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TRANSCRIPT

Institutional Investor Dialogues - Henry Fernandez Interviews Chris Ailman

Featuring:

Henry Fernandez, Chairman and CEO, MSCI

Chris Ailman, Chief Investment Officer, CalSTRS

Henry:

Thank you, Michelle, and Joan for the warm introduction. And welcome all to the Annual MSCI, Institutional Investor Conference. A very special thanks to CalSTRS and CalPERS for co-hosting with us for 16 consecutive years. It is my absolute pleasure to join you all today alongside my very special guest and my dear friend, Chris Ailman, Chief Investment Officer of CalSTRS.

Next month marks the 21st anniversary of Chris's arrival at CalSTRS. Today, he leads an investment staff of more than 200 people and oversees a portfolio valued at nearly $311 billion dollars as of July. As many of you know CalSTRS recently announced an extraordinary performance of 27.2%. net return on investments for the 2020-2021 fiscal year. A record high and surely far exceeding the investment assumption of 7%. I always enjoy chatting with Chris. I am so happy to welcome him today. Chris, it's so good to see you. And thank you again for agreeing to this interview.

Chris Ailman:

You bet, Henry. It's great to see you. It's always fun to chat. I'm sorry it's not in person. But thank you for the opportunity. And thank you for the warm welcome. It was an extraordinary year. It's hard to say, but we made the best return we've ever made in a global pandemic. That just seems wrong, but that's the power of federal stimulus.

Henry:

The power of fiscal and monetary stimulus, right.

[Chris Ailman]

You got it right.

Henry:

Well, I want to start by congratulating you again and all of your colleagues at CalSTRS on your recent pledge to achieve a net zero portfolio by 2050. The investment industry and the capital market participants in it, are an essential force driving the transition to a decarbonized economy. And I commend you for making such a bold commitment. So, Chris has a public pension, you engage with a wide range of stakeholders, including government officials, as a manager's public and private companies, community leaders, and of course, current, and former educators. Was there any one specific, stakeholder group that pushed the hardest for CalSTRS to adopt a net zero pledge?

Chris Ailman:

You know, Henry, I would say the hardest or the strongest voice was actually that of our board members. Our actual retirement board members, the teacher members, and some of the state elected officials. Now, clearly, we get a lot of loud voices. We have about a hundred, very zealous. retirees and current school teachers, who come to every meeting, and they're from fossil free. So they just absolutely advocate that we divest of fossil fuels. And in their view, that will solve climate change. We've cared about climate change long before them. And it really was the board who initiated this. Now, we do get, we're probably going to get government pressure. There's no question, California is out ahead on climate change. And the governor has a task force and has some very vocal people on it, like Tom Steyer. So we and PERS are going to probably get an increasing amount of governmental regulations, and pressure, and bills over the next couple of years. But without question, this is led by our board.

Henry:

In an interview at the beginning of 2020, so almost two years ago. You said you were surprised at the slow reaction that the institutional investment community was having to climate change. Do you think that has changed?

Chris Ailman:

Again, Henry. When I look back, I bifurcate that. On one hand, I'm actually now flat-out disappointed at the lack of response from some of the asset owners and some of the asset managers. On the other hand, I'm impressed. Europe, Australia are just way out ahead of the curve, doing some really bold things. On the other hand, within the USA, I have to say I'm saddened by just the lack of response in the entire middle of our country. It really is being isolated to, you know, the New York and some of the east coast, and then California. With respect to the asset managers. And I don't want to take a tough shot at them, but I guess I am. I have seen far too many asset managers who are quick to sign up to the PRI. Quick to sign up to TCFD, and they did nothing. You know, maybe they hired a sustainable officer. But frankly, they need to really step up and integrate climate change and really ESG. Not just in a few products, but across their entire investment process, from top to bottom. And have all of their staff thinking about this and working on it within their portfolios. It's not a fringe area. It needs to be a central part of the investment process.

Henry:

So, Chris in the context of that, you know, many leaders, many members of our society around the world, point to government officials, regulators, the energy industry, technologist, technology companies, renewable energy companies as the solution to the climate change problem. But seldom do they talk about the role of capital and the role of investors in creating that solution. So what can you say to that?

Chris Ailman:

Investors have a huge role because you're talking about trillions of dollars, that's needed in this, I'll call it, overall energy transition. Some of that will be the new technologies and things were not even talking about today, but they'll be huge opportunities. So there's a-- the world is awash with capital. I mean, you see it with not just pension plans, but mostly the sovereign wealth funds. There's plenty of capital chasing good ideas. We have the capital to fund new ideas, to fund projects, that banks might not frankly be willing too. And let's face it, in that middle debt market, the banks have really had to step away. So we do have a really critical play.

Now. I think the other side though is, the energy companies are absolutely huge. And let's face it, the vast majority of energy is privately held by-- Well, not privately, but by like countries. And so we need the few publicly traded energy companies to really be the ones that lead this transition. And they may be part of the solution because there's no question we're going to need carbon capture of some sort, and then we're going to have to find a place to put it, which is not dumping it in the sea, but probably pumping it back underground.

Henry:

Late last year, as you know, a dozen or so asset managers created a net zero asset manager alliance, which now has over a 120 members of signatories, and over $40, or so, trillion dollars of assets under management. One of the signatories to this alliance has indicated that, that he feels that they have reached a tipping point, at least of awareness. Is that so? And, and if, if not you're talking to your peers in the institutional investment community around the world. What can all of you do to continue to encourage the asset managers to do their part in this transition?

Chris Ailman:

I think we are-- have reached that tipping point where, where managers big and small are talking about this, and realize they need to be aware about it. There are mega trends. And this is one of those mega trends that they can either get ahead of, or then wait and follow along. But they need to be aware of and factor it into their investment process. They're far too many CIOs I talked to, who are just not even interested in getting into a discussion on climate change. Partly, because it becomes so binary, there are so many people out there, just saying. Oh, the answer is divestment. That's all you got to do. And, you know, I think realistically, we know it's much more comprehensive, much more involved in dynamic.

Henry:

You have been very vocal and a strong critic of using divestment as a tool in the investment industry. I think you even tweeted back in December, something like, divestment has not solved its social problem in 25 years. So what do you say to those activists, you know, climate activists, for example, some other investment organizations that are using divestment as a strategy?

Chris Ailman:

It's been a hot debate. That comment is one of the many that pushed me off Twitter.

Henry:

[laughs]

Chris Ailman:

Henry, I would say divestments' an investment decision. You know, just means you're going to sell. And I've had really good debates with people going back to South Africa. So let's go all the way back to 1986. CalSTRS divest of banks and businesses doing business in South Africa. Not until 1991 and early '92, does Apartheid end. And we all agree that's a good outcome, a great outcome. But in between, there's Sports boycotts, there's banking boycotts. The whole world gangs up on South Africa. And that was huge.

CalSTRS, I'm sad to say, is kind of the poster child of divestment. We divested from six different areas. We're now at the point where we broke even on two of them. But otherwise, we had lost money in everyone. And part of the challenge has been none of them brought about any social change because they weren't a social decision. They were an investment decision, And, you know, Henry when I've seen in, and we'll talk about firearms, a really passionate area for our teachers and for our board. We have engaged Dick's Sporting Goods for years on firearms. But when the students at Stoneman Majority started tweeting and, and personally went after the CEO. It's social change that really has brought about attention. That CEO paid attention right away.

Henry, I often use an analogy. You know I love analogies. And I tell the teachers, like if you don't like the school board, and your school district and their curriculum, you're going to write letters. You're going to go to the school board meetings and complain. You might even go so far as to run against the school board and to try to bring about change and you'll get their attention. If you're mad and you sell your house and you move to another school district, you're going to sell your house at the market, you're going to sell it to somebody else, who may not even care about that board. And the school board doesn't care at all because you're gone. Did you solve a problem? You made an investment decision, but did you solve a problem?

Henry:

So if it's not divestment, it's engagement. And let's talk about ExxonMobil. So, back in December, you made an announcement that you were going to support the slate of independent directors proposed by Engine No. 1 to the Exxon board. And in the spring, three of those four members were installed at ExxonMobil. So, can you share with us a little bit about that process? And what were some of the surprises? What were some of the negatives, you know, that came out of that?

Chris Ailman:

It was a great experience, I have to say. You know, we've been in corporate governance since the late 80s. We have been a steady, but fairly quiet, we've only done a couple of very, say public, or taken on a company and confronted them. We prefer to talk offline outside the boardroom. And, and I had kind of thrown in the towel on Exxon. I was so disgusted with their board and their CEO over the past couple of years. The way they have just been, obviously, subterfuging. climate change and pushing out misinformation. It was very frustrating. So I was eager to see when our staff brought the opportunity to team up with somebody to take them on. And we really debated whether to join them or to just team up with them. And the decision was team up with them. Let them go first. And the hill looked giant in front of us. I have to admit one of my analogies with the staff was, you know, I said, hey, you know, we've been climbing the local hills for years and we're really good at that. But now, you want to take up mountaineering. And the first hill you want to climb or mountain you want to climb is Everest.

The really interesting lesson learned, was how Engine No. 1 really went after this from a technology standpoint. A huge voting block for the Exxon retirees. And they really figured out actually how to approach them through technology. And not just do, you know, sidebar, ads on different pages, but I'm told that in technology, if you get in and close above the half, a percent, to a 1% click-through, that's huge. You know, they were up in the 7% - 8%, where retirees were listening to their message and paying attention to the change.

So, yes, we were surprised to be so successful. Our phones went crazy when Exxon suddenly froze. Didn't end but froze the general meeting. The annual meeting. And it was clear they were calling institutional investors, begging them to change their vote, which outraged many people. And hopefully that'll be a little forensic review of that at some point with the SEC about whether that's allowed or not. But then. finally. toward the end of the day, you know, it finally came out that we had one and then two and then later when the count went through, we had three board members. And you look at the dialogue of ExxonMobil from that date to now and it's completely changed. Just dramatic, what they're talking about and where they're going. So now the hard work begins. Now that board really does need to change that company from the top down because it's sure clear to us that from the bottom up in that company, you know, it was just drill baby, drill, and we don't care, and we're going to push everybody out. They got to completely change that attitude and look at this differently.

Henry:

So we cannot commend you enough for that leadership. And it was about time that somebody would step up. And as you said, try to climb Mount Everest opposed to the local hills. And climb you did. It was enormous an achievement. So the question now, that you have put the whole corporate world on notice, that something like this could happen. What is next? Is this a one-off or you think that this is the beginning of a series of activist campaigns, in which selectively CalSTRS will be involved in?

Chris Ailman:

It's not a one-off. I think what we proved, Henry, is that that being an activist shareholder, as a tool in your tool kit is important and it works. And like you said, it put corporate CEOs on notice of like, hey, we're going to use this as a tool in the future. We're not afraid to take it on and we showed other institutional investors that when we team up, we can be a powerful way for change. But it's got to be, you know, and there are companies that don't use their capital, allocation. They waste their earnings and CEOs, who just don't think long-term. Those are the companies that are at risk because we want them to change the way they operate, and they think long-term. And so, they're not immune. Hopefully, that's the message, that that anybody has to be, they have to be aware, and they have to listen to their long-term shareholders, and pay attention.

Henry:

A lot of our investment institutional clients point to the pool nature of their Investments as an impediment for them to affect change, in their portfolios, as it relates to the climate threat. So, is that an excuse? And, secondly, is what are some of your thoughts as to how pension funds like, like CalSTRS are able to influence those managers to do so? Those pooled vehicles to be able to work, to engage in a transition to net zero?

Chris Ailman:

Henry, a two-fold answer to that. You know, as direct owners of assets, you obviously have a lot more pull and you have much more ability to influence change and make the owners of a company, the board of a company, or physical asset, pay attention. But it's not an excuse just because it's a pool vehicle. Because good grief, we're seeing pooled vehicles in every kinds of shape, and size and index. You. alone, produce a zillion indexes. So if somebody wants to pooled vehicle that is paying attention to climate change, or reduced carbon exposure, or focuses in on one change opportunity. They can take advantage of it. The endowment world does a lot of direct investing within venture capital and private equity. I think people have to really look at their pooled Investments and they get to choose which pool and how what's their benchmark, and they can make some changes in that. So it's not an excuse. It's just a different vehicle in different, different structure, say,

Henry:

It's a lot of our advice and counsel to, especially the endowments is that we recognize that the best managers can be very selective as to who they want to take, take as their investors, but that should not be an excuse not to bring up the topic about the carbonization of the portfolio that they're invested in. So turning our attention to banks. Clearly banks are a major source of financing to the energy industry. And I recently spoke at a, at a group of senior bankers, from one of the largest banks in the world. And I was telling them that they should refuse to take a company public, or do a bond offering, if the company hasn't yet made a pledge to net zero, or they should refuse to engaged in certain other, you know, lending activities that will lead to a highly carbonizing outcome. It's very challenging for them because their answer is, if we don't do it, somebody else will do it. That's the usual answer. But anyhow, what advice would you give to those blanks as to how they should go about managing that exposure?

Chris Ailman:

Be very loud and clear, is that were an equity owner in all those banks. And we want them to have a cleaner book of business. They don't want to be stuck with legacy assets, that might have a very volatile pricing, or be regulated out of use. So while they look at it now as somebody else will take the business. I would not be surprised within five years that their attitude would change to, oh, let them take the business. We don't want that kind of business because it's not good for our company, not good for our book. We want to be focused in and other areas that have better legs.

Henry:

So, Chris, some of the members of this audience and obviously, other pension funds around the world come from states that are gold mining states, oil and gas producing countries or provinces, or heavy metal, heavy manufacturing, in which, obviously, energy, fossil fuel energy is an important component, you know what they do. So when we talk to them, what can we tell them about the way to go about the decarbonizing their own portfolios and dealing with their own constituencies?

Chris Ailman:

It's tough, Henry. I've got some good friends who are CIO in some of those mid-west states. They aren't, frankly, not allowed to talk, even say the words, climate change in their board meeting or even talk about that. Because it means jobs. Look, your job as a CIO is to periodically climb up the crow's nest and look out on the horizon at the risks to your portfolio. You've got to recognize this is a big, massive risk. This is the biggest change in all of our lifetimes. This So huge. You know, the [00:21:19 inaudible] weather is just the beginning of the story that we're all going to have to get used too. Everything has changed. It's not going to go back in time. Long-term business risks is a much easier thing for people to focus on. I find high credit managers loves that word and they focus on it. Private equity focuses in on it. Value managers focus in on it. So CIOs can gather it in. Include it in their investment analysis without using words that get everybody in trouble. And I think, there are states that are honestly very worried because they realized that that transition is coming, and they got to figure out how can we retool for something else? The good news is there's time and it's going to be a transition over time, not a hard stop and a hard start, but that change is coming. So they got to reflect that. And got to think about it in their pension plan because it's going to affect-- You know, if you're a state pension plan, and your state relies on dirty energy sources, it's going to affect the credit worthiness of that state. You better believe the rating agencies are thinking about it and the bonded buyers are thinking about it. So it's real and they got to have that discussion.

Henry:

I agree fully with you. It's an uncomfortable conversation. But one that needs to be had. And also when we look into the fact that if the residents of the state or the province end up with both fewer jobs and lower pensions because of the lack of decarbonizing of the portfolio, that's going to be a worse outcome, you know, for those, for those people. So clearly climate change has a very significant risk in portfolios and around the world. We've been talking on great deal about that. But it also presents massive opportunities for portfolios, and opportunities clearly in green technology, and renewable energy and the like. So how do you at CalSTRS are going about capitalizing on those opportunities? Financing those opportunities? Searching for them? What recommendations can you give to our fellow pension fund managers in this audience?

Chris Ailman:

The number one thing I would say to the audience and to my peers, is risk and return. You got to start with that when you look at any investment. And there are some of the climate change opportunities that are going to be very high return, but also very high risk. When you think about some of the venture opportunities from the technology. New energy opportunities. And believe me, because we've made money, And we've lost money in some of those ventures. But there's also on the other side of the spectrum, there's going to be fairly low risk, and stable return opportunities, with some of the infrastructure. I'm trying to look at it from a holistic, portfolio standpoint. Recognize there's a spectrum of opportunities in climate change. It's a change. Opportunity is risk, and not risk and return. And so, it always comes back to that, Henry.

Henry:

So when you examine a lot of what you're doing and you talk to others in the industry, what strikes you as the most unappreciated, underappreciated aspects of this opportunities? You know, what are areas in which there is plenty of return? There's plenty of runway? And people are not focused on?

Chris Ailman:

I'm not going to give away my secrets, Henry. Come on. You can buy by lots of people. But seriously. You know, I think one of the areas-- And I don't know, there's a lot of return opportunity yet. I really believe there will be, is in the boring area of retooling. It sounds silly. But some of the massive gains we've had on energy efficiency have come from simple technologies. You know, the shift from incandescent light bulbs to LEDs. In California, basically, can only buy LEDs. You have to hunt around to find an incandescent bulb. But when I look at homes, the lack of energy efficiency in any home built before, say, 1990, you're not going to tear them down and rebuild them. But the energy efficiency of a new-built home is just mind-blowing. But a few simple retooling things would actually make that very viable. So as things change, those will become an economic opportunity. Maybe they're an isolated invest in opportunity you could make. But you're talking about millions and millions of homes. And so there could be a large grand scale, very stable return, because people aren't going to do massive improvements to their home and pay it in cash. They're going to want to finance it.

Changes to the electricity grid. Clearly. we have a problem where we have a lot of hydroelectric power in Canada. And in the north, California's dams unfortunately have gone dry. So we don't have any. How do you store that and transfer? You know, we already have a really volatile electrical system. Finding a way and that might be, you know, chemical, that might be physical to store that energy and even out the grid. And there's a lot of really bright companies working on that. Again, I don't know that these retooling efforts will be an individual trade, but I think they're going to be an interesting theme that some of the big players are going to capitalize on and jump all over to make money from it.

Henry:

It's a very insightful comment, Chris because when you think about what, what is the starting to happen and will accelerate, is no less than a major reconstruction of the entire global economy From relying on fossil fuels, the relying on renew renewable energy. So clearly a lot of people are focused on the sexy part of that. You know, what are the, the Tesla's of this world, the new innovations, and the light? But what is also, probably, even more rewarding, is the mundane businesses that need to be part of that transformation.

Chris Ailman:

Let me put it this way. I have a grandson who was born this year. Before he gets out of high school, the world's going to be look radically different. The gas stations today, are not going to completely disappear, but they're going to be fewer and less needed. The charging stations are going to be everywhere. It will-- Life will look radically different than we are today. And those are investment opportunities. Some are going to succeed, some will fail. So it's always going to take a lots of due diligence to get there. But think about that, the kids that are born this year, before they ever finish high school, the world's going to look totally different. Life changes pretty quickly.

Henry:

So that frame of reference has actually been something that I focus on. I have actually started giving up talking about 2050, 2040, 2035, 2030. I have begun to talk about 10 years from now, 15 years from now, 20 years from now because for some reason when you talk about 2035 or 2030, people think is a very long time. When you talk about 10 years. It feels like a lot shorter, but this year, as you know, is a very special year. Chris, because in November about 200 country, delegates, policymakers, business leaders in finance and in business, will be gathering in Glasgow, Scotland for the UN COP26 Climate Conference. It's a very pivotal year, as you know well, because this happens every year but every five years, this case, six, because of the pandemic, the countries need to repledge, you know, their net zero. And hopefully we can get the world to start competing, we can get country start competing as to who is going to provide the lowest net zero of pledges or, or [00:29:36 inaudible] to them. When you look at that conference and you look at the agenda. What are the things that excites you the most? What are the things that you would like to see happen? You know, your expectations will be overdrawn, if they happen, that will achieve help us achieve more success coming out of that conference.

Chris Ailman:

Tough question, Henry because for me, I guess I've been on Wall Street too long. Talk is cheap. Actions speak louder than the words. I think will be excited to see the pledges. I'm excited by the sheer number of countries that are coming. You need India, and China and the USA at the table. And so, that's exciting, is to see the world come together. I would not be surprised, as I said earlier, that if I see them shorten that 2050 to 2045, or somewhere in the 2040s, based on the most recent scientific information. And, and I'm sure we're going to hear wonderful pledges. Wonderful commitments in

2030, 204. But, you know, talk, again, talk is cheap. What I'm going to look for the actions. This has to be a slow steady transition. If it's, if it's too harsh, then people are going to overthrow their government and revolt and go back the other way. And then come back to their senses, a couple of years later. So I'm optimistic. I'm glad. I think we're going to hear some really challenging information. We will be there virtually and sharing our voice with institutional investors, as well as asset managers with the asset Owners Group. And then, even with all the financial institutions talking to banks. I'm pleased to see this the level of seriousness. You know that Ronald Hanley at State Street. Brian Moynihan. It's got their attention at the highest levels and they're serious about it, which is great. And so I'm optimistic from that standpoint, but what I want to see is that follow through and that consistency, not that we have a come together. exciting moment, you know, make massive commitments, and then go away and don't anything. I've often said to my staff. I'm going to pledge to be 180 pounds by 2050. If I'm alive, I'll probably be 180 pounds. But I can't just lose that all in the last five years. I need to do that slowly and gradually to be healthy. So I think it's that starting early. That's what I'm looking to see. Is people step up and start now. I will hope China shortens their goal from 2060 and brings it in line with the rest of the world or shorter. We need to see that change.

Henry:

Well, Chris, I cannot. thank you enough for these incredibly insightful comments in this conversation. You have been a leader for many-- for over two decades now at CalSTRS. And in some places before that. And the world in California, the teachers California would not be where they are today with respect to their pensions, If he hadn't been for you, your team and your leadership, your stewardship, So I'm glad that we were able to spend this time together. Share some of your thoughts with our other colleagues here in the investment industry. Many of them are clients. And I appreciate the time the effort you have put into this thing. Thank you very much and stay well and stay safe. And let's hope for another 27% return.

Chris Ailman:

Well, let's just hope for long, steady returns. Well, thank you for the opportunity. My staff will be the first to tell you, Henry, I love to talk. So it was a great chance to talk to you. Next time, I'll say, let's do it in person. So thank you for the opportunity, and good luck to the conference. I wish it well.

TRANSCRIPT

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