Saving capitalism from futile diversification
Domini, Amy
Organisation for Economic Cooperation and Development. The OECD Observer; May 2010; 279; ProQuest
pg. 15

Saving capitalism from futile diversification

Amy Domini, Founder and CEO of Domini Social Investments

©Lucas Jackson/Reuters

Current theories of portfolio management are at odds with the well-being of citizens. Only government policy can address this.

Capitalism has become the planet's dominant economic force because it is an extremely successful mechanism for delivering goods and services to a majority of people. This is clearly a desirable outcome, and to facilitate this, a structure emerged: finance. By luring investment into traditional asset classes in search of return, capitalism is able to provide food, clothing and comforts to many.

The problem is the role of diversification, which is a key component of modern portfolio management. Diversification, this theoretical means of reducing specific risk, failed to meet that end significantly enough to help investors during the credit crisis. What is more, it exacerbated system-wide risk. Specifically, diversification into asset classes that do not contribute to the furtherance of healthy capitalism is a danger to it.

First, consider the historic purposes of various asset classes. We start with equity. Years ago, a local community would develop a need with a common benefit; in my home town of Boston, Massachusetts, sea captains sold shares in a ship sailing to China. In this instance, providing investor returns meant that Bostonians received the spices and teas they desired. In this way, equities enable a large-scale enterprise of community benefit.

Sometimes government itself needed capital for the purpose of building infrastructure or conducting war. The borrowing of money became structured, and debt became marketable, which proved to be helpful to corporations building infrastructure as well. When debt was very short term in nature, perhaps needed only for a month, the use of commercial paper and cash developed. Every asset class had a direct benefit offered to citizens who were not necessarily investors.

Until quite recently, the relationship between capitalism, finance and society was well balanced. Financiers profited enough to be tempted into assisting government and corporations. Government and corporations provided citizens with goods and services. Citizens provided government with power and corporations with customers and employees. But over the past ten years, this complex beneficial relationship has begun rapidly to unravel.

The ubiquitous portfolio management theory demanded diversification into asset classes that behave differently from each other. For many, this led to investments into international securities. But these failed the test of contrary behaviour, so the search continued. A shift took place: rather than capitalism and its needs creating financial vehicles, investors seeking a certain sort of diversification and return became a driving force. Investors craved enhanced returns regardless of whether or not they enhanced capitalism's purpose as an economic system.

What these institutional investors found, thanks to the "creativity" of Wall Street, was the chance to make bets on assets they didn't want. They found they could bet on real estate without owning it, they could bet on the interest rate a mortgage paid versus what a treasury bill paid, they could bet on robust demand for rice without owning the rice.

Consider the history of commodity trading. Since the earliest days, purchasers of commodities, such as wheat or rice, would take delivery of the product they bought. The relationship between a food processor and a producer was an intimate one. But then the pension funds wanted to participate in new products, and Wall Street wanted to invent them.

The result was elaborate commodity index options and the pools that traded them. In short, it became possible to buy a bet on commodity pricing. These were new, economically useless vehicles. In 2006, Deutsche Bank, Dow Jones, Barclays and PowerShares all launched vehicles to collect dollars into commodity allocations. Deutsche Bank's educational literature points to two acts by government that assisted them. The first was the US Commodity Futures Trading Commission, which granted exemptive relief from most disclosure. The second was the US Securities and Exchange Commission, which granted relief, specifically allowing managers of commodity futures pools to sell short (and make profit) in a falling market.

As Michael W. Masters, Managing Member, Masters Capital Management, LLC, outlined

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

in testimony before Congress in 2008, institutional investors now dominate commodity trading–with disastrous results. He points to that which he calls index speculators, who are not true purchasers,

Until quite recently, the relationship between capitalism, finance and society was well balanced

but merely asset allocators. Still, they compete with true investors who want delivery of the specific commodity. The flood of funds these index speculators brought into the markets drove prices up and led to massive disruption of commodity systems.

The human costs of this game-playing are devastating. Citizens of several countries experienced double-digit surges in their citizen's primary food staple. In the Democratic Republic of the Congo, cassava constitutes 55% of caloric intake and prices rose 60%. In Nigeria, sorghum rose 50% during a nine-month period in 2009. This translates directly into starvation. In Mozambique, where cassava constitutes 33% of caloric intake, undernourishment grew by 8% during the year.*

This same concept lay behind the real estate bubble, which, in turn, led to the derivatives of the real estate bubble. The credit collapse would not have been possible were it not for the hundreds of billions of new dollars chasing a finite product through shadow or index accounts. It would seem that portfolio management theory would be on the racks.

But although the shortcomings of modern portfolio theory are widely discussed, the sacrosanct notion that diversification reduces risk in a positive way has worked its way into law. In the US, the two primary guides on prudence are the Employee Retirement Income Security Act of 1974 (ERISA) and the Uniform Prudent Investor Act (UPIA). Each of these specifically directs fiduciaries to diversify. ERISA, which governs trustees of insured corporate retirement plans, mandates diversification of a plan's assets in order to minimise the risk of large losses to the plan (section 404c). UPIA replaced prior law that held fiduciaries liable for individual losses. UPIA states that diversification across asset classes is a necessary act to be considered a prudent investor. Taken together, these standards mandate the very behaviour that so crushed the lives of millions of people.

Diversification into asset classes that create societal benefits adds value to the portfolio manager in two ways: it reduces the volatility of the portfolio and hosts a healthy ecosystem within which capitalism can succeed. This is the sort of diversification that ought to be encouraged, while the other ought to be viewed as a public policy risk.

Those who work in a foundation setting have often run across the conundrum created when grant-making decisions are separated from investment decisions. At a simple level, take a foundation dedicated to environmental grant-making that invests in a private offering of a real estate firm that cuts corners with local authorities and builds on pristine places. In this example, because these sites should normally be protected, the foundation is actually financing activities it was intended to fight. We who serve on investment committees see such events happening every day.

But until the credit crisis hit, we had not seen them in terms of a structural threat to all humankind. Now we do. Speaking at the Brookings Institution in March 2009, Lawrence Summers, director of the White House National Economic Council, said, "On a global basis, $50 trillion in global wealth has been erased over the last 18 months." In the US, we still have tens of millions of citizens who would like to work or would like to work more hours, but are still unable to find an opportunity to do so. In the meantime, the use of non-productive assets continues to explode. The US Comptroller of the Currency reports that just the notional value of derivatives held by US commercial banks increased by $8.5 trillion in the fourth quarter of 2009 alone.

The question of whether there ought to be securities that benefit only at the portfolio level is one of public policy. Certainly, it would be well within a government's right to impose taxes upon securities that introduce speculation and risk without providing goods and services to the vast majority of citizens. The funding of such instruments by pension funds is not in the best interest of the citizens they are sworn to protect and should be prohibited by law.

Modern portfolio management gave birth to a healthy idea: diversification. But that healthy idea has been subverted. This is not a problem that markets can correct on their own: the strong arm of government must be utilised before the second wave occurs. Diversification into assets that produce no goods or services to humankind undermines capitalism.

References

* Figures from the Poverty Reduction and Economic Management Network of The World Bank Group and February 2010 "Food Price Watch", based on information provided by the UN Food and Agriculture Organization.

Lydenberg, Steven, "Beyond Risk: Notes towards a Responsible Investment Theory", in Hawley, James and Andrew Williams (eds.) (Spring 2011), *Institutional Investors–Risk/Return Tradeoffs and Corporate Governance Failures*, University of Pennsylvania Press, USA.

Mason, Paul (2009), *Meltdown: The End of the Age of Greed*, Verso, London, UK.

For more on commodity futures, see www.futuresindustry.org

For more on portfolio management theory, see www.travismorien.com

For more on the US Comptroller of the Currency, see www.occ.gov

Visit www.domini.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.