BNY X STANFORD LONG-TERM INVESTING

BREAKING THE MOLD WITH ASSET OWNER INNOVATION

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Dr. Ashby Monk, Executive and Research Director, Stanford Long-Term Investing

Rohan Singh, Global Head of Asset Owners, Asset Servicing and Digital, BNY

Rohan Singh

Hi, I'm Rohan Singh, and I lead the Asset Owner business at BNY. BNY "Rapid Insights", is a series of short podcasts aimed at providing exclusive industry views and perspectives on the most pressing topics impacting asset owners, to help you turn insights into opportunity and prepare for the future.

Our topic today is on "Innovation". Asset owners around the world are at a major inflection point as they face unprecedented challenges e.g., high and persistent inflation, geopolitical crises, shifting investor demands and expanding investment mandates, requiring them to rethink, innovate and evolve their current processes in order to achieve long-term growth.

I'm delighted to have Dr. Ashby Monk, executive and research director at Stanford University's Long-term Investment Program, joining us in this session. As you may know, BNY has recently collaborated with Stanford Long-Term Investing or SLTI in short, on a multi-year program to provide best in class resources and thought leadership. Ashby has more than 20 years of experience studying and advising investment organizations and has authored multiple books and published hundreds of research papers.

I'm thrilled to have him here to share his insights and views on the topic of institutional innovation for asset owners today. Ashby, Welcome to the podcast.

Ashby Monk

Thank you so much for having me. I'm already excited hearing you talk about rethinking, innovating and evolving the process of investment. I think we're going have a good chat.

Rohan Singh

And we're excited to hear from you. So with that, let's kick off with our first question. Your research efforts focus on four key areas – technology, portfolio resilience, data and operating models to enhance investing and institutional innovation. Today, we are going to focus on institutional innovation. Can you tell us what this means for your research effort and share some examples of innovation you're witnessing, both in terms of investments and technology?

Ashby Monk

Happy to. So as you could imagine, all the research projects we're working on require the asset owner investors to innovate. So in a way, the institutional innovation project at Stanford is a foundational project that hopefully empowers the investment community to understand and adopt a lot of the work we're doing. So in that sense, it's a little bit self-serving to do a research project on innovation.

It's a means of helping this asset owner community ingest the projects that we're doing and make use of them. But in terms of what does it mean, I mean, ultimately, in order to understand what institutional innovation is, you have to understand what investors do. And so a large part of what we work on at SLTI is just studying the asset owner, right? Understanding how they produce returns and in effect, defining a return production function. People, process, information and capital are the key inputs to that production function. And if you're going to innovate, ultimately you need to hire new people. You need to change your process. You need to power that process in people with new information and you need to meet the demands of your capital.

And by that I mean every capital base comes with constraints and advantages that you really need to understand before you take something on that's too innovative. If you have short term, you know, liabilities, for example, then you can't take on direct investing in infrastructure as your innovation. So understanding that capital is critical. And then we look hard at the enablers that help investors change those inputs.

And based on our research, that's governance, culture and technology. And so all of that comes together into what we think of as an identity of investors. You've heard of the Canadian model, the Yale model, maybe you've heard of the collaborative model out at CalSTRS (California State Teachers Retirement System) or the Norwegian model. These are all different combinations of these inputs and enablers, and we think of them as an identity.

And ultimately, one of the big components of every identity is its capacity to change. You know, the Yale model was invented in the eighties. The Canadian model was invented 25 years ago. And so at a certain point, these models will have to shift and change. And ultimately, that's the work we're doing at SLTI, to understand what they're doing, how they'll have to change to keep up with, as you said it, really interesting and uncertain times in the world. And you know, as we see ChatGPT and all the different technologies heading, I feel like there's a incredible focus on technology for the first time.

Rohan Singh

That's super interesting. And actually I was intrigued by your point on identity. Because that seemed like foundational. And just the further question to that, do you see that identity formulation quite different across the world because you're running across asset owners, you know, from different geographies? Be curious about your perspectives on that.

Ashby Monk

I love that question. I would have planted it if I could because honestly, I think there are no two investment organizations that are the same. Every single one of them has a unique sponsor. In general, their capital base is incredibly different. You know, even in Toronto, you have the Canada pension plan, you have Ontario teachers. Both those organizations are often thought of as, you know, the creators of the Canadian model. One is a very mature, defined benefit pension plan. One is still in an accumulation phase.

So you're going to see very different identities and implementation models across those two organizations. I see this In Australian super funds. I see this in American pension funds, U.S. endowments. There is a very unique aspect to the things everybody is doing. And so the purpose of this little model we put together, the identity model, is to try to reduce, to boil down what investors do to these seven criteria so that we can start to think about that apples to apples comparisons. How do people get their people? What is the process they're running? What is the key information they require? Those are types of questions we ask as we're going in to do case studies and sort of assessments of investments organizations.

Rohan Singh

Interesting. We use a similar catchphrase when we've done some research to deliver insights across areas such as internal versus external management, SaaS (Software as a Service) versus DaaS (Data as a Service) et cetera. And we call it, you know, there is no one size fits all, so your point is very relevant.

Second question, as clients, as institutions embrace this, what are some of the key challenges that asset owners face when implementing innovation, and what have you seen in terms of the successful ones that have overcome those challenges?

Ashby Monk

Sure. Great question. Again, these organizations were designed not to innovate. So that's the first challenge when we set them up, you know, 30, 40, 50 years ago, the idea was they would just, you know, be a conduit, a post office box, taking the money from the sponsor and handing it off to the managers. And in so doing, you know, we created quite a lucrative asset management industry in this country and around the world.

But over time, you know, in order to meet their unique objectives, these asset owners have sought to change that post office box style institutional investment. And then they start bumping into the challenges of innovation. And obviously prudent person rules are fabulous, but it pushes these organizations to really look hard at what their peers are doing before they do something, similar with fiduciary duty.

Again, you know, you often hear fiduciary duty held up as a reason not to innovate. Many of these organizations have monopolies over their asset base, which means they're not going out of business. And, as people in the private sector know, that threat of failure, that threat of exit from industry is often a huge driver of innovation.

If you're working at a pension fund or university endowment, that pension fund and endowment will exist beyond you. The question is, are you still going to be there? And so that actually creates an interesting incentive not to change at all, because if you can kind of meet the peer benchmark, then you're probably not going to get fired. I often joke that the only way to get fired from a public pension plan is to innovate and deviate from your peer group. And that kind of speaks to that.

And then there are other issues like the consulting model that many of these organizations rely upon, tends to push organizations to establish strategies and managers that consultants can kind of sell many times rather than once. And then boards of directors often prioritize efficiency, which is to say, let's keep the cost down of running our organization. And anybody who's done an innovative project knows you can't run innovation in a just in-time style, you know, project. It is messy and it's expensive and there’s going to be failure. And so that focus on efficiency tends to really hinder the ability to innovate. I'm having to pause there. I could or I could tell you how we overcome it.

Rohan Singh

I'd be interested in just picking up another view on that. So you spoke about pension funds and some of the news here. What about sovereign wealth funds who don't have that asset liability management model necessarily, have a bit more freedom, might be a bit more private-oriented. Does that enable a greater degree of innovation or do you find similarities?

Ashby Monk

Your instincts are right and ultimately, that was why I, back in 2006, 2007, began to study sovereign funds. We at the time, we're seeing this incredible uptake of sovereign wealth funds among governments around the world from States, we call them permanent funds or legacy funds to investment authorities, to, you know, central banks spending out their foreign exchange reserves into investment corporations. So these organizations were everywhere and so we started to study them with the idea that there's blank pieces of paper there that they can begin to build new models.

And what we learned was it really depends on the style of sovereign fund. Is this a stabilization fund or, you know, an intergenerational savings fund? Those organizations tended to adopt very similar approaches as you would find in a Canadian pension plan or even a central bank for that matter. Where we saw real innovation came in the form of development funds. You know, in Ireland, in Abu Dhabi, in India, around the world, we have these development funds established where they're trying to combine return objectives. So they have to go make money, but combine it with some other, you know, development objective. And in that case, you can imagine there is no off-the-shelf product you can invest in to drive development. And so it's a mandate to innovate. It's a mandate to do something new. And in a government context, that means compensating people well, that means hiring amazing people and empowering them to go and try to drive these new outcomes. And that was strangely a kind of a magical combo. If you look at the success of Temasek over 40 years, you'll see kind of the role model of development fund, where they were incredibly innovative, they drove the development of Singapore and the performance has been astounding.

Rohan Singh

It's a fascinating topic because we could talk about development funds or intergenerational funds, who probably have been more innovative. So, you know, kind of goes against a little bit contrarian, but we'd need another half an hour. So let's move on. We'll pick that up in another time. So once asset owners establish and accept that they need a degree of innovation, they need to foster a culture of innovation within their organizations, they need to collaborate. How do they go about doing that? How do they get that cultural element, in particular, going?

Ashby Monk

Yeah, I think in my experience and this isn't going to be potentially, you know, praised as a comment, I think you need a crisis in order to drive past some of these constraints. In my experience, the biggest kind of step changes in institutional investment over the last 25 years have come just after massive crises. We got liability driven investing after the perfect storm in 2002-ish, we got factor-based asset allocation coming after the financial crisis in 08, 09 and now what are we getting? Are we going to get a renewed look at ESG? Are we going to get new technologies coming out of this crisis? I think we'll see. But the reality is that notion of a crisis kind of obligates the board of directors to empower staff to do something new. Otherwise, there's a focus on efficiency and, you know, doing the prudent thing. And then all of a sudden a crisis hits and that prudent thing doesn't look so prudent anymore. You know, if you're holding, for example, real estate in Florida, you're probably wondering if you need to build, you know, a net zero portfolio that is resilient to climate risk, for example. Well, that's a pretty big innovation. And the more times your buildings get hammered by hurricanes, the more times it becomes a palpable crisis you can't ignore.

Now, the good news is many of these organizations are sitting on crises, unfortunately, but it requires transparency to demonstrate them. So, you know, big project that many of these organizations do before an innovation is simply to get the data and the facts in place. What are we holding? What are the exposures, where are the products, you know, what are the risks? And so what you're seeing in this industry today is a huge investment in technology, what I would call the portfolio GPS. Once you have that GPS for your portfolio, then you can start to think about how to actually go about changing where your portfolio is today. And that's where collaboration comes in, because if you're partnering with your peers, you can almost by definition bypass the prudent person rule. I'm doing it. This other big pension fund is doing it, this other endowment is doing it. We're doing it together. We're all prudent, we're all fiduciary bound, you know, I'm not going to get fired is the punch line. If you do something with Ontario teachers, you can have confidence that people are going to say, all right, that was pretty prudent of you to do that. And that's where collaboration really empowers people to, first of all, understand the space and use resources more effectively. But then also to avoid that career risk that often hinders people from taking that next step.

Rohan Singh

I love the portfolio GPS reference. I'm going to remember to use that myself. But jokes aside, it is a very significant point in terms of, you know, getting a good handle and perspective on how all of the data is, how it comes together, particularly to apply, you know, scenario analysis in what is a heightened risk environment we live in. You know, at BNY, we label it in three ways that we hear from our clients that it's with respect to data, it's data integration. I need better data integration that I need better data aggregation. And then I only then can I apply insights and analytics. So there's still some ways to go.

Last question, so looking ahead, how can asset owners identify emerging trends and technologies that may be relevant to their investment strategies and then what are some of the best practices for implementing these innovation initiatives?

Ashby Monk

Yeah, once again, I'm probably going to disappoint people by saying that the ESG world is actually useful in this. There's this massive rejection going on right now of ESG I feel like. And unfortunately the part about true is this, you know, a lot of the ESG stuff that investors end up seeing are ratings. You know, they're trying to take all of these different signals in the world and combine them into a rating.

Well, if that's your approach to doing ESG, then you're not going to be able to spot emerging trends or technologies that are threats to your portfolio or opportunities to evolve. But if you're going and running, what I would say ESG facts, like you're looking at companies to understand how are they transforming, you know, their environmental footprint, how are they empowering their workforce, things like that. Those are the capabilities inside an investment organization that are tuned for tracking technological disruptions. It's that forward looking, long horizon risks that seem to be often described as non-financial or non-commercial but will be once you cross five years. And so my colleague and I at Stanford, Dane Rook, we've developed this more broad framework for portfolio resilience, which is saying, look, we want a resilient portfolio. We're not trying to make sustainability or whatever the key focus, but we want it to be resilient to these crises that inevitably hit.

And we develop this DARL framework which is Detect, Absorb, Recover and Learn. And so detect is about getting all that data, all those analytics, looking through ESG or alternative data sources to begin to spot patterns that could be a threat to your portfolio, traditional tools and, you know, mean variance optimization value at risk, drawdown risk. They don't help you with this. You have to have an alternative data ingestion capability or ESG capability. I think of those is very similar. And then once the crises hit, ideally you're in a position to absorb it because you've spotted these things ahead of time and then focusing on the recovery and the learning is really the kind of component of innovation that is really powerful because bizarrely, Rohan, the traditional financial theories don't really tell us much about recoveries, recovery profiles of assets. Is it a straight line recovery? Is it a long duration recovery? And so we encourage investors to think of their longer horizon and to see crises as inevitable and to think of the recovery profile and learn from those recoveries and then kind of cycle it back in. And so that's the way we've thought hard about implementing kind of a rigorous process of detection, learning and implementation.

Rohan Singh

Now, that's very interesting, particularly the point on ESG and the linkage to resilience. So that's, you know, putting a different perspective on it. And I'm sure the institutions would love to see some of that research work on. Did I and if I heard you correctly, was it DARL?

Ashby Monk

DARL, yeah, that's the detect, absorb, recover and learn. And so we have a paper too on that, and then the work that we're doing together, I'm happy to say you're helping to support some of the work we're doing on submergence. And submergence is an innovative way of thinking about your portfolio, not just as what is the drawdown risk, but what is the potential recovery pathway. If a surfer gets knocked off a wave and goes underwater. It's not just the depth of the, you know, of the crash that scares the surfer. It's how long it takes to get back and get air. And we think it's a very similar concept in the investment space. How far are you going to go down? But then how long does it take you to get back to the surface? And so we're trying to build math around that concept of submergence and make it a single artifact.

Rohan Singh

Wonderful. Look forward to working with that further at our next session. So I think we're out of time. Thank you, Ashby, for this very engaging session on what innovation means for asset owners. Institutional innovation stating the obvious, a vital aspect of organizational growth and success in today's rapidly changing world. And I think and hope our listeners got some new perspectives listening to Ashby.

Whilst it can be challenging to implement, it does require a concerted effort from all levels of an organization and collaboration with all the various stakeholders. At BNY, we feel we're very well positioned to help you shape your innovation journey, optimize your firm's operating model while you maintain the highest standards of security and resiliency. I hope our conversation has provided some insights and ideas.

Thank you all for joining. I hope you enjoyed the session. Thank you, Ashby.

Ashby Monk

Thank you.