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TRANSCRIPT

Can Asset Owners See Around Corners?

*Featuring: **Baer Pettit**, President and Chief Operating Officer, **Roger Urwin**, Advisory Director*

Adam Bass:

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 February 18th, 2021. In today's episode, we examine the concerns of asset owners, pension funds, sovereign wealth funds, and others whose actions affect well, all of us. MSCI's recent global institutional investor survey, analyzed responses from 200 of these investors who collectively manage close to $18 trillion. While the survey delves into a number of issues, today we're going to look at climate, private assets, the move toward in-house asset management and data and technology. All issues that are on the rise. To sort through it all we're joined by industry veterans who know the asset owner organizations very well, though they do come at them from different perspectives.

Baer Pettit:

So my name is Baer Pettit. I'm president of MSCI, and I run all the operating functions at the firm. So pretty much everything bar legal, HR, and our general counsel report to me at MSCI.

Adam Bass:

And...

Roger Urwin:

I am Roger Urwin. I am, in my day job, I'm going to say a global head of investment content at Willis Towers Watson. So that's a job that keeps me busy with the asset owners of the world who are all very stretched at the moment for various reasons. We can go into that. But I also have a long-term relationship doing advisory work for MSCI. So that relationship has been really interesting journey. And I kind of have some insight that I can share on this insights paper, particularly.

Adam Bass:

We'll get to those insights, but first we're going to take a step back because my guess is that more than a few of you listening are asking yourselves, "Asset owner? What exactly do you mean by that?"

Baer Pettit:

First of all, within this category, there are a broad range of different types. And so it's very tricky to lump them all together, whether they're acting on behalf of a government or a group of universities, or what have you, the key point is it's the centralized decision making around a large pool of capital that makes them interesting because a relatively small number of people in those institutions can have, risk, clearly risk oversight and constraints and all of those things, but nonetheless can have a fairly out-sized impact.

Adam Bass:

Can we get a bit more specific?

Roger Urwin:

Yes. So asset owners are a very well-defined group to some people in the world, but it's quite subtle because you have to see them in categories. So pension funds, you've got public pension funds, you've got corporate pension funds. You've got defined contribution pension funds. You've got sovereign wealth funds. You've got insurance assets and you've got endowments and foundations. If I called out six, that's probably correct. But essentially these organizations are ultimately kind of the most influential in the investment world at the moment, even though they have far smaller staff, they have a bigger sway on how the investment industry is changing.

Baer Pettit:

And hence, the survey is interesting because if you say that 31% of plans over 200 billion think that climate is the most important issue facing them, then likely they're going to do something about it. And that in and of itself will almost certainly influence capital market.

Adam Bass:

It struck me that both Baer and Roger mentioned how asset owner organizations were relatively small. I asked Roger if he could put that into context. Help us with relative size here, maybe say compared to, oh, I don't know, maybe asset management firms.

Roger Urwin:

If you think about the relative scale in terms of frontline investment professionals, roughly speaking across the world, there are six times more people who work for asset management organizations as who worked for asset owner organizations. Kind of large asset owner may well be 200 or 300 people working on the investment challenge, whereas a large asset manager, you're talking about several thousand people working on the investment challenge. So, that's a reality check on how far the asset owners have developed their internal capability, because of course the asset owners would argue when you actually look out there, they've got all the resources they need because they have access to the whole of the investment management industry, all those different firms from BlackRock, the biggest down to organizations that may well be boutiques.

Adam Bass:

Now that we've got the lay of the land, let's turn back to Baer's example of the sway that asset owners can have. When he brings up a focus on climate it's not just a hypothetical example. ESG and climate came up time and again, in one form or another across regions, and also with asset owners of different sizes. Now on our last episode, we spoke about how significantly climate change is affecting investors generally, but given the influence asset owners have we want to spend some time examining how they are thinking about it. Climate change also happens to be a good place to dive in because it brings out some of the more surprising findings from the survey. We'll start with Baer when we asked what stood out for him as he read through the survey results.

Baer Pettit:

Well, look, I guess the element that was striking and it's not a huge sample size, but it's 200 major institutions across the world, is that there are some significant variance in emphasis based on both the geography of these investors and their size. So, just maybe to pick out a nugget that caught my eye, amongst the very large plans, 31% climate change or climate risk was the most important issue they were facing. When you go down to the smaller plans, which is below 25 billion, which is still in our case, fairly decent sized plans, that concern on climate change or climate risk was only ranked 11% amongst them. And in fact, the major concern of small plans, 26% of them was market volatility or market uncertainty. And in turn that concern for large plans was only 12%. So with some rounding error, the emphasis of those two categories from the biggest plans to the smaller ones in our survey was almost reversed.

Baer Pettit:

Another element that I was struck by was more from a geographical point of view, the region where climate change and the increasing importance of ESG were ranked first and second priority was the Americas. And in turn, climate change appeared as the third priority in EMEA and in Asia Pacific. So it's still up there for sure. It's the third priority on a much longer list.

Adam Bass:

It is surprising compared to Europe. Any thoughts on what's behind that?

Baer Pettit:

I don't want to put excess weight on this to a degree because let's say the space between the second priority and the third is call it roughly one's roughly 19 20% and the other 14%. So it's not a dramatic gap. It may well be that it reflects the fact that Europe already, or EMEA already was out more ahead of this. It could in fact, be some element of specific example influence. But my bias is to believe that this topic has really become way more front and central in the Americas in the last year. And that with the change of administration that emphasis will only increase as we've seen the Biden administration issued quite a number of executive orders related to ESG and climate in the very first weeks.

Adam Bass:

The first point you mentioned about size, however, that really is striking, especially since, as you mentioned, it's almost completely polar opposite, large to small. I'm wondering if that's coming from... Is that perhaps more of a operational response, our larger firms? Yep. Go ahead.

Baer Pettit:

Yeah, no, look, I think you're onto something there. My bias is that the larger plans have perhaps at the margin, well, they have better infrastructure. They likely have or are better staffed in areas across the investment process in risk management, et cetera. And so I think it's likely that the smaller plans feel a bit more sort of acutely sensitive to market volatility.

Roger Urwin:

What is becoming the case is that with the development of the Paris alignment strategies, and basically really making sure that portfolios are Paris aligned and have the capability to at some stage, get to net zero, that particular proposition has cascaded into the biggest funds and hasn't yet filtered through the entirety of the asset owner spectrum. And the reason for that is that the biggest funds are easier to engage directly on it and have a bigger profile.

Roger Urwin:

And I think this is one of those kind of filtering processes that exists where nation states have been doing things on climate change ambition. And they're asking for the private sector to play the appropriate part, and they're doing so by asking the biggest funds first. It's obviously been on their agenda from a risk management point of view, but it's also now starting to play a role in their kind of overall framing of what the fund is there to do. It's more in keeping with the wider stakeholder responsibilities as well and what's called a license to operate. Now, smaller funds just haven't had the same pressure and smaller funds are more nervous about markets. And you could say that is reflective of the fact that they haven't got the same degree of investment resources, that those big funds have. Those big funds are probably more at ease with the fact that markets are volatile and that they're in the program on that as it were. Whereas the smaller funds are more nervous that they haven't got their investment results fully in control because of the volatility of investment markets.

Adam Bass:

Whether the issue is climate, managing volatility, or even keeping the lights not just on, but shining bright through a global pandemic, the survey highlighted the importance of data and having the technology in place to collect it, parse it, and this is the part keeping folks up at night, putting it to work effectively on the investment side of the house and to do all of this as the scope and sources of the data continue to increase. One example that came up in our survey was an in-house private equity team looking into a chain of fitness centers. They would likely need to analyze long-term fitness trends, demographics, and even the rate at which expensive fitness equipment will need to be replaced, but they also need to look at new datasets, such as satellite imagery or even data from wearable fitness devices. All of this data can be costly and difficult to assess when it comes to cost benefit questions. The point is, as in every industry and every aspect of life these days it's show me the tech.

Roger Urwin:

I think that these organizations asset owners are coming to terms with the fact that they have to master the technologies that will make a difference to their futures. And so from that point of view, that hasn't been easy for them in the past. I think the platforms they've run the problems with data that they've had that data to manage their portfolios efficiently and integrate all the different technologies of multiple pieces of the puzzle as it were. They've been bolting these things together, they're still running a lot of spreadsheets. They haven't necessarily got all the latest technology in place to be efficient for the next three to five years.

Adam Bass:

On the other hand, when COVID lockdowns hit...

Roger Urwin:

You might've expected more hiatus around the idea that workforce that did turn up at the office was actually working from home using Zoom communication, video communication. It actually shows that an intellectual capital business like this can adapt quite quickly with the benefit of technology. So if we'd worked on the technology of five or 10 years ago, this would have been a disaster in my view, but in practice, the operating model of these organizations was surprisingly robust. And so from that point of view, nothing fell over and therefore these organizations were able to pick up a rather change landscape for how they can be successful into the future. And they have indeed embraced technology more successfully as a result of that. So from that point of view, some of the future is really to do with how technology will play a bigger part in their operating model in future.

Baer Pettit:

I don't have the exact number in front of me, but I do recall very clearly that in fact, it was U.S. investors who were most convinced that technology would have a fairly significant impact on what they do in the years ahead. Because I do think that still at the margin, that's where we've seen a lot of these changes being brought into play. So look, I think that the role of technology will both as it normally is, be more dramatic than we expect in some areas and less dramatic than we expect in others. I do think that the role of technology will significantly enable efficiency at MSCI. One of the things we do is create pre-payment models for asset backed securities, which is a very complex area of financial modeling. And this is, again, with rounding error, but to readjust these models, to changing prepayment data, coming in from millions of homeowners in the U.S. as an example.

Baer Pettit:

Used to take various experts months to do that. With machine learning and AI, elements of that work can be once you do the programming, obviously, and once you've you've trained the machine, can be done in like 10 minutes.

Adam Bass:

Baer and I went on to discuss the benefits of machine learning and whether they extend beyond the idea of machines performing human tasks more quickly, or if technology was actually offering more, even unlocking the door to insights, we mere humans may otherwise miss.

Baer Pettit:

The machine driven method is marginally more accurate. It depends what he say marginal. It is more accurate, but it's not dramatically different. It doesn't give you a different outcome, but it's more accurate. And for [inaudible 00:17:12] it's more efficient and timely. And so I think it will... While machines and we at MSCI intend to continue to build those machines, so I'm definitely a believer in that part of it. The machines will, I think, be able to tell you more and more quickly and accurately the degree to which certain types of events are anomalous in view of previous inputs or previous constraints. But there are other things in those categories, which are more than just efficiencies. They're uncovering patterns that are otherwise not seen. And I also think it will drive the user experience.

Baer Pettit:

With consumer technology, there is enormous amounts of effort put into the look and feel and the ease of use. And generally, of course, the thing needs to do what it says on the box. If it's a phone, people want to make a phone call, well at least someone over 30 wants to make a phone call. My 16 year old son does not want to make a phone call. That's a whole nother subject. But anyway, but other than that, it's heavily focused on the attractiveness of the experience. Whereas, the more complex stuff in financial markets, typically the more complex you get, the worst the user experience to a degree, whether it's [inaudible 00:18:47] programming their own things, or some highly sophisticated tools, one area that I think will be, which I think there's a lot of opportunity, is to make the user experience of sophisticated financial technology, much more attractive.

Adam Bass:

Well, sure. Right. Because those same people, or even your 16 year old son, or my 13 year old daughter, they're going to grow up, they're going to be in the workplace. If they were to get a job, even in a very advanced financial services type of processing, decision-making they have grown up coming to expect that it's also going to be attractive and easy to use.

Baer Pettit:

Yep, for sure.

Adam Bass:

So data and accessing data. That seems to be the themes that we're coming to here. And we're definitely in the survey. I want to stick with that, but shift a little bit into the idea of private assets and as investors continue, we've been talking at MSCI for a while now to migrate more toward private assets. Real estate, but also private equity, private debt. When it comes to the data here, this has typically been difficult to get to because it's not a very transparent market to say the least. How can investors deal with that?

Baer Pettit:

So I think there's generally a trend over time in financial markets, for there to be more transparency, Bloomberg brought enormous amounts of transparency to global fixed income markets in the late eighties, early into the early nineties. Right? So, that's an example of a market where, sure you could make comparisons. And there were people who were sophisticated who could do it, but, suddenly if you had a Bloomberg terminal, everybody could do it. But there's also the private debt markets themselves. So there's private debt markets, private equity, infrastructure, some aspects of real estate. So I think in those areas, the elements that are taken for granted in terms of transparency in public markets, notably related to pricing and valuation are clearly, not so clear. And there aren't a lot of common standards for making those judgments.

Baer Pettit:

Now in turn again, depending a little bit on the data source and the time horizon, the strong cases have been made for the outperformance of those markets, precisely because they have illiquid and maybe even slightly less transparent characteristics. But long story short, we think that we're at an inflection point here where private markets transparency will certainly be on the rise. And our belief is that the need for transparency in private assets will accelerate quite dramatically likely in the next, I would say, they call it, it's hard today, exact amount of time, it called the next three to five years.

Adam Bass:

In the midst of these shifts, asset owners are also working to find the right balance between internal and external asset management. The survey found that just over one fourth of those who manage more than $200 billion, those with the most freedom to choose, said that finding this balance was second only to asset allocation when it came to achieving what they would define as investment excellence. This highlights not only the importance of this issue, but also the divide between the largest and smallest players that we spoke about earlier in the program.

Roger Urwin:

The largest asset owners have taken a lot more of portfolio management and strategy decisions into their own organization. So they have teams of people working for them that they've made themselves look a bit like asset managers in practice. And the very largest asset owners, truly do look like an asset manager through that lens. Now, what are the drivers? They have been a lot really about getting more control. So that does represent the idea that if that core delivery is investment performance, why would you outsource all of that, all of that to outside asset managers, when you could actually influence it and control it better if you have your own people? These organizations started out asset rich, time poor, but they've been able to put resources to work in this area, their own teams and their own organizational structures. And they've been able to control things better, and they've also been able to get scale advantage. So that's why this story is very much a story about the biggest asset owners doing that.

Roger Urwin:

The report segmented the asset owner community in into those categories. And it was the group that was more than 200 billion AUM where this internal movement has been so strong. But those of 25 billion AUM and below has stayed largely dependent on their outside asset managers. That type of relationship and that type of setup hasn't changed tremendously.

Adam Bass:

What's been the reaction from the asset management side? How were they handling the shift on their end?

Roger Urwin:

It's been really interesting that the asset managers have been very nervous about this movement. I mean, for obvious reasons. And they have, I think, given these organizations at times an element of they'll come round. They will see the benefit of using us in a future. I mean, that's been a bit of the narrative in the background because they've felt that it's very difficult to build the culture and build the excellence. So asset management organizations have managed to do over time. That's, I think, the experiences of the leading asset owners have been good. Some of them are very good. So some of the outstanding investment professionals have started to cluster in these asset owner organizations. Whereas previously, the asset owners had difficulty hiring the very best people in practice. The worlds leading asset owners have a very high caliber investment team. And so I think that ship has sailed, that this is not a trend that is going to turn around.

Adam Bass:

We've noted before how COVID has accelerated trends that were in motion during the before times. And the survey touches on that point as well. But why don't I let Roger explain.

Roger Urwin:

So we're going to, I think, look back and say there was a pre COVID experience. There was a post COVID period as well, but actually it's rather unique to be looking in on the actual COVID period and getting a data read. What I got from it was the reassurance that the industry was definitely moving on a bit, but it hadn't had to fundamentally change the way that it works. What reports like this do is produce a little bit more texture for your understanding of the current dynamics. And that is really, I think, an important feature that can come through and it helps all of us do something that I think we want to do here, which is basically see around corners into the future. Because investment actually, to be successful, is all about anticipating dimensions of change in an uncertain world.

Adam Bass:

That's all for today. Our thanks to Baer and Roger, and to all of you for listening. For more details about how asset owners are moving forward, you can access the full survey report at MSCI.com. Next up on Perspectives, inclusion, diversity and equity in financial services. How far have we come and how much more work is there to do? We'll speak with those who work at asset managers, asset owners, and right here at MSCI. Until then I'm your host, Adam Bass and this is MSCI Perspectives. Stay safe everyone.

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