LAUREN FOSTER: Hi, everyone. Welcome to *Take 15 Podcast.* I am Lauren. Today on the show, lessons of financial history, the Federal Reserve's new approach to monetary policy, the role of central banks, and much, much more. And what a great time to be having this conversation. There are big economic challenges awaiting the Fed this fall, and so I'm really delighted to introduce my guest, Cheryl Smith, to help us think through some of the pressing questions facing investors.

She's an economist, portfolio manager, and research analyst at Trillium Asset Management. Cheryl earned her doctorate in economics from Yale and is also a CFA charter holder. We talk about the Fed's new strategy our flexible average inflation targeting and spend some time on whether central banks have a mandate to solve social problems. As you'll hear, Cheryl has a very thoughtful perspective that's been informed of a long career as an investor and observer of the markets.

So let's get to it. Please enjoy my conversation with Cheryl Smith. Cheryl, good morning. Welcome to the podcast.

CHERYL I. SMITH: Thank you. Good morning, Lauren.

LAUREN FOSTER: It's great to have you here today. I feel like we've got lots to cover, and I've been really looking forward to our conversation. So I thought a fun place for us to start maybe what I'd call a retrospective. I was looking at your bio, and there were two dates that jumped out at me. So you joined Trillium in 1987, and then you had a brief stint elsewhere and you rejoined in 1997.

Now, as any student of financial history knows, those are really important dates. 1987. Black Monday. The stock market crash. 1997, the financial crisis. So for good measure, let us throw in there 1991, the savings and loans crisis. What have we learned from history? How have those rolling crises shaped policy and shaped where we are today?

CHERYL I. SMITH: That's a really interesting question to think about it retrospectively. In 1987, I actually began my investment management career at Trillium, as you noted, and I began mostly in the bond market. So people think of that as the equity market, but actually, it was a spectacular year for the bond market because the Federal Reserve was trying to restrain an economy with growing real estate, and it just kept raising interest rates and raising interest rates and raising interest rates.

And I can remember going in every morning, the 30-year bond was down 3%, down 3%, down 3%. And that went up and up and up, even as the stock market was roaring along, until around August when it sort of started being shaky again. So we have a couple of themes here, one is interest rates, the other is real estate, and then there's the stock market is the stock market in reality.

So first experience of really equity market disaster was that October crash, and I remember the quote run back then couldn't keep up. We were looking at everything. It was just delay, delay, delay. So what was interesting from that to me as an economist was how quickly we rebounded from that. So the Federal Reserve pivoted on a dime and immediately started lowering interest rates.

And actually, when you look back on it for the United States, the market was positive that year in terms of the stock equity market returns were positive, which is really astounding. Going to 1991, as you mentioned, the savings and loan crisis, again, a sort of interest rates and the equity, the real estate market coming to a screeching halt. You had the Bank of New England, I was living in Boston, going bankrupt, which was really shocking for that period of time.

So again, something with interest rates, some things with illiquid assets, people trying to trade illiquid assets as if they're liquid assets and not realizing the risks that they have for leverage in that. And then the 1997, again, this was a more international crisis, again, interest rates, again, people trying to take things that are illiquid and trade them as if they're liquid and filling up their balance sheets with things that are illiquid with the presumption that everybody can exit through the door at the same time, which time and again we find, no, you can't put the entire crowd through the door at once.

LAUREN FOSTER: So you've had the benefit of experience. You've gone through these rolling crises as an investor. If you could magically impart one piece of wisdom to investors, what would it be?

CHERYL I. SMITH: I call it my elevator criteria, and that is if you are trading a financial instrument that is too difficult to explain to someone as the elevator goes from the 10th floor to the first floor, that is not a liquid instrument, and you will not be able to get out of it when you want to get out of it and everybody else is trying to get out of it.

So you had leveraged bonds. You have CDOs, collateralized debt obligations. You have CMOs, collateralized mortgage obligations. You have all these different ways that the financial markets, again, returning to that liquidity, try to slice and dice things to take something that's illiquid and turn it into a AAA liquid instrument. The same thing on equity markets, when you have the effect of options and straddles and things like that are a little bit more complex, you may have a computer model that tells you what it's going to do, but it doesn't tell you what the whole market is going to do when everybody else's computer model is also frozen.

And so again and again, and I think that's really an important element that as daily participants in the market, you have many, many, many, many, many days of liquidity and maybe a little more volatility, but it's still liquidity until all of a sudden, everything comes to a screeching halt, and there is no liquidity. So an important part of learning to have those long-term returns, not the daily returns, but the long-term returns, not losing the principle, is to remember that liquidity is extremely valuable when it is nonexistent. And so be willing to pay a little bit of liquidity premium for keeping that liquidity.

LAUREN FOSTER: So you mentioned you're an economist by training, and as I learned our call before we had this conversation, you spent one of your summers working at the Board of Governors. So let's talk a little bit about the Federal Reserve, and in particular, the new approach to monetary policy. And so just a quick recap for your listeners, the approach is cornerstone, which was unveiled last summer, is Flexible, Average, Inflation, Targeting, or FAIT.

So help us off with, I guess, that sort of FAIT 101, maybe give us a better explanation that I just gave in terms of just spelling it out. And this pivot, so what prompted this major shift, and why is it so significant?

CHERYL I. SMITH: I'm really glad that you're highlighting that because I think it is absolutely critical and outside, perhaps, the equity and bond markets people, in general, don't understand what an important pivot it was. So I'm going to go back in history a little bit. So 1970s and 1980s, you had a persistent inflation that had gripped the US, and it was a fairly significant level.

And the Federal Reserve and economic policy, in general, became very concerned about this. What would they do to break it? And they pushed interest rates up and up and up and up until you had the 30-year bond treasury was trading at 14%. I mean, that's unimaginable today when we're at 1.8%, somewhere around there. And this was to break the back of inflation.

And after that experience, every time there was even a whiff of inflation above 2% or 3%, the bond markets went crazy. And William Greider wrote a book on this. People were talking about the bond market vigilantes were forcing the Fed to act because if there was any inflation, interest rates would be pushed up, and the economy would slow. So you have this stop, start, stop, start kind of rhythm being done.

But we also have as we look out over time, a structural unemployment problem, and that structural unemployment problem is that there's really multiple different labor markets. There's a labor market for white men. There's a labor market for men, in general. There's a labor market for women. There's a labor market for minority women.

And what the Fed realized as it was looking at this, after a 10-year period of too low inflation, not being able to get the inflation rate up to 2% post financial crisis was that the stop-start policy-- every time there's a tiny whiff of inflation, raise the interest rates, slow the economy down-- had very different effects on these different segments of the labor market. Because sort of a maxim in labor said last hired, first fired. So you just get to full employment, and then you slow the economy down. And so the women, minorities who have just gotten that job get fired.

And of course, the other thing about labor markets is that breaks in employment are very bad for your long-term employment history, and you never recover in terms of salary or pay from these breaks in employment. So what the Federal Reserve realized, and perhaps, it's not a coincidence under Janet Yellen and then Lael Brainard, two women, very pronounced, excellent economists realized that this Federal Reserve policy was basically balancing the whole economic policy on the backs of women and minorities.

And that this was perhaps, not the best approach in a time and that really, the economy could be allowed to move into full employment and really see what would happen in terms of a structural inflation, which we're really seeing no signs of in order to get a more comparable labor experience for these different groups of people in the market.

And so it's really a very, very significant shift. The Fed has always had a dual mandate of inflation and unemployment, but what the Fed said last year at the Jackson Hole when they went to this flexible average inflation targeting is, that the Fed has advertently or inadvertently really prioritized the keeping inflation low over the unemployment element. And that it was time to really go to a more balanced approach of prioritizing that employment number.

LAUREN FOSTER: So you mentioned the Fed's mandate. I'd love to spend a bit of time just on what is the proper role of central banks. I was reading an article in *Bloomberg* that it was headlined something about there's a do-it-all central banks. And I wanted to just read a couple of things just for the listeners and for you.

It said, "Central bankers are engaged in the most sweeping a rethink of their role in decades, spurred by the success of tight collaboration with governments and countering the pandemic crisis and a new political reality of increased demands on monetary policy makers." And they say, "As the crisis recedes, many policymakers favor keeping their expanded role in shaping economies and even broadening it further to incorporate social goals such as climate change and curbing inequality."

So should central banks take an active role in tackling wider societal change challenges?

CHERYL I. SMITH: You can count me as a very active vote in favor of active policy. Because what we need to think, there's this conception that by not taking an active role, they're not being active in any way. But really, by focusing only on the inflation and only on, well, we can't do anything except raise interest rates and lower interest rates and worry about inflation, that's a very, very active thumb on the scale. It's really an elbow on the scale in the favor of non-intervention, let the market go. In a situation where clearly there are market breakdowns. There are places that are not operating smoothly.

And so it is, in my view, an abrogation of their responsibility to look at the economy as a whole and to work on economic activity and figure out the ways in which very restrictive policies may have been imposing very significant costs on the rest of the economy. So I really welcome this opportunity to look at the opportunities for monetary policy to positively affect our modern economies.

LAUREN FOSTER: So we're having this conversation at the beginning of August, and actually, this episode will air middle of August, we have the next Jackson Hole Conference coming up at the end of this month. What will you be listening for? Do you expect to hear anything different than before?

CHERYL I. SMITH: What I would like to hear is a further elaboration and discussion that they actually are serious about this pivot, about this change to the flexible average inflation targeting. August of 2020 is a very different time than August of 2021 in the sense that deep into the pandemic. Right now with the Delta variant, we don't know. I mean, we are seeing rising cases. We might be deep in it again by September or October.

But it's important to not make this an episode in the stop-start history to make this an episode of saying, no, we absolutely are committed to understanding that there are two mandates here and that the unemployment mandate, the overall health of the economy is equally important to that inflation mandate.

LAUREN FOSTER: So I'd like to introduce something, one of the newsletters that I read calls the second act problem. This is from a data track newsletter. And they were saying, so the first act is easy. You introduce the characters and the problems that they face. In this case, the pandemic was the problem, and all the characters addressed it.

The third act is also straightforward because the characters resolve the problems. The third act is the pandemic passes. What we're sitting in now is what they call the second act, and that's tough because you don't know how the characters, what they're going to do and how they're going to affect the change. So you're the playwright, and you're going to write Act II, the now. What is the narrative that you see unfolding now?

CHERYL I. SMITH: OK, you're putting aside the fact that I have a severe writing block, so this playwright is not particularly excellent at that. But the central conflict that we have here is exactly about that active policy, and it's not only active policy for the monetary authorities, but also, active policy for the fiscal authorities.

Because one of the most amazing things, to me, as someone who's lived in the United States for 60 plus years is that in the spring in the midst of the pandemic, you actually had fiscal policy actions. You had the legislature come together and the executive branch sign it. And it was really full-throated economic policy. Unemployment insurance including unemployment insurance for independent workers or gig workers.

It was payment to support income, and that made this an extremely unusual recession in that people's incomes were supported. And our recovery from it has been very, very swift. We've had a lot of issues on the production and supply chain side, which are totally to be expected when you had an economic shutdown like that. So one thing is will the fiscal policy authorities maintain their nerve, and will the monetary policy authorities maintain that pivot that we've talked about?

So there are many, many forces. And if you look at the increasing wealth inequality and income inequality that we've had over the past 40 years, there are many forces of the Chamber of Commerce, the Business Roundtable who would perfectly love to keep that hands-off attitude, the winners take all kind of attitude and are pushing for that. Oh, inflation is going to explode. It's right there. It's right there. Can't you see it? Lumber prices are up.

OK, lumber prices are up, but lumber prices will come back down when that supply chain re-establishes itself. So there are many forces that are pointing to the past and trying to drag the monetary policy authorities and the fiscal policy back to that static in action that we have seen for 35 or 40 years. So that's the conflict set up, the forces of change versus the forces of reaction.

LAUREN FOSTER: So as I was preparing for today, I did a bit of background reading, and I came across a conversation between the *FT's* Rana Foroohar and Heather Boushey, and she is a member of Biden's council of economic advisors. And I just want to read you Rana's opening question because I think it raises a lot of very interesting questions that I love for us to discuss.

So she writes that "A lot of us think that we're at a major economic pivot point. Are we going back to the 1970s? Are we entering the post-financialization era? Are we in some new era of globalization or regionalization?" So perhaps you could take each one of those three. You've touched on inflation, but I guess I'll pose the same question to you. Are we going back to the 1970s?

CHERYL I. SMITH: Absolutely not. I am firmly convinced that what we are seeing in terms of price rises right now is a transitory effect, and it is due to that disruption of supply chains that I mentioned. The 1970s inflation was a cost push, in-demand pull inflation. There was excess demand, but there was also an embedding of price increases in wage contracts.

The position of labor in the United States now is so different from what it was in the 1970s with Reagan's destruction of the PATCO strike, Professional Air Traffic Controllers, and the decline in unionization that labor is really much less powerful, so that embedding of price increases in labor and contracts is something that's missing entirely.

My fear is more that we'll go back to the 1980s, a period of very high, persistent unemployment, inflation going down, but the unemployment just going on and on and on and on. So that's the inflation element.

LAUREN FOSTER: So what about this post financialization era?

CHERYL I. SMITH: The post financialization era, I hope that we are entering into that because, again, in that transition from the '80s to today, we did see a great financialization of the market going back to the earlier part of the conversation, people trying to make liquid things that are illiquid and being able to trade everything. And with that, you really saw a huge portion of the economic gains. The gains from productivity were all going to the finance people. The were going to the CFOs, the CEOs, the management. They were not going to workers, and with that, we saw a stagnation.

Very difficult to get economic growth above 1% or 2%, and real wages for families basically unchanged for almost 30 years. That's a challenge because the economy is really all those people. And so hopefully, we will move to that more active policy that really looks at how average families are doing, how people in the spectrum are doing and that really understands the need for all members of an economy to be doing well for you to say there is strong economic growth.

LAUREN FOSTER: And so I guess the third leg of the stool, are we in some new era of globalization or regionalization?

CHERYL I. SMITH: What I would like to see, I think that there are some changes. I mean, we've seen some aspects of willingness to act globally, for example, the Paris Accords, and then hopefully, something positive will come out of Glasgow this fall of recognizing that there are world-wide issues that climate change, for example, can't really be run away from. It's affecting us all everywhere, but also, hopefully, a recognition that the gains from globalization, while they are definite and positive are very, very, very diffuse; very, very small amounts to everyone.

But the cost of globalization can be very concentrated, and we need industrial policy to focus on say, industrial Midwest, areas where jobs were lost. So what do you do about that? How do you address that? You don't just say, well, the invisible hand will make it all work out. You really have to address it actively.

So to continue to have a global interconnected world and economy, but yet to recognize the need to not just let that happen in a laissez-faire fashion.

LAUREN FOSTER: So you mentioned climate change a moment ago, and in the article, Heather Boushey singles out what she calls the full, big crises that have to be tackled-- health care, the economy, climate, and then racial justice and equality. And maybe this is a good point in our conversation to talk about a through line that's in your bio, so from the foreign service degree and I guess, international economic development from Georgetown to your work as an investor. And you wear multiple hats.

You wear the foreign service hat, investor, portfolio manager, research analyst, and if there's a through line, it seems to be this economic and social justice aspect of investing. And you have a very interesting origin story, and I love hearing about origin stories. And I had read that your call to capitalism, as the article put it, came from the US Conference of Catholic Bishops. I would love to hear your origin story of how you got involved in investing, and how you ended up at Trillion.

CHERYL I. SMITH: Sure. So the origin story actually goes even further back than that. My father went to a Benedictine college. And the Benedictine Order believes in work and prayer and work being part of prayer, prayer being part of work and is also very in tune with the historic Catholic teachings on social justice, that you need to pay attention to that.

So I was raised by my father and mother, but my father with that very, very strong sense. So when this US conference of Catholic Bishops came out with their letter, it basically said, it's not just good to be a Catholic on Sundays. You have to make it throughout your life. You have to make it throughout your work as well, and you have to think about how the work that you do fits in with this.

And as I worked on that with a friend who was a theologian, we went around the State of Colorado talking about this. Every audience was asking about investment. Every audience was saying, OK, so you're tying it to the work that I do. Am I a production worker, or am I a factory worker? Am I a lawyer, whatever?

But what's the archdiocese doing? What are they doing with their money? And that really crystallized for me the role of assets and that financialization of the economy that was just rampant throughout this time. I'm trying to think about how do you create positive social change in an environment where 1986, the government is stepping back. We're trying to reduce the amount of government.

Labor has been broken, so labor unions are not going to be a force. Where is it coming from? Well, corporations seem to have a lot of power. So ah-ha, you could use the power of ownership in corporations to try and change those corporations. So people could use their wealth to ask about environmental issues, to ask about how companies were treating their labor force.

And Trillium Asset Management was just a couple of firms doing at that time, working to really use shareholder advocacy to put that question to companies and to say, you have a responsibility. Unlike what Milton Friedman said, you have a responsibility to the whole of society, not just your shareholders. Your shareholders alone are not sufficient because in the long run, paying attention only to shareholders will result in economic collapse. So let's think about this from a longer point of view.

And so it was an amazing opportunity. I was hired by Joan Bavaria, our firm founder, to be able to pursue this idea, and I have been fortunate to be able to do it for 35 years during this time. And that movement has really grown. It's gotten bigger. And the power of shareholders to create change at corporations, I think, has only grown stronger. And people recognize that ability which is very, very gratifying at this point.

LAUREN FOSTER: So let's spend just a moment on, like I said, evolution. So back in 2008, when you asked an investor what kinds of things do you steer away from, you responded weapons and war. I presume that it's gotten a lot more complex over the decades. So tell us a little bit about your approach at Trillium to socially responsible investing.

CHERYL I. SMITH: Sure. So just on that weapons and war, I was 16 and going to college when the Vietnam War was raging. So that weapons in war part, it was a very strong concern, as I saw people going to war. And another way of saying it is, we like to avoid products that are when used as designed to kill people that would include tobacco. Used as intended. Used as designed. Kills people. So that's a very small element. That's kind of the negative screening element.

On the positive side, it really is looking to create that positive change, asking companies to think about how are they going to get to net zero by 2030, 2050? How are they going to account for their supply chain? And as the company that is the major purchaser for a supplier across the world, what's their responsibility to those workers, and how are companies being governed?

So it's really expanded. It's always, from my perspective, been an interest in the social aspect. But the social aspect-- and that is how workers are treated, do people get paid, what's the level of unemployment, all of those conditional things. But those social aspects also translate into the environment. So if you look at where are the most polluting plants placed, they're placed in the area of poor people. They're not placed in Knightsbridge in London, and they're not on Central Park in New York City. They're placed among people that don't have power, so asking about those.

And then looking at that environmental issue. If you look at the issue of climate change, the people in Bangladesh that live at sea level are the most vulnerable people. Surely, they matter. Surely, they count, so trying to bring this issue to corporations, as we talk about it.

LAUREN FOSTER: Great. So that's a good note to move to our closing question. You spoke about, so positive screening, and my first closing question is what I call the ray-of-sunshine question. And this started in the early days of the pandemic when we were just trying to look for something positive that would come out of it.

So that's the question. What is the one positive, long-lasting change that you hope to see as a result of the pandemic?

CHERYL I. SMITH: That is a challenging one. What I hope is, and I'm clinging to this hope is that it helped us see the John Donne, the poet, you know, don't ask for whom the bell tolls. It tolls for thee. This idea that we are all a community and that you can't just say, well, those people over there are sick, and I'm perfectly fine, so I don't care.

So I hope that it helped us understand the way in which we are one world community and bring a little compassion to our hearts, if you will. That doesn't sound like an economist, but there you have it.

LAUREN FOSTER: Well, it's good, and it reminds me in South Africa, we have this expression, Ubuntu, I am because of you. We only exist because of communities, so I love that answer from you.

So the second question is what I call the NASA question. I should probably call it the space tourism question now because Bezos has gone up.

CHERYL I. SMITH: Eye roll.

LAUREN FOSTER: And a couple of millionaires are going up, so assuming that you could go on a long-duration space flight and you can take one object with you, one item, what item would you take?

CHERYL I. SMITH: Oh, dear. That's very, very challenging. I think I would bring my yoga mat.

LAUREN FOSTER: Good answer.

CHERYL I. SMITH: Give a little chance for contemplation. If I'm going to be at it for a very long period of time. I need to keep fit, but I also need to experience some meditation and calmness. I would need to cultivate calmness. So that's what I would bring, my yoga mat.

LAUREN FOSTER: Well, hopefully, your yoga mat wouldn't be floating in space with you. That could be a bit challenging.

CHERYL I. SMITH: We have to anchor it somehow.

LAUREN FOSTER: Right. And then the final question is the super powers question. And its flights or invisibility. I'd like you to choose one of those. Whichever one you choose, you're the only person in the world who has that super power. Which one do you choose, and what do you do with it?

CHERYL I. SMITH: OK, so it was flight versus invisibility?

LAUREN FOSTER: Yeah.

CHERYL I. SMITH: Definitely, invisibility.

LAUREN FOSTER: Oh.

CHERYL I. SMITH: The invisibility because invisibility gives you the opportunity to observe the halls of power where I'm not allowed. It allows you to observe without presumably changing what's happening there. And then from that, you get that clarity of what needs to be done and how do you organize people to get that done.

Flight, I can book an airplane. It doesn't really do anything for me, but invisibility would be an awesome power.

LAUREN FOSTER: And I love that you've chose invisibility because I had to go back and sort of think this out, but I'm sure most people choose flight. And you were emphatic it was invisibility from the get go.

CHERYL I. SMITH: Yes, absolutely.

LAUREN FOSTER: That's interesting. Well, on that note, it's been terrific talking to you today. Thank you so much for joining us.

CHERYL I. SMITH: Thank you. It's been a real and rare pleasure.

LAUREN FOSTER: You've been listening to the *Take 15 Podcast* from CFA Institute. If you haven't yet subscribed, you can do so on our YouTube channel or wherever you listen to the show. That way, you never miss an episode. And if you enjoyed today's show, we'd appreciate a rating and review. Or if you'd simply tell a friend about the show, that would help us too.

And a quick reminder, this podcast isn't intended to provide expert advice on the topics we covered. If you need tax, accounting, or legal advice, please consult a professional. I'm Lauren Foster. Thanks so much for listening, and see you next week.