TRANSCRIPT

Analytics Risk Summit London 2024

Focusing risk on the long-term

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So the role of risk research is a new one, came since I joined MSCI in January.

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It really is more of a thought leadership role than a implementation role.

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My job is to look at what is necessary in order to move risk forward.

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What is the future of risk and to try to help us move in that direction.

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So I came to Wall Street in 1985 when options and other derivatives were just getting started.

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And the nature of options is that they cause problems in terms of risk.

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So as time went on and it's clear that different investment banks were having sizeable losses because mishandling options and other derivatives these firms needed somebody to really focus on risk management.

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And because of my background, I just wanted Morgan Stanley, who was tapped for that role.

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And ever since then I did risk management, did Morgan Stanley, then moved to Solomon, then moved to other institutions to hedge funds.

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So that one move sort of redirected me from where I started, which was more in research into risk management, and I've been there from the mid-1980s since. The nature risk management initially was a control function, it was for compliance.

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So that's what's called middle office.

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But the chief investment officers and portfolio managers, which is what's called the front office, realized that they could actually take positions more intelligently if they knew the nature of the risk of the positions they're taking.

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And so risk management started to move into what's called a front office function.

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I've always tended to be more on the front office side working with the chief investment officers and portfolio managers because my positions were what's called a chief risk officer.

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So I just wanted to sort of overseeing all the risk and figuring out what among the risk issues was most dominant and important to the people who are actually doing the trading and investing.

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So the risk management already has moved is, you know, from the middle office compliance function to the front office working this with the CIO.

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So the, I don't think the issue is the way risk management operates within a company.

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It's more what risk management focuses on.

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Up till now, risk management's looked at short term risks.

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If I have a portfolio, what might happen over the next week or month?

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With the issues like geopolitical risk and climate change, the focus is starting to be longer term.

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So if you're concerned, for example, about the risk from climate change, you're not looking out one month.

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You're looking out at the implications of what might occur over years.

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If you're looking at geopolitical risk, you're not looking at things that really have a precedent in the past.

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Everything is different and so you can't rely on historical market relationships to try to determine what is going to go on in the future.

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So longer term focus is one part of it, looking at risks and more of a bespoke or idiosyncratic way is another part of it, in terms of the way I think risk will change going forward.

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And of course there's also the big elephant in the room, which is artificial intelligence.

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And it's not even clear totally what that effect will be because it's so new for risk management and the nature of risk.

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There's a few challenges going forward that really either have not existed in the past or have not been appreciated in the past.

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One of them has to do with the sort of slow-motion tidal waves that are emerging in terms of risk, climate changes in demographics, geopolitical risk and AI.

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These are things that either were not dominant issues in the past or simply were not treated.

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The other component that's related to these is a focus on physical risks.

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So rather than worrying about what the Fed Federal Reserve might do, worrying about inflation, which is kind of part of the encapsulate within the financial system, now we have to worry about what might happen, say, if there's a blockade of Taiwan, what will happen if some critical infrastructure is flooded due to climate change.

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So these type of physical risks need to be considered and the nature of how you consider them is a lot different than the way we've considered risks in the past because you have a supply chain disruption that might occur.

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There might be a problem in one part of the world or in one sort of a resource that'll wind its way through.

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So for example, if there's a problem with copper, it's going to affect electric motor production because copper's a dominant part of electric motors.

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If there's a problem with electric motors, it's going to affect electronic - electric vehicle manufacturers like Tesla.

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So tracing the path of one shock through the economic system is another challenge that we have that really has either not been critical in the past or in any case has not been really addressed in the past.

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One of the things that I've focused on in the last while I, I wrote a book called 'A Demon of our own Design' during just before the financial crisis that sort of said we were so leveraged and complex that things might not turn out well.

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And sure enough, they didn't turn out well.

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And that led to a focus on the dynamics, the way markets might evolve and change to have risks cascade and multiply.

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More recently, I wrote a book that came out with Princeton University Press called 'The End of Theory', which talked about the limitations of standard economic and financial methods to deal with crises.

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And part of that is, is to look at when we have crises, why is it that they occur?

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Why is it that we can't seem to solve the problem?

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And the reason is that you can't just use quantitative methods.

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You, you can't look at what happened in the past and expect that to answer the problems that can occur with crises because the crises come out of apparently come out of nowhere.

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They're not related to the recent past.

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So one thing I've focused on is to try to understand crises in isolation from sort of the day-to-day risk as a market.

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Another thing that I focused on that's related to that is trying to develop risk as a narrative as opposed to risk as simply metrics, as simply quantitative.

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Because if you're, say, a chief investment officer, you're using the risk metrics that you're given, but you're melding them into a story, into a narrative.

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And it's important to think of risk in those terms, as opposed to simply numbers on a page.

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