Perspectives Podcast “Ashley Lester: Don’t Call it a Comeback”

Transcript, 24 August, 2023

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is August 24th, 2023.

(00:19):

A few months ago, May to be exact, MSCI hired a new head of research, Ashley Lester. Besides a previous tenure at MSCI, Ashley has amassed experience at companies like Morgan Stanley and most recently, the asset management firm, Schroders. We sat down with Ashley to find out what brought him back to MSCI, where he sees the industry as a whole headed, and also to learn a bit about what drives him, what's he thinking about when he has that first cup of coffee in the morning. One programming note, regular listeners may have noticed that part of my sign off each episode is a thank you from Joe and me. Joe is Joe Collevecchio, co-producer and sound engineer extraordinaire. Today, we had guest hosts to that list because as I was battling a nasty bout of Covid recently, Joe stepped up to the microphone to have this conversation with Ashley. I hope you find this conversation as interesting and as engaging as I did. I'll see you on the other side.

Ashley Lester (01:30):

My name's Ashley Lester. I'm the global head of research at MSCI. I oversee the 450 or so researchers at MSCI who produce all of the intellectual property that goes into MSCI's models, and those include our family of indexes, of which these days, we not run, not only, of course, the market cap indexes, but also indexes that involve ESG, climate factors and all sorts of other concerns that investors might have. We continue to run arguably the industry's leading risk models in the form of Barra and Risk Manager, and of course these days we spend a great deal of time and thought on ESG, climate and also, increasingly, private assets.

Joe Collevecchio (02:25):

I heard Henry say in an investor day presentation once that he has an ambition of building an index for every portfolio. I don't know if we can get there, but that's a lot to oversee, Ashley.

Ashley Lester (02:34):

Yeah, the scope of what MSCI does is really pretty amazing. It's inspirational but also slightly terrifying. What holds it all together, I think, is that fundamentally, we are concerned with producing tools that produce better investments for our clients, often in the form of helping them build better portfolios, and whether that's an index or whether it's a tool that alerts them to investment risk, including the investment risk posed by the ESG practices of a firm or by its exposure to climate change, for instance, all of them ultimately a concern with helping investors solve real world investment problems.

Joe Collevecchio (03:20):

I do know from speaking to you in our pre-production meeting that you have quite the mind. I also recall recording you for a separate internal video where I was privileged to see a glimpse of your bookshelf, so I know that you have a very wide ranging background. What got you into finance?

Ashley Lester (03:36):

That's a great question and actually, I didn't grow up wanting to work in finance at all. I guess one way of answering that is to sort of think of my sort of professional life in three stages. I'm Australian and I was very interested in politics and public policy and problems like inequality and unemployment, and so I was very interested in pursuing those sorts of questions about economics. So the first stage of my career was really as an economist. I studied economics at the University of Sydney. I went to work in the economic group at the Australian Central Bank, the Reserve Bank of Australia, and then following a few years there, I went to do a PhD in economics at MIT, where I continued to be interested in macroeconomics, but actually spent more time on the economics of growth and development and of inequality and of politics.

(04:30):

And so, while I was there, one of my advisors, Daron Acemoglu, won the Bates Park medal for the best American Economist under 40, and my other lead advisor, Abhijit Banerjee subsequently won the Nobel Prize for his work on economic development. So that was very much my set of interests. And after graduating, I spent a couple of years as an assistant professor on tenure track at Brown University and visiting Columbia Business School. And it was when I was at Columbia Business School, actually, that I got an email from pretty much nowhere, from a former classmate saying, "Oh, hey Ashley. I was wondering if you might be interested in running market risk methodology at Morgan Stanley." I'd heard of Morgan Stanley, in fact, I'd read a book about it by Ron Chernow, it's a great book, but I had no idea what they did, but I thought it would be fun to find out.

(05:19):

So I got dressed up in my business school teaching suit and I went downtown to Times Square to do an interview with the guy who eventually became my boss, and the interview mainly consisted of me asking stupid questions like, "What's Morgan Stanley and how does it make money?" And at the end of it, it seemed a bit weird because it seemed like he might give me the job. And he said, "Have you got any other questions?" And I said, "Yes. Don't you care that I've never researched finance, studied finance, thought about finance, taught finance, shown any interest in finance in any way?" And he said, "Oh, don't worry about that. You can take this job, I'll give you a book." And so with that backing, I decided to take a year off from academia and to give finance a go. And my first day was the 1st of October, 2007, which some of our listeners may know was an interesting date to join the financial sector.

(06:16):

I think it was actually the all time market high in the MSCI ACWI for about 10 years, because after that, we plunged almost immediately into the depths of the financial crisis. Morgan Stanley lost something like $8 billion on a single trade. So why did I stay? I think ultimately, it was the excitement and the relevance. As soon as I joined finance, people were interested in what I had to say about questions that they were asking, and they were prepared to take actions based on it right away, and that sense of immediacy and real world relevancy was very addictive to me, and that's why I stayed in finance.

Joe Collevecchio (06:54):

To drop into the wave at 2007 in risk, we all know what happened immediately after that, as you alluded to. I mean, yeah, I can see where that adrenaline rush may have come from.

Ashley Lester (07:06):

It was quite an adrenaline rush. One story which my brother-in-law always likes me to tell is about how... I think it must've been in about the three days after Lehman collapsed. I was fresh into finance, I didn't have, really, a proper bonus behind me, wasn't clear with that I could go back to academia and Morgan Stanley's stock was plummeting by the second. And so I went down to the cafeteria, and in those days, you had those little cards that you had to pre-fill with some money, and generally, I would put $20 on, but on this particular day, I only put $5 on the card because it wasn't clear that I would have an opportunity to spend the other $15 that I might put on normally. So that was a particular sort of adrenaline rush, that was also really an amazing experience to be in the room with the chief risk officer and the other risk managers.

(07:59):

To actually be in the room as the modern bank run happened was really a pretty sort of incredible and foundational experience. That was really the start, in some sense, of the second phase of my career, which was the six years I spent running market risk at Morgan Stanley. And what was really important about that was the learning that happened after that, after we became a bank holding company and came to be regulated by the Fed and the OCC, which involved completely rethinking the framework by which we measure market risk, completely rebuilding our market risk models to capture much deeper tail types of risk, but more philosophically, also to spend a lot of time thinking, how do we know that a model that we build in finance is a good model?

(08:52):

And what does it mean for a financial model, which can only ever be a pretty loose abstraction to the real world, what does it mean for a financial model to even claim to be a good model? And in order to be able to answer that question, you have to ask much more immediate questions like, a good model for what purpose, and compared to what other simplification of the world? And I came to the conclusion quite quickly that if you weren't asking those questions, then any model that you built, if it turned out to be a good model for the purpose for which it was being used, that was just good luck and you shouldn't expect that to be the case. And so, coming out of that experience and having seen what happens when you use models improperly without proper verification and validation and testing and thinking about purpose, I formed a really foundational view that constant questioning of a model's purpose and of its validity is really absolutely critical in financial research.

Joe Collevecchio (09:59):

Well, that sets me up nicely for the next thing I want to ask you actually, that you were at Schroders for the past eight years, but in May, you came back to MSCI. It does seem interesting to me that you would come back after a rather long absence. What drove you?

Ashley Lester (10:15):

To understand that, it does make sense to just think quickly about why I moved on and took on that sort of second stage of my financial career, which was in investment. I wanted to see more of the world than it was possible to see from the narrow but fascinating angle of bank quant risk. And so, I

did that for a while at MSCI, and then I was drawn like a moth to a flame to actually doing investment. It seemed to me that investment problems were really fascinating problems intellectually, and I felt like I really wanted to understand them from the inside. And so, I took the job at Schroders where I started out as head of research in the a hundred billion dollars plus multi-asset group, and then ended up founding and running systematic equity factor investment desk that, at peak, was running about 30 billion US. And my theory that investment problems are fascinating and can take a lifetime was abundantly proved true.

(11:21):

Questions of risk management, seeking excess returns or alpha, of being able to articulate an investment philosophy, all those questions are fascinating, but when an opportunity arose to come back to MSCI grabbed it. The reason I grabbed it is that I had a strong set of views that the investment industry as a whole, including, but not limited to, asset managers, faces a whole new set of challenges. There's a lot of fee compression, there's the challenge from passive investment, there's new expectations being placed on the asset management industry from the end clients. Many of these changes are driven because of underlying changes in technology enabling new ways of doing investment. Helping one asset manager overcome those challenges was exciting to me, but helping the industry as a whole define and confront and solve those challenges for the purpose of building portfolios that better meet the needs of their end investors, that was even more exciting.

(12:40):

So in a word, it was easy for me to come back to MSCI because of the scale of influence which MSCI has and can have in helping to shape the industry as a whole and the solutions which the industry provides to end investors as a whole.

Joe Collevecchio (12:59):

Earlier you did say that one of the fascinating things about finance was just the idea of building models for a purpose, right? So that's an interesting nexus, the ability to influence and to build things with a purpose. Do you mind elaborating on that a little bit? Why do you feel MSCI is a place that can influence the entire industry and towards what purpose?

Ashley Lester (13:21):

That's a great question. Well, really, it's two great questions. So I'll answer one and then if I forget to answer the other one, remind me. Henry Fernandez, our CEO, talks about MSCI being built on the pillars of data technology and models that help serve the investment industry. And because we specialize in the tools that power the investment industry and make those tools available to many industry participants, therefore the intellectual property and the thought process that goes into those tools has a capacity to shape the views of industry participants, or more importantly, the ways of thinking about the world of industry participants, which is really difficult to accomplish from the perspective of a single asset manager.

(14:24):

So to take, perhaps not very controversial, example, in order to build portfolios better, as necessary to build various portfolio construction routines and algorithms, to the extent that we make some new algorithm available for portfolio construction, then that's a new way of thinking about trade-offs between excess returns and risk that may not have been thought of before, and certainly that may not

have been available to investors before, and that now is available to a whole set of investors are collectively serving, perhaps, trillions of dollars of end investments. That's a simple and not very controversial example, but there are also obviously examples that are more controversial but can potentially have great impact as well.

(15:14):

And here I'm thinking of the way in which MSCI can contribute to society's discussion about ESG and climate in terms of providing the information to investors and their end investor clients that enables them to make their own decisions about to what extent they wish to mitigate investment risks or seek investment opportunities coming from ESG and climate, and to what extent they wish to build into their portfolios, their own views about, for instance, investing in companies that might mitigate climate change or investing in companies that might be improving their carbon dioxide path or whatever those views are. And so, we need to take our position of influence really seriously. We provide the tools and the data and the understanding and the capacity for investors to better express their views and to express those views more efficiently and effectively than they would have otherwise. We are not here to tell investors or end investors what to think, right? Ultimately, the investment industry is about enabling end investors to get better outcomes from their portfolios. So that's the influence side of things.

(16:40):

In terms of the purpose of MSCI, building on what I was just saying, all of us are entitled to our own views about all sorts of social or ecological issues, but what's fundamental in investment and in the finance industry is, one, the allocation of capital within society to the most efficient uses of that capital, and two, enabling end investors to best pursue their goals, whether those have non-financial aspects or not, like impact investing, or whether they're purely financial, right? Someone saving for their retirement and wanting to find the best combination of returns on risk to give them a decent shot at having a decent life in retirement.

(17:34):

So these are pretty noble goals, I think, for the finance industry, which [inaudible 00:17:38] MSCI because of the nature of our client base and because of the connection of the service that we provide through that client base to helping the financial intermediaries, primarily, to serve the needs of their end investors, I find it easier at MSCI, perhaps, than at other parts of the financial industry to bear in mind these higher purposes of the financial industry. I think these are really noble aims and I think it's easy to forget that in finance, but I think MSCI is very clear that that's our purpose.

Joe Collevecchio (18:09):

I want to follow up on something you said in our pre-production meeting. You said something interesting in that meeting about influence, and that was that to be a follower, you, by definition, can't be influential, but you also can't have a vision that's a hundred years ahead of everybody else in the industry, the sweet spot is really somewhere in the area of three to five years out. You've already brought up the subject of how technology is changing, what trends are you seeing? And if you can put yourself five years in the future, what does investment look like

Ashley Lester (18:40):

As perhaps it's been coming through in some of my comments, I like to think about trends, not only in the sense of what's been happening in the last three months, but in a broader historical context, and I think it's often underappreciated just how much the financial world we live in has already been shaped by technology. For instance, if you work in a bank or certain sorts of hedge funds, perhaps that's relatively obvious. If you work in certain types of asset managers, it may be less obvious because you can think of yourself fundamentally as still selecting a handful of stocks or bonds and it's less obvious the effect of technology. But overall, I think it's in incumbent on us to realize that the financial sector has not always been the pivotal sector in the economy that it is today. For about, at least, a century through to about the 1960s, or certainly for the first 50 or 60 years of the 20th century, finance was a fairly boring, sleepy sector.

(19:46):

There were some good times and some bad times for financial sector workers, but overall, in the US for instance, finance averaged about 4% of GDP, and it definitely wasn't seen as sort of an industry of the future. And then between 1970 and, say, the late 1990s, something obviously changed and finance became the sector of the future, became the place where the largest incomes were made, it was the subject of movies like Wall Street and books like Liar's Poker. So what happened? Obviously there were a number of changes, there were some important changes in the regulatory and political environment in the seventies and eighties, but I would argue that perhaps the most important changes were technological. So in order to make that case, and I'll build this case around what happened in the seventies to give some context to what I think is going to happen now.

(20:47):

So 1971 saw the launch of the first index fund, obviously a development which was incredibly important, ultimately, to the development of MSCI. 1974, Barr Rosenberg published his seminal paper on factor risk, which led, ultimately, to the development of Barra, part of MSCI. '75 and '76 saw Merton and Shaw on option pricing and Steve Ross on the arbitrage pricing theorem, in some sense that the theoretical underpinnings of much of modern finance. 1980 saw the SEC adopt the world's first VaR based capital rule, right? So in the course of those 10 years, you go from a financial world, which is totally unrecognizable to us, to a financial world in which all the bits that we see today from passive and index investment, to a VaR based risk management. It's all already there. And what changed, I would argue, was the technological capacity to use formulas like Black-Scholes on option pricing or to calculate a VaR or to do enough trading that would be relevant to do either of these things, right? Or to keep your records quickly enough that you could start to establish the sorts of leverage which we saw established in modern finance.

(22:08):

So the technological changes which were happening at the same time included, but were not limited to, things like the first memory chip introduced by IBM in 1970, or the floppy disc introduced in 1971 or the foundation of Microsoft and Apple in 1975 and 1976. So there was a technological revolution in computing which underpinned and made possible the world of finance, which we see today, a quarter of the way through the 21st century. And I think about technological revolution as, really, the first computer revolution. And I've started calling it the first computer revolution because what it really did was enabled, all of a sudden, calculations, numerical calculations to be done close to zero cost, and, of course, the cost has just continued to fall literally exponentially ever since. And so, if the cost of doing numerical calculations starts falling exponentially, you start doing a lot more of them, and that's modern finance in a nutshell.

(23:15):

So what's the second computer revolution? Well, I think when ChatGPT was released on an unsuspecting world late last year, it was really sort of, to the public at large, that was the creation of what I think will be the second computer revolution, which is the ability of computers to handle words just as quickly as the computers, which we were all used to, handle numbers, and that will have enormous consequences very quickly for the world at large, very much including for the world of investment, and I think it's that fundamental. And so I did the history lesson because I wanted to demonstrate to our listeners just how fundamentally technology shapes the world of finance that we know, which is perhaps not something that's completely obvious, and to think about how the types of models that we run and the ways in which we quantitatively think about the world are shaped by the types of computers that we run. And now that the types of computers that we've run have changed so fundamentally or in the process of changing so fundamentally, we should expect similarly fundamental change in the financial industry.

Joe Collevecchio (24:37):

Okay, so computers got good at crunching numbers, now they're getting good at crunching words. What does this mean for a risk officer or somebody on a trading floor?

Ashley Lester (24:46):

Looking at my own personal experience, both as a risk manager and as a portfolio manager, the risk management part of the financial industry is really fundamentally built around running a bunch of risk models overnight. And bear in mind that those risk models essentially rely on the types of linear algebra, which can be done pretty simply by computers, and on highlighting the types of enduring exposures, which also can be conveniently captured in numbers, running a bunch of risk models suited to the way in which computers run today, and then a risk manager looking at or observing some report on those numbers early in the morning and spending a lot of time digging through that report in order to find something that might be interesting, some outlier, something that's changed, something that's surprising or seems not in line with good risk management. And then once the risk manager has spent a few hours doing that, then they might have to spend some time digging in because, of course, we're often not completely sure whether the surprising feature of the risk report is actually there or it's some problem with the data.

(26:07):

And then once they've spent a few hours digging into that and are reasonably convinced it's there, they might write up their observations and take them to a chief risk officer, and the chief risk officer might review them and ask them more questions, and that might take some more time. And by the time they've done all that, finally, by sometime, let's call it mid-afternoon, the risk manager or the CRO can go to the portfolio manager or the trader and say, "Hey, we've observed this surprising thing in your portfolio." But portfolios and traders are changing their positions all the time, so it may well be that by that time, that position's gone anyway, right? Now, I'm being a little bit unfair to the process of risk management perhaps, or caricaturing it a little, but I think not too much, right? So risk management is, as we know it today, is great at risk monitoring, it's great at controlling risks, it's great at reporting those risks to senior management, it's great at making sure that big or surprising risks don't persist for too long.

(27:09):

But it's difficult just because of the nature of the interactions and the nature of the models and the timing of the delivery of information to bring risk management significantly closer to the actual business of portfolio management or direct risk management on a trading desk because the time horizon of PMs or traders tends to be much quicker than that. So now imagine, instead of that whole workflow, that overnight, as the risk models run, and perhaps the risk models, by the way, because they can read the news and they can read company reports and so on, might understand many dimensions of the world that current risk models might not.

(27:55):

The computers run the risk models overnight and in the morning, before anyone's even woken up, an email is delivered to the CRO or to the portfolio manager or the trader on the desk that not only says, "Here's the risk report," But more importantly, "Here's the risk report and here's what you need to know. Here's something that's really unusual about your current risk exposures, and it's really changed since yesterday, and it's changed since yesterday for the following reasons; Because you traded into a new position or because you have a big position in a stock and there was lots of news out about that stock yesterday, and so both the factor risk and the specific risk in that stock has really gone up. And by the way, the news about the stock was that the CEO is resigning."

(28:47):

All that information is at the fingertips of the actual decision makers as they drink their first cup of coffee in the morning. And so the first thing they do, the first action they take in this version of the world is framed by the actionable information contained in their risk report, and that vision of the world, that risk report, which is available at that time, with that degree of reliability, with that degree of insight into both positions and markets and companies, all of that is enabled by artificial intelligence as we know it now.

Joe Collevecchio (29:27):

MSCI has been using AI to data mine for a while. Can you go into that a little bit for us, please?

Ashley Lester (29:34):

Yeah. I think that there's two steps to understanding the relevance of the types of applications we've had of AI for a while. One is the literal step of understanding the sorts of applications which we've had in AI for a while, and which will naturally be very much expanded as we see this sort of revolution in the capacity of AI primarily via large language models or LLMs. So literally the sorts of applications which we've used AI for to search in written information about companies in a programmatic way for information about the activities of various companies in order to sort them, for instance, into investment themes, we've used various types of AI to assist us in unheralded but incredibly important parts of the financial system, like just cleaning data and helping us to spot problems in the billions of data points that we process a day.

(30:36):

So we've had experience going back five to 10 years across a variety of those types of applications, and that's been very valuable and we can build on that experience directly as we go forward with the next generation of AI. I do think it's fair to say that the next generation of AI represents, really, a qualitative leap in AI's capacities. Virtually anyone who has been working in AI until now, I think, needs to recalibrate their expectations and the types of questions they wish to ask or think that they can

answer because of the really dramatic progress we've seen in large language model. There is this sort of quite fundamental, or at least qualitative break, which should cause everyone in the industry or in other industries using AI to sort of pause. In some sense, I think what is more important about our past use of AI is our awareness of its limitations and of the challenges which will arise in its use. I'm incredibly bullish about AI.

(31:47):

I think it's a completely transformative technology, but it's still serving humans, and there are real challenges with harnessing AI to serve humans, particularly in a field with very limited tolerance for errors such as ours. AI models are very hard to understand, they're hard to validate, their output is hard to verify. In fact, in some sense, a lot of the time, the output of AI models is hard to verify because it can even be difficult in some sense to understand, unless we're very careful, exactly what question the AI model thinks it's answering. So that means we need to be incredibly careful and conscious in our use of AI. So for example, one could imagine asking AI to tell you about the top 10 firms that are involved in some given theme, some particular type of biotechnology or the metaverse or whatever theme you happen to be interested in.

(33:01):

And AI is great at giving you an answer so will definitely give you 10 firms, and you could even ask the AI will give me a rating of how much these firms are exposed to this theme, the metaverse, and it'll give you a rating and it'll give you some numerical value. Now if you want to ask, what does that numerical value actually mean? That can be hard for us as humans to interpret. It's not clear that it has a natural scale in the way that centimeters or kilograms have a natural scale. If the AI scores one thing twice as much as another, does that mean it's twice as exposed, or does it have some completely different meaning? One is the square of the exposure of the other? I don't know, right?

(33:50):

So our task is to really think hard about how we ask the questions of AI and seek to be very critical about how we interpret the answers because we can't take risks here. To come back to the social purpose of finance is for end investors to get more out of their savings, to better finance their retirement that they've worked so hard, for example. And so, we can't be cavalier in just throwing any old thing that the computer generates at that incredibly difficult and important problem. To come back to your question, our past experience in dealing with AI alerts us to some of these problems, not only with errors, which, of course, the whole world knows about, but also these deeper problems with understanding the output of AI, which I think will be critical to getting the best out of its use.

(34:45):

Just quickly in terms of the look ahead, MSCI researchers are working, as we discussed at the start of this interview, on a vast array of topics all the time. The topics which excite me most are the topics where we see convergence across previously divergent investment themes. What's the connection between making ESG and climate and a broad range of factor information available to investors and enabling investors to build the best possible custom index for their portfolio? What's the connection between that, in turn, and enabling wealth clients to build a portfolio that specifically fits their needs and preferences? So we're doing fascinating work on wealth, we're doing fascinating work on custom indexes, we're doing fascinating work on AI. A lot of these threads are drawn together by customization, by giving investors greater control over their end portfolio than they had before.

(35:49):

Those are just a handful or a sprinkling of the most important research topics that researchers are working on and that we'll see some progress in over the next few months.

Joe Collevecchio (35:59):

Well, Ashley, I look forward to seeing some of that progress and look forward to having you back on the show to maybe discuss some of those topics at another time. Thank you for your time today. It was an absolute pleasure talking to you.

Ashley Lester (36:10):

Thank you very much, Joe. It was an absolute pleasure to be on the show.

Adam Bass (36:14):

That's all for this week. A big thank you from Joe and me to Ashley, and to all of you for listening, and I hope everyone listening is able to enjoy this last little bit of summer. We'll see you in September. Until then, I'm your host Adam Bass, and this is MSCI Perspectives. Stay safe.

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