

CONVERSATIONS WITH MIKE MILKEN



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(GPIF)

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Mike Milken: Hiro, thank you for joining us today.

Hiro Mizuno: Mike, thank you very much for inviting me.

Hiro, when I think about your career and your interests, there are so many similarities between the two of us. We're concerned about the financial leaders of the future and the background that they have. When you took the leadership as the co-chair of the Milken Institute Global Capital Markets – 300 to 400 organizations with \$25 trillion in assets, you being the largest at \$1.6 at the Japanese pension fund – you set an agenda focused on ESG. Talk to us a little about how that evolved and how your leadership evolved in that area.

Thank you, Mike for a nice introduction. It's my real honor to join as a special advisor to the Institute. I was just a beneficiary of the Milken Institute five years ago, but now I think I'm more contributing to the Institute. So, it's a great transformation. When I became the Chief Investment Officer of the Japanese Government Pension Investment Fund [GPIF] with \$1.5 trillion to \$1.6 trillion, I really struggled with the older conventional wisdom of the portfolio management or finance. I'd hoped what I had

studied and learned throughout my career would really help me to fulfill my fiduciary duty or stewardship responsibility. I was really disappointed the knowledge that I built over the years didn't seem to really give me any good clue or good direction on how to do that. So, I had to think differently.

I had the opportunity to talk to the PR asset owner which I met at the Milken Global Capital Markets Advisory Council [GCMAC] – which I ended up co-chairing – and I concluded for some reason big asset owners, which I defined as a universal owner, still operated like a small asset manager. Compared to the asset manager whose performance is more evaluated on how to beat the market, asset owners have to accept that our long-term performance is pretty much determined by the global economy, as we own the global capital markets. So I really needed to change my thinking: 'how we can approach the whole market as a whole financial system?' That's how I came up with the idea of the ESG

integration. It can actually have a view of the whole capital market, a whole global economic system. The approach should be different from the asset managers who are competing to outperform the other managers. The asset owner of a global economic system must have a long-term investment horizon and pay attention not only inside their own portfolio, but outside of its own portfolio, because at the end of the day, over the years, what's happening outside of our portfolio will affect the performance of our portfolio. That's the thought process I went through and I just decided to become one of the biggest advocates for the ESG in this industry.

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As you were talking to the other asset owners that you are now leading as the co-chair, you're now trying to explain to them that there is social risk. There is governance risk. There is environmental risk. And all of these things affect the portfolio. If you don't think of the world as a zero-sum game ... when collectively this group has \$25 trillion, the only way to generate superior rate of returns is to increase the size of the pie or increase the world's economy. Eventually I think you succeeded in convincing the people that doing good was good business, and these were risks that were far larger than people thought. Can you think of some of the pushback you got during this period of time?

Well, I got a lot of pushback. Everybody uses fiduciary duty very casually. But in reality, I researched many jurisdictions for a clear definition of fiduciary duty, but there is not. And then we actually use the fiduciary duty as our excuse not to think outside of the

box. The financial community has been incredibly difficult community to change their mindset.

They actually grew up thinking their job is just to make a financial return in a considerably short period of time. They have also been trained to beat the market or beat the competitors. I always say like a beating the competitor is a way for you to stay in the business. Because at the end of the day, the big asset owners long-term performers, 90 percent that can be explained by dyno market, right? So although 90 percent of their effort is focused on how to accumulate alpha, every day they accumulate alpha that is swiped away by the marketplace. We spend more energy and resource on something that makes little difference, but we basically pay no attention to

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something that really affects our long-term performance, which the market leader. So, I just need to start the debate whether too much focus on extra return generation is really appropriate. I started arguing we should pay attention to that quality of the whole capital market system. And got the huge pushback from my own industry and my own community. I always had the combination of just forcing them to think, and at the same time, we need to move in an action like you did with the non-investment grade

bond. You need to have action and you need to have a concept to change. I stepped down from the GPIF CIO role, I just decided to continue this mission, but now I can approach the other from different angles. I'm actually trying to change the business school I'm associated with, their curriculum and do our research to support it.

And also I agreed to join the future of finance advisory council of the CFA Institute [Chartered Financial Analyst], because that's another professional education body. ESG is probably the hottest topic in the asset management industry, but there is not even a chapter allocated for ESG in the CFA curriculum. If we can change it, it will make our industry more aligned with the long-term agenda, which should matter to those young professionals.

Sustainability is so important; the discipline of good governance. I think a lot of the money managers had difficulty, Hiro, at the beginning because they might be managing \$500 million, \$1 billion, \$2 billion. They think they can dart in and out of markets. But this collective group of our Global Capital Markets that has \$25 trillion, there is no darting in and out of markets. You are the market. What percent did the Japanese government pension fund you led own of the entire stock markets in the world?

We probably own about 8 percent to 9 percent of the Japanese equity markets and 1 percent of global equity index. When I came up with this idea of a universal ownership, the GPIF equity universe, we own the universe. That's why we have to pay attention not only to what we own, but the whole system or whole capital market universe. I heard even on the panel discussion at the Milken Global Conference, they said, 'Oh, Hiro, you are universal owner because you own \$1.6 trillion, but we only have \$10 billion, so we had not a universal owner.' Right? But my counter argument is as soon as they invest in a global equity index, their risk-return profile is exactly the same as GPIF. So in terms of the risk-return profile of their portfolio, they are as universal owner as GPIF, regardless of the size.

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So I always say this to even retail investors: if they invest in a global index their risk-return profile is exactly the same as GPIF risk-return profile. It's trying to just bring in more and more people in this thinking, saying we actually collectively own the capital market. Regardless of the size, we have to think as a universal owner. That's the one thing I just wanted to emphasize. We cannot separate our risk-return from what's happening to the whole capital market. For us to have a sustainable portfolio, we have to have a sustainable capital market. And for us to have a sustainable capital market, we need to have a sustainable society. And for us to have a sustainable society, we need to have a sustainable environment. It's all connected. Now people believe that ESG needs to be a professional practice to grow into their daily portfolio management operation. So I'm really glad to see the progress.

We all move together in some degree, and we can't focus on a zero-sum game; we need to focus on growth. To meet the needs of society, we are unfortunately in a very difficult period. It's not World War II physically, but it's World War III against a virus, and the whole planet is affected. Tell us a little bit about how we can create financial markets to protect our society as we know it. What is a pandemic bond?

We are lending this money to the organization on the basis that they will use that capital for a particular purpose. So we tested it with green bonds and social bonds; went out with the GPIF. The green bond is still not the mainstream investment product that it's becoming because they are the GPS or whatever green bonds. Thanks to our strategic partnership with MDBs [Multilateral Development Banks], including Wildman Business Group, now they place their green bond or social bond directly was the GPIF's existing bond managers.

The pandemic bond, I think that the GPIF was one of the anchor investors in the first issuance of the COVID-19 response bond issued by the African Development Bank. I see the other opportunity that the bond instruments can create a more explicit and clear

opportunity for the other investors to actively participate in the solving of the problem. The people like GPIF, we won't be able to be very adventurous or speculative in a way for us to invest in a fixed income, but that's why we use the AAA-rated and MDBs, so that when they issue those kind of purpose bonds our asset monitors are incentivized to buy it rather than the general corporate or general bonds. So this pandemic, we coincide with the action taken by a European union to define clearly what is meant by green bonds or social bonds.

A green bond, basically, you have to address one particular environmental issues, but they can create a social bond to address all the different types of social issues. And the pandemic is one of those. So I'm actually very, very hopeful that the bond market can be more innovative and creative to direct more capital of the asset owner into solving the problems specifically designed for that purpose.

Give us an example of what a green bond would be. What would it specifically do?

For example, like a World Bank Group issued a green bond, and they still issue the general bonds. Now they label it the SDGs [United Nations' Sustainable Development Goals] bond because they said everything they do is actually related to the other solvings, the SDGs. But the green bond is basically the bond that the investor either give

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money to the other issuers on the agreement that the issuer use the funds into the green project. It's very difficult for the investor to really guide that issuer to do a capital allocation and do those types of green projects. So this green bond is the instruments that the investors know can invest in and benefit from same risk-return from the issuer. But at the same time, we have confidence that the issuer will direct that capital or fund into a green project. So, some investor may take the impact of a green project into their risk-return analysis. For the investors like GPIFs who are under stringent fiduciary requirements to satisfy, we can at least say we are not compromising risk-on-return because this is the exactly the

same risk and return we are getting from like a Waterman Group and MDBs that is gray rated, but we are sure that they are not going to use that the capital for non-green products. So this is kind of like a fiduciary agreement between the investor and issuer. I really appreciate that some people come up with that kind of innovation.

I first visited Japan in the early 1970s. We were focused on business in Japan. I was focused on the culture and I noticed a building where the lobby was 30 feet above the ground. And I was so interested in why they were doing that. And they told me long-term the water might rise; they were preparing for a 1,000 years, not 20 years. That event is so vivid in my mind when we talk about green bonds or the environment because so many places in the world today, rising seas and other things jeopardize their environment as they know it.

I'd like to switch if I could to another element that you took leadership in. Not only the focused on this concept of universal ownership, that by increasing the size of the pie we will all benefit, but long-term investing. Talk about the pushback you had in making sure you're supporting management teams that are long-term oriented, not short term oriented.

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I always think long term is easy to say, but it's very difficult to implement. When I really analyze how they invest, they are all totally overweight like a short-term performance. So, I need to challenge how you accommodate the discrepancy and one of the approaches I came up with was, they probably need to trade reacting to what's happening in the market because their mandate is to beat the market. I'm going to beat the benchmark. But on the other hand, I just came to realize asset managers couldn't become the long-term active owner. They basically have a two tools: I think the corporate executive one is by trading and changing pricing, and then the other is how to engage with the company on how to do a proxy voting? So, the second aspect of how they can affect the business, we actually thought this is actually more effective and it can be detached from their trading activities to some extent.

So we became the biggest advocate that the passive managers who don't need to beat the market, who don't need to trade daily, they should be the ones to actually they play moral as the active owner and engage the corporate executive for the long term. So, acting manager, I understand sometime they have to trade because they cannot afford to lose to the market, but the passive manager, they don't need to worry about the relative performance. So their focus should be on how to support the corporate executive who is trying to implement the long term strategy. This is a great opportunity.

The environment is kind of easy, but particularly it's social factors. A lot of corporate executive now bring in a strategy which they probably wouldn't have in the past, like the Salesforce's Marc Benioff. He actually pledged to no layoffs very early days of this

pandemic and the Japanese airline decided to refund all non-refundable tickets to support the community or their customers in the travel. So these kind of things, how the other investor will react is that it's going to become more apparent in this pandemic. And I always trying to see whether ESG investors will really walk the talk by supporting what you just mentioned, like those are corporate except food trying to bring in sustainability or ESG factors in their the business strategy.

So as you've left the government pension fund after five years, it was revolutionary when they announced that they're going to sell Japanese government bonds back to their government, the federal reserve, and take the money and invest in equities around the world. In the United States, if we look at our Social Security funds, they're all invested in U.S. governments. And so Japanese government debt yielding zero meant you're invested at a zero rate of return and part of the growth strategy and the market strategy led by your Prime Minister Abe, it was revolutionary. But this is not something you find, the idea that the pension fund would not own just Japanese government bonds yielding zero, but could invest throughout the world. Take us back to the dynamics of that decision.

First of all, the Abe Administration wanted to re-energize the Japanese economy by first getting rid of deflation and also redirecting capital into equities to promote growth. They just

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wanted to direct more capital into risk assets and that the promote the economy. So that, that's actually one catalyst for that change.

But the other catalyst for that change is now there's a growing awareness among Japanese general public saying we are an aging society and our pension scheme, which is basically the same as the U.S. – the pay-as-you-go mechanism. So

younger generations pay the pension benefit of retired generation, right? So for that system to continue to work or remain sustainable, we need to have the younger generation support the aging society. But in reality, we have less and less in the younger generation, yet, the burden on them is growing. So we just need to make sure that we make the better use of the already-saved funds to reduce the burden on the young future generation. I'm sure that the U.S. will face that the issue sooner than later, but we cannot just depend on the younger generation to support us.

My vision that the public pension funds investment equity is the one effective way to just reduce this gap, because this is a very effective way for the ordinary people to participate in a capital return. So, that's actually the additional factors I had. For me to really persuade myself to take this role because this is the way to reduce inequity and wealth for the ordinary people can participate into the economy growth and the benefit from the very low fees, which the other GPF can enjoy compared to the retail investors. So there are a lot of factors, including

my only other belief in that this is something we should do to prevent the ever widening wealth inequity. So that's the biggest decision, but I think that we kind of navigated well, and I believe that the all the big public pension scheme in the world should think the same thing.

When you left the government pension fund, I said to myself 'what company in the world would Hiro most likely be recruited to go on the board of directors. Then I get to read on the tape that you've gone on the board of Tesla. Tell us about that decision that you made.

I received the 104 offers to join corporate boards. I just wanted to use my expertise to promote sustainable investment and long-term investment. We need to shift today's economy into more sustainable business model. Tesla definitely fits into that category. Tesla holds the key to turn the auto industry into sustainable business model. And I can imagine the sort of chain of reaction if the automakers change to the electric vehicle. The older suppliers have to react to that. That's the kind of the thinking I have.

It surprised me in many ways that Japan wasn't the leader in the electric car and what we might call alternative or renewable energy today. I am sure that in your meetings you were nudging them, as the largest stockholder of companies in Japan, to think about these issues. Do you see the ability for Japan to catch up and change and become a leader in these areas in the future?

That's a question I have been asking for the last five years and with respect to the auto industry, I saw some silver linings. Toyota is now claiming that they're a mobility company and Nissan finally introduced a new SUV. But, I totally agree with you they actually suffered from all of their success with the hybrid. Now they really have to shift and take it as a wake-up call. My serving on the Tesla board creates more awareness in Japan.

Hiro, I want to thank you for joining us today. Not everybody understands when you're a trailblazer, you take a lot of arrows in the chest, as well as the back. But I think the wake-up call that we've received over the last few years, whether the free enterprise system or capitalism can meet the needs of our society, was here long before COVID-19 or the issues regarding racism and equality being raised. We look forward to seeing what we can do together. Thank you for joining us and I cherish our friendship.

Well, thank you very much. I'm really glad that I will be able to contribute to the Milken Institute. I cannot stress enough that I really benefited from the wealth of your knowledge and the wealth of the other Milken communitites at the beginning of my endeavor at the GPIF. Thank you very much.