska, besmirching what had been wilderness and sending television images of dying, oil-covered sea birds and aquatic mammals around the world. Interestingly, the CERES Principles were initially called the Valdez principles, until one of the early participating companies objected. "No one wants to join a group named after dead, oily birds," the CEO told us.

So, though the focus was on governance, there were rumblings of environmental and social concerns. In 2005, those concerns were turbocharged by then UN Secretary General Kofi Annan. He invited 20 large institutional investors to design what would become the Principles for Responsible Investment, or PRI.

This is stage two corporate governance, with the E and S added to the G. The purpose of modern corporate governance remains to this day the performance of firms and of our investments in those firms. But the definition of performance has broadened from a somewhat narrow, purely financial performance, to a more macro-economic view, more closely aligning with my epiphany that a healthy capital market was reliant on a healthy economy and society.

Phase two expanded corporate governance from G to ESG. But the focus remained largely on individual companies. Yes, there was a hope that we could "get the herd to run," but we did that by targeting slow zebras. We didn't give the herd vitamins.

Today, that is changing. We have entered a third stage of corporate governance.

The third phase builds on stages one and two. But it differs in that it directly targets material systematic risks that shape beta – the systematic risk/return of the market. Remember, MPT does not provide a tool to do that, so stage three corporate governance activism is additive to MPT. In effect, it creates the third leg of a three-legged stool. MPT already suggested security selection and portfolio construction as the first two legs; third stage corporate governance suggests a third leg, designed to deal with systematic issues. We call this beta activism.

Unlike alpha activists like Carl Icahn or Chris Hohn, beta activists target market-wide risks, not individual companies. Perhaps the purest example of beta activism comes from the world's largest asset owner. In November 2017, Hiromichi Mizuno, the Executive Managing Director of the Japanese Government Pension Investment Fund (GPIF), with assets of about $1.4 trillion, noted that, due to its sheer size, its returns are overwhelmingly a function of the real-world economy, rather than beating a benchmark. (An epiphany with which you are now familiar.) He said that seeking alpha was irrelevant and then announced that GPIF would hire specialty investment managers to focus on environmental and social concerns, in an effort to impact the economy. The G of ESG wasn't ignored; GPIF already had a Governance program run internally.

Let's move from Japan to the UK. LGIM, the asset management portion of Legal and General, is well known for its stewardship activities. On its website, it notes that it "strive(s) to achieve positive societal impacts, in the belief that it will create more sustainable long-term value," which is classic stage two macro performance theory. But then it says that one of the ways it tries to do this is by "Influencing the debate."

"We take action to address key themes and emerging governance and sustainability issues that could impact the value of our clients' investments.

"We…have a responsibility to address topics that can impact all companies. This may be done by engaging directly with companies or with governments, regulators, other investors and wider stakeholders."

Think about this for a bit to understand how wide-ranging is LGIM's definition of investing. LGIM is trying to influence regulation, jawbone the market, make common cause with other investors and NGOs. Stage three governance investors understand that to affect beta, you need to do much more than move electronic dots on a trading terminal.

Stage three investors take on a variety of systematic risks that affect entire markets, rather than individual companies. Let's look at one example from each of the ESG categories, starting with the G.

In November 2014, New York City's pension funds announced the "Boardroom Accountability Project." The pension fund trustees had been frustrated by the inability of shareowners to directly nominate corporate board members in the United States. The Securities and Exchange Commission had tried to allow such direct nominations through a process called "proxy access" in 2010, but a lawsuit had overturned the rule. There was an exception to that prohibition, however: shareowners of each individual company could, if they so wished, adopt proxy access. However, making that change on a company-by-company basis was expensive and cumbersome. As of 2014, only six American companies featured a proxy access rule.

The "Board Accountability Project" announced that the New York City funds would attempt to establish proxy access as a new market standard by filing resolutions to mandate proxy access at 75 companies. Interestingly, those companies were chosen because they were exposed to various other known risks, both systematic – 33 were in carbon intensive industries and 24 had little or no gender, racial or ethnic diversity on the board – and corporate specific – 25 had executive compensation problems.

The unusual circumstances around the SEC adopting a rule, then a court staying the rule, then an exception being used to try to partially implement the rule by the NYC Funds across a material subset of the marketplace, created a natural experiment. As three academicians found, the Boardroom Accountability Project announcement caused a 53-basis point excess return in the shares of those 75 companies. To me, that is a powerful justification of beta activism. Notably, the pension funds' announcement did not guarantee proxy access would be adopted, even at the targeted companies, and the study suggested that market-wide adoption likely would have resulted in an even larger rerating across the entire marketplace.

The New York City funds' efforts to be beta activists has largely worked. At 53 basis points, the excess return to the City's funds over the roughly $5 billion it owned in those 75 companies created $266 million in value. Were that 53-basis point re-rating applied to the entire US equity market at the time of the announcement, it would have added $132 billion to the US equity markets.

Today, proxy access has become something of a de facto market standard, at least among large capitalization US public companies. As of July 2019, less than five years after the 2014 Boardroom Accountability Project announcement, more than 600 US public companies featured proxy access, and the number is consistently climbing.

Let's move on to the S. Many of you may have seen photos of the sculpture "Fearless Girl," a wonderful bronze of a young woman, hands on hips, defiantly looking into the space in front of her. It was situated, initially, so that she was staring down the charging bull that sits on Wall Street, in front of the New York Stock Exchange.

The statue was commissioned by State Street Global Advisors, to publicize its gender diversity efforts. State Street became concerned by the lack of diversity on corporate boards and in executive suites. In March 2017, it started a major campaign. It publicized a number of studies showing the

risks created by single-gender boards of directors. It commissioned Fearless Girl. And it engaged 1,357 global companies that had no women on their boards. As of September 2019, 582 have either added a female director or had pledged to do so.

State Street isn't perfect. It has been criticized for some inconsistencies in its proxy voting record on this issue. However, it is clearly trying to use third stage governance to address a systematic risk. And, again, in doing so, it is expanding the traditional bounds of investing.

Which, of course, brings us to the E, and the question of "Why investors might be climate allies."

A little more than 25 years after my "aha moment," a much more consequential figure in investing told us of his and his firm's epiphany.

On January 11, 2020, Larry Fink, the Chief Executive Officer of BlackRock, told the world that "Climate Risk Is Investment Risk."

Now, to be sure, this was not news. Mark Carney, the Governor of the Bank of England, has been warning for years about a "Minsky Moment" when the values of carbon-related assets could collapse. The Bank for International Settlement, the bankers' bank, has said that central bankers can't save the world's capital markets from climate risk. An investor coalition, partially organized by CERES, was instrumental in pushing through the Paris Climate Accords. There are billions and billions invested in low-carbon index funds and in clean-tech portfolios.

So, the fact that "Climate Risk is Investment Risk" was not news. But the fact that BlackRock was saying it, was. BlackRock is the world's largest asset management company, with some $7 trillion of assets under management. Fink has been writing letters to the CEOs of the portfolio companies in which BlackRock invests for years. They often have focused on the need for companies to think long term and to have a societal purpose.

But BlackRock had been criticized by some for talking the talk, but not walking the walk, particularly when it came to environmental issues. It had not, for example, joined Climate Action 100, though 350 of its peers had. Some of its votes on shareholder resolutions relating to climate were inconsistent and, in the view of many climate activists, not helpful. BlackRock explained by saying that the votes were influenced by its private talks with companies. But those talks, and what was or was not accomplished in them, were not transparent.

However, as I found out 25 years ago, and as Mr. Fink found out 25 days ago, epiphanies make things manifest. BlackRock joined Climate Action 100 in early January. Then, two days later, Mr. Fink released his 2020 letters to CEOs and to investors. He wrote: "Climate change has become a defining factor in companies' long-term prospects…I believe we are on the edge of a fundamental reshaping of finance…In the near future – and sooner than most anticipate – there will be a significant reallocation of capital." He went on to announce "a number of initiatives to place sustainability at the center of our investment approach, including: making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers, launching new investment products that screen fossil fuels and strengthening our commitment to sustainability and transparency in our investment stewardship activities."

And then he asked the CEOs to whom the letter was addressed to start reporting data according SASB and TCFD standards. SASB – the Sustainability Accounting Standards Board – is a foundation that has established a framework for "industry-specific disclosure standards across environmental, social, and governance topics." TCFD is the Task Force on Climate-related Financial Disclosures, which has suggested a set of "voluntary, consistent climate-related financial risk disclosures."

I find the suggestion that companies report using SASB and TCFD frameworks particularly noteworthy; standard setting across the market is definitely a stage three corporate governance tool.

Reporting on ESG factors has been, and to some extent, remains, a ball of confusion, as governments and traditional accounting standard-setters like the IASB here and the FASB in the US have, until now, refused to regulate disclosure standards. So there has been an alphabet soup of disclosure frameworks. A 2018 report that I commissioned at the IRRC Institute noted that 78% of the S&P 500 companies issue sustainability reports, but that they had virtually zero standardization. Ninety-seven percent of them customized their reports, picking and choosing from the various frameworks as they like – one referenced six of those alphabet soup frameworks – or using no framework at all.

BlackRock's attempt at standard setting seems destined to be a game-changer here. Already, within days of Mr. Fink's letter going public, SASB was inundated by inbound inquiries from corporations.

Now, as noted, BlackRock was certainly not a leader in the climate fight. I say that not to criticize BlackRock – in some ways, its position as the largest asset manager in the world meant it could not move as quickly as others – but to emphasize just how strongly BlackRock's announcement confirms 1) that we are now in the third stage of modern corporate governance, and 2) that climate change is front and center as the key systematic risk investors care about.

Investors have both the motivation to have the markets rerate when climate risk is reduced and the desire to avoid the climate Minsky moment of collapsing asset values. They have the third stage of corporate governance beta tools. They can use policy and publicity. They can try to set standards, whether that is proxy access or reporting according to SASB and TCFD. They can publicize good climate research, counteracting some of the politically motivated and paid for climate denial social media.

That BlackRock wasn't the first large investor to cite climate change as the core issue facing markets isn't a reason for consternation. Rather, it's a reason for hope. It shows that beta activism is now mainstream. It suggests that investors – though certainly not uniformly nor as vigorously as many would like – but, in the main, investors will, indeed, be climate allies.