

Broadening diversity consideration

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Summary

Diversity within an organization is a good thing, not just conceptually, but also because it can contribute to a more robust investment management process. While the benefits of diversity are certainly obtainable from firms with a diverse ownership structure, we also believe that the composition of investment teams is an important component of investors being able to capture the benefits of diversity. Effective diversity engagement may help investment management firms improve the ways in which multiple perspectives are brought to bear in their investment decision making process. Firms with a conscious focus on diversity may improve their chance of producing strong investment outcomes and are more likely to be able to rapidly achieve diverse ownership goals.

Introduction

In this paper, we will start with the conventionally accepted definition of diversity in the investment industry, which is measured typically in terms of firm ownership. We will also outline what we see as two desired outcomes of diversity; the creation of optimally functioning investment teams that benefit from diversity of cognitive thought and the broader benefits to the social good¹ of promoting diversity within investment management organizations and the investment industry. We will then look

¹ A social good is something that benefits the largest number of people in the largest possible way. The concept of social good can be traced back to ancient Greek philosophers and implies a positive impact on individuals and society in general.

at areas where the conventional definition promotes these two outcomes and where it may fall short, and will suggest additional mechanisms whereby a broader definition of diversity may contribute to these desired outcomes.

Diversity defined – conventional and extended

The conventional definition of diversity for fund management firms is focused on the percentage of the firm owned by various minority or historically under-represented racial/ethnic groups. The percentage threshold of ownership for a firm to be considered diverse can vary. A recent research paper² commissioned by the Knight Foundation incorporated two definitions of diversity: substantial diverse ownership (25 to 49 percent) and majority diverse ownership (50 percent and higher). The advantage of defining diversity based on firm ownership is that it is objective and externally verifiable. The data are readily accessible given that ownership information is requested in form ADV for SEC registration, and the ownership of the firm reflects an economic reality. In an industry where the economic rewards can be substantial, and where an individual's status is often defined by their participation in the economic rewards generated from the investment process, significant diversity in the ownership structure suggests more than a simple pretense of concern for diversity issues. Firm ownership is an objective and clear concept which makes it a good simple proxy to describe both the degree to which employees from historically under-represented groups have influence on the investment outcomes produced by an investment management firm and the degree to which they participate in the economic upside generated by the firm.

There are additional ways to define diversity that may add to and improve the conventional definition when the objective is to consider the influence of diversity on investment outcomes. These definitions might involve current firm ownership percentages lower than the conventional threshold but would focus more broadly on the diversity in composition of investment teams; diversity of those who have influence on investment decisions such as research and risk management; and diversity in recruiting practices and policy. While these definitions are more difficult to verify objectively and introduce gray areas not inherent in the conventional definition, they may provide useful additional dimensions to the diversity conversation.

Desired outcomes of diversity

We see the desired outcomes of diversity as twofold; first, we recognize that diverse viewpoints and methods of problem-solving are often characteristics of cognitive diversity which may lead to more robust investment decision making, and second, that diversity within investment management organizations is inherently a social good with positive impact on the community at large.

² Josh Lerner, Harvard Business School Bella Research Group, 2019. "A Study of Ownership Diversity and Performance in the Asset Management Industry." *Knight Foundation Executive Report: Diversifying Investments*.

Regarding cognitive diversity, academic research has documented advantages of diverse groups for process and performance over short time periods and noted the potential advantages are greater for longer-term groups³ (Watson, Kumar and Michaelson, 1993). We believe one of the chief benefits of diverse fund management organizations is the greater diversity of cognitive thought brought to bear in the investment process. This view is bolstered by numerous financial industry publications. In one example⁴, James Ware and Michael Falk identify diversity of thinking styles as important to 86% of a group of top teams they identified to participate in their study. Ware and Falk make another observation related to soft skills, noting that 86% of these teams agree capacity for good debate is important.

A more generalized framework constructs a model studying individuals who differ in how they represent problems internally (perspective) and the algorithms they use to generate solutions (heuristics), (Hong and Page, 2000)⁵. The paper posits that collections of agents outperform individuals partially because people see and think about the problems differently.

These research pieces are a small subset of a broad set of research from the fields of management, economics and psychology supporting the notion that cognitive diversity can lead to better decision making.

The broader societal benefits of diversity are also important. A society which opens opportunity to all, and which proactively and effectively tries to ensure that members of historically under-represented groups are not barred from success will be seen by many as a better society. Indeed, inasmuch as the issues involved have political charge, at least in the United States that political disagreement is often driven more by different views of the best tools and approaches to use, rather than fundamental disagreement over the underlying benefits of fairness, equality and equity⁶. Ensuring that the hiring, promotion, and compensation process of a firm is fair is in the interests of all, and a firm which promotes fairness, and which provides opportunity broadly – and across many dimensions – is likely to be both a better place to work, and a more attractive employer. There may be plenty of disagreements over the exact best approach to achieving the common good, and over exactly

³ Watson, Warren E., Kamalesh Kumar, and Larry K. Michaelson. "Cultural Diversity's Impact on Interaction Process and Performance: Comparing Homogeneous and Diverse Task Groups." *The Academy of Management Journal* 36, no. 3 (1993): 590-602. Accessed March 2, 2020. www.jstor.org/stable/256593.

⁴ Ware, James and Falk, Michael, 2016. "Top Performing Equity Teams: The Common Factors They Share", Focus Consulting Group white paper.

⁵ Hong, Lu & Page, Scott E., 2001."Problem Solving by Heterogeneous Agents", *Journal of Economic Theory*, Elsevier, vol. 97(1), pages 123-163, March.

⁶ We use these terms here – each of which is, of course, a term of art – fully recognizing that where there is disagreement in this space it circles around the exact definition of these terms and the correct balance between these concepts, but that there is broad underlying consensus that these issues are all important. The exceptionally interesting research in this space performed by Jonathan Haidt, in particular in his 2012 book "The Righteous Mind: Why Good People Are Divided By Politics And Religion" helps clarify both the degree to which this consensus exists and the degree to which people often see others as disagreeing with them more than is in fact the case.

what that looks like: there are, thankfully, vanishingly few today who do not agree that opportunity for all is a core part of a fair and just society. The investment management industry should be no exception.

Increasing diversity of cognitive thought – challenges of the ownership model

Defining diversity in terms of overall firm ownership can have several benefits and can lead directly to cognitive diversity. A diverse ownership structure for the firm can act as a foundation stone and can help set the cultural tone for the firm, encouraging diverse recruitment, diverse teams and diverse recruitment practices. Diverse ownership, when also translated to diverse management, may directly encourage establishment of investment processes and policies that lead to cognitive diversity.

Nonetheless, we believe there are potential detractors of the firm ownership model as the sole diversity success metric. First, as asset management firms get larger, there may be looser linkages between the individuals who own the firm and the professionals who directly impact investment decisions. Diversity at the ownership level may not be reflected within the investment team, and the diversity of cognitive thought may not be as significant as implied by firm ownership percentages.

Second, investment team members without firm ownership may be less aligned to the success of the firm. In their paper, Hong and Page note inclusion of incentives makes some interpretations of their model more compelling than others. This is particularly true for a team member working for a firm where the firm has structured incentives so that team members receive benefits related to their specific contribution rather than allow the possibility of free riding. For this reason, when evaluating an investment team, we look beyond the ownership characteristics of the firm. We believe alignment of interest between investment team, management and clients is a critical factor to evaluate regardless of firm ownership structure.

Finally, success of the diverse asset management firm, i.e. AUM growth, does not necessarily translate to broader ownership distribution if it is perceived as disrupting the ownership characteristics that are partially responsible for that success. We see this outcome as an unintended consequence of investment programs that focus exclusively on ownership statistics as a qualifying characteristic for investment. They provide an incentive for owners to maintain more concentrated ownership rather than distribute it more broadly as a means to incentivize second and third generations of the firm.

Diversity of Cognitive Thought – Benefits of a Broader Definition

We believe there are benefits to broadening the definition of diversity to include other factors in addition to firm ownership. For instance, members of a diverse investment team can each bring a different perspective to a portfolio decision, thereby benefitting from cognitive diversity at the team level regardless of the ownership composition of the firm. Considering

firm diversity and team diversity results in a more direct link from the diversity characteristics of the team and potentially diverse cognitive thought brought to bear in the investment process.

Also, this broader definition can have positive implications for enhancing diversity characteristics of second and third generations of the asset management firm, regardless of first-generation ownership structure. Diverse-owned asset management firms already are committed to ensuring those diversity characteristics are reflected in their second and third generations. Broadening the definition of diversity to investment teams provides an incentive for non-diverse owned asset management firms to prioritize diversity in the structure of their investment teams – this action in itself will make the argument for diversity of ownership stronger in the longer term, as the pool of eligible diverse candidates for ownership will grow.

Finally, as investors incorporate a broader definition of diversity, they can reinforce the feedback mechanism that will incentivize asset management firms to 1) emphasize diversity in their recruiting efforts; and 2) provide greater transparency on the composition of their investment teams.

One of the challenges involved in going beyond firm ownership characteristics as a measure of diversity is that diversity characteristics of investment teams are not as easily available as ownership data, which are available in the form ADV or on standard databases, nor are they as clear cut. Due diligence moves beyond a screening or tick box exercise to developing an understanding of the diversity elements of the investment firm and team and the degree to which they impart cognitive diversity to the portfolio decisions that impact their clients. This involves understanding the alignment features of the firm and team as well as the decision-making structure inherent in implementation of the investment process. This extra work is likely worth doing, however, as it provides greater insight into the firm as a whole – worthwhile in itself when trying to understand whether to place trust in the organization.

Conclusion

It is important, both potentially to improve investment outcomes and for broader ethical reasons, for investment firms to make sure that they take diversity issues seriously. While this can be measured, to some extent, by looking at equity ownership characteristics, this can fail to take fully into account broader issues that can provide additional context. Looking at these issues – the degree of diversity present across the organization, the degree to which intellectual diversity is a clear part of the investment process, the degree to which the firm takes diversity and inclusion issues seriously and engages with them appropriately – can provide broader context for investors looking to ensure good investment outcomes while also paying attention to broader issues. Equity ownership is an excellent metric – but signs of a clear path to ownership, and a truly inclusive environment for all while working down that path can make the diversity discussion more multi-dimensional and may help investors better understand the managers with whom they may choose to do business.

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