Council on Foundations

Shared purpose. Collective voice. Greater impact.

DIVERSE MANAGERS

Erika Seth Davies, Director, External Affairs, Association of Black Foundation Executives

Philanthropy's Next Hurdle

In recent years, philanthropic organizations have made concerted efforts to diversify their leadership, culture, and staff, seeking to become more inclusive and representative. Diversity initiatives have flourished in philanthropic institutions as a result. Today the public is no longer surprised when our nation's largest grantmaking foundations and corporations appoint African American, Latino, and women leaders as chief executive officers, chief investment officers, and chief operating officers.

While foundations and corporations are working to make their own institutions more inclusive, their diversity initiatives are not only directed toward internal innovation. Funders are beginning to look outwards, as well, asking their grantees, contractors, and partners to provide data about diversity in their organizations. In their external initiatives, they seek to determine whether their investments are actually affecting diversity outside the field of philanthropy and to track their spending on businesses owned by minorities and women.

As their initiatives have gained momentum, philanthropic organizations have become aware of a phenomenon that many of us predicted all along: prioritizing diversity energizes organizations, making them more competitive and successful in our evolving economy.

Nevertheless, although they have actively engaged women and minority staff, appointing them to leadership positions, and have contracted with businesses owned by women and members of minorities, philanthropic organizations still have a lot of work to do. In particular, philanthropic investors and other institutional investors involved in asset management need to lend their strength to the diversity movement.

According to a study published in the September 2014 issue of Chief Investment Officer Magazine, "Whiteout: The Staggering Sameness of Asset Managers," nearly 90 percent of asset managers are white and approximately 75 percent are white men. African American and Latino employees together make up 28 percent of the nation's workforce—but these workers only hold 3 percent of leadership positions in the investment industry. The percentage of asset managers who belong to minorities and who own their own firms is even smaller.

Women and members of minority groups face many barriers when they seek to enter the field of asset management, especially when they own their own investment firms. Investment firm owners in this demographic encounter a predominant perception that they lack the ability and qualifications to compete with other firms and to produce comparable or superior returns on investment. They also encounter a perception that their firms lack sufficient experience in the investment industry or that they have an inadequate amount of assets under management.

However, research on the performance of firms owned by women and members of minority groups does not bear out this prejudice. On average, asset management firms owned by women and minorities show a stronger performance than firms whose owners are not among these groups. This comparison holds true across asset classes, whether calculated in absolute returns or risk-adjusted returns. Having perceived the strengths of asset management firms owned by women and minorities, these philanthropic organizations are working to engage these firms. In the process, they are revising their foundations' policies to institutionalize inclusive practices.

Taking the Pledge

> *Becoming a signatory to the investment manager diversity pledge allows your organization to publicly demonstrate its commitment to diversity and inclusive investment management practices and places your organization at the heart of a community of foundations and endowments seeking to ensure a level playing field for minority and women investment managers. Your commitment acknowledges that hiring a diverse pool of quality investment managers is not contradictory to the goal of maximizing returns or fiduciary standard of care; it demonstrates a focus on finding the best investment management talent and alignment with the mission of community philanthropy by helping to build wealth in communities of color and among women.*

So begins "The Investment Manager Diversity Pledge" that foundations and endowments undertake to ensure that their organizations adopt inclusive practices encouraging managers of diverse ethnicity and gender to compete for positions in endowment management. Although the idea of inclusion in investment practice is slowly growing momentum, foundation leaders and decision makers might wonder why they, in particular, should stand at the forefront of this issue. The answer to that question lies in the missions of these organizations, whose fundamental purpose is to improve the human condition, to alleviate suffering, and to support innovation to solve some of society's toughest problems. A more pertinent question is, how can the leaders and decision makers of such institutions neglect to align their investment policy with inclusive practices?

This paper aims to illuminate the reasons that foundations, in particular, should lead the effort for more inclusive investment practices. Some of these reasons are obvious and others are not as apparent. A growing body of research on program related investing and mission related or socially responsible investing has provided data informing communities of practice. However, the little information available reveals a tremendous imbalance—foundations are not choosing a diverse group of managers to manage their endowment assets. Philanthropic organizations have an enormous opportunity to correct this imbalance by introducing investment management practices that encourage greater diversity, equity, and inclusion in the field.

Foundation decision makers who seek greater diversity and inclusivity in their investment management practices need to address structural barriers to diversity and to make the case for inclusion. To make the case effectively, they must educate themselves regarding the benefits to foundation investors of inclusive investment practices. Instituting such practices in the field of foundation investment may influence the financial services industry, generally, and that ripple effect could extend to the broader society.

Making the Case

Foundations that adopt an inclusive approach, choosing investment firms owned by minorities and women, can realize innovative ways of achieving their mission, particularly as it relates to equity and inclusion, and may improve their investment performance, at the same time.

Foundations are increasingly pursuing opportunities to align their investment policies and strategies with their missions, or at least to ensure those investments minimize harm to the environment and to the communities and populations that they serve. Mission Investors Exchange is an affinity group with a membership of more than 230 foundations and mission investing organizations. Its existence demonstrates the appetite of foundations for ideas and tools that will increase the impact of their capital as they address social and environmental challenges. Philanthropy has come to understand that the pursuit of financial returns and social value are not mutually exclusive.

A core characteristic of impact investing is intentionality. Investment managers must act with regard to the investors' intent, which is not only to achieve a financial return, but to have a positive social or environmental impact.[1] Aligning foundations' principles and values related to diversity, equity, and inclusion also requires intentionality. Foundations should consider the pursuit and hiring of a diverse staff of asset managers as a practical policy that aligns their activities with their values.

According to Dr. Robert K. Ross, President and CEO of The California Endowment, which released the "Foundation Diversity Policies and Practices Toolkit" in 2009, "Diversity is best achieved when it is understood , prioritized, and integrated into the operations of a foundation as a tool for effectiveness in, and responsiveness to, the communities being served."[2] The "Foundation Diversity Policies and Practices Toolkit" suggests that institutions adopt a policy statement that explicitly espouses the principles of diversity:

[1] Global Impact Investing Network (GIIN), "Core Characteristics of Impact Investing," *www.thegiin.org*.

[2] The California Endowment, "Foundation Diversity Policies and Practices Toolkit" (Oakland, Calif., May 2009), *www.d5coalition.org/tools-and-resources/ foundation-diversity-policies-and-practices-toolkit/*.

> A commitment to the principles of diversity is often grounded in a policy statement. Indeed, a declaration of the values that guide the development of inclusionary philanthropy can help inform successful grantmaking. Institutions may choose to integrate their pledge to diversity in their overall mission statement—as in Z. Smith Reynolds Foundation's vision statement. Some foundations develop separate statements that specifically address equity—as shown in the Statement of Diversity Principles from the Hyams Foundation, Inc. and The California Endowment's Commitment to Diversity and Inclusiveness. The statements from the David & Lucile Packard Foundation and The San Francisco Foundation reinforce their inclusionary policies with demographic data on their board and staff. The definition of diversity goes beyond race and ethnicity and can include age, gender, class, sexual orientation, physical ability, geographic location, philosophy, and viewpoint.[3]

Many foundations ground their vision, mission, or values in a respect for and commitment to diversity, equity, and inclusion. In practice, they base their grantmaking, leadership, policies, and staffing on these values and commitments. However, the first D5 Coalition report, released in 2011, demonstrates that foundations still have work to do to align their policy and practice with these values. "State of the Work: Mapping the Landscape and D5's Path Forward on Diversity, Equity, and Inclusion in Philanthropy" documents key findings relevant to this issue:

- The demographics of foundation leadership—including executives and trustees—do not reflect the nation's overall diversity, nor do they reflect the demographics of the nation's workforce.
- Less than a third of foundations have diversity policies and practices in place.
- Philanthropy needs more standardized data collection and more studies on issues related to diversity.[4]

Absent from this assessment is a review of a crucial piece of the puzzle: the core economic engine that makes all other foundation work possible, namely, the billions of dollars in foundation endowments. Until recently, foundations rarely addressed the topic of diversity as a business strategy. Past efforts focused primarily on staff and leadership diversity, including senior executive and board representation, and on directing grantmaking dollars to support underrepresented and vulnerable populations. Few foundations reflected on the need to address diversity and inclusion in their own business relationships. Almost none considered diversity and inclusion as values relevant to endowment management.

[3] The California Endowment, "Foundation Diversity Policies and Practices Toolkit."

[4] D5 Coalition, "State of the Work: Mapping the Landscape and D5's Path Forward on Diversity, Equity, and Inclusion in Philanthropy" (report, Chicago, 2011), *www.d5coalition.org/wp-content/uploads/2011/05/State_of_the_Work_2011_Report.pdf*. The Joint Affinity Group (JAG 2.0) has lead responsibility for issuing an annual State of the Work Report. Association of Black Foundation Executives (ABFE) is an active member in JAG, along with Asian Americans and Pacific Islanders in Philanthropy, Funders for LGBTQ Issues, Hispanics in Philanthropy, Native Americans in Philanthropy, and The Women's Funding Network.

Pension plans are considered leaders in the use of emerging management, but they allocate less than 5 percent of their managed assets to managers described as "emerging." However, the term "emerging manager" can be misleading. Newer firms, or firms with fewer assets under management, may be categorized as "emerging"; the term might refer to the firm's track record in investment returns; or a firm might be considered "emerging" because of the character of its ownership. Firms owned by women and by members of minority groups are often relegated to this category even though they are well established firms, thereby reducing their hiring opportunities.

The sources of funding for managers are also out of balance. Among hedge funds owned by women and members of minority groups, the largest share of assets under management derives from individuals and from family offices. Minority and women cohorts own virtually no investments derived from foundations and endowments. Despite the fact that alternative strategies account for an average of 44 percent of asset allocation, foundations assume that businesses owned by minorities and women represent a poor marketing opportunity for investment managers.[5]

If we accept the proposition that aligning investment policy and strategy with a foundation's vision, mission, and values offers a viable and unique opportunity for a foundation seeking competitive investment returns, to what degree is the diversity of asset managers an added benefit?

The November 2014 McKinsey & Company report, "Diversity Matters," looks at the bottom line and finds proof that diversity benefits corporate financial performance. Using proprietary data sets for 366 public companies across a range of industries in Canada, Latin America, the United Kingdom, and the United States, this study's findings were clear:

- Companies in the top quarter in regard to racial and ethnic diversity are 35 percent more likely to have financial returns above their respective national industry medians.
- Companies in the bottom quarter in regard to gender, ethnicity, and race, are statistically less likely to achieve above average financial returns than the average companies in the data set. This data means that companies in the bottom quarter in regard to diversity are not leading the industry—in fact, they are lagging behind.
- A linear relationship exists between racial and ethnic diversity and better financial performance in the United States: for every 10 percent increase in racial and ethnic diversity on the senior executive team, earnings before interest and taxes rise 0.8 percent.[6]

[5] Barclays Capital's Capital Solutions Group, "Affirmative Investing: Women and Minority Owned Hedge Funds" (study, Hedge Fund Pulse, June 2012), *www.managedfunds.org/industry-resources/industry-research/affirmative-investing-women-and-minority-owned-hedge-funds-a-barclays-capital-report/*; 2014 Council on Foundations-Commonfund "Study of Investment of Endowments for Private and Community Foundations" (study, Council on Foundations and Commonfund Institute, Arlington, Va., and Wilton, Conn., 2014).

[6] Vivian Hunt, Dennis Layton, and Sara Prince, "Diversity Matters" (report, McKinsey & Company, London, November 24, 2014), *www.mckinsey.com/insights/organization/why_diversity_matters*.

This performance advantage holds true with investment returns as well. On average, the performance of asset management firms owned by women and minorities, both in terms of absolute returns and risk-adjusted returns, is stronger than the performance of firms that are not owned by minorities—and this superior performance carries across all asset classes. "Affirmative Investing: Women and Minority Owned Hedge Funds" found that, "WMOHFs [women and minority owned hedge funds] and FOFs [funds of funds] have outperformed the universe at large over the five year period ending March 2011. A fund-weighted index of single manager WMOHFs generated a cumulative return of 82.39% for the five year period ending March 2011, while an index of single manager, non-diversity funds returned only 51.00%." The report goes on to say: "For the five years ending March 2011, an index of women and minority owned FOFs generated a cumulative return of 39.32%. In comparison, our non-diversity FOF index returned only 11.66% for the same period."[7]

A 2012 report by the National Association of Investment Firms (NAIC), "Recognizing the Results—The Financial Returns of NAIC Firms: Minority and Diverse Private Equity Managers and Funds Focused on the U.S. Emerging Domestic Market," offered similar findings: "NAIC Firms have produced superior investment returns over a sustained period benchmark [1998 to 2010] against the general PE [private equity] industry, including the buyout subset . . . in each of the four industry benchmarks."[8]

One of the most important roles of foundation trustees is that of fiduciary, charged with acting in the best interest of the foundation to access asset management that is best in class and that will preserve and grow capital for the benefit of the mission. Trustees miss opportunities to honor their role when they fail to offer their foundations a diversity of ideas, perspectives, and talent.

The Ripple Effect

Beyond the obvious benefits of mission alignment and competitive performance, the intentional engagement of firms owned by women and minorities has a ripple effect, not only influencing philanthropic organizations to include people of color and women, but also encouraging the financial services industry to hire members of underrepresented communities:

[7] Barclays Capital's Capital Solutions Group, Affirmative Investing: Women and Minority Owned Hedge Funds."

[8] National Association of Investment Firms (NAIC), "Recognizing the Results—The Financial Returns of NAIC Firms: Minority and Diverse Private Equity Managers and Funds Focused on the U.S. Emerging Domestic Market" (report, KPMG, Washington, DC, and New York, 2012), *www.naicpe.com/eventmobi/NAIC-RecognizingTheResults.pdf*. The last reports on the performance of firms owned by women and members of minority groups used data from 2011; further study, using more recent data, would be desirable.

- **Investing with minority managers builds wealth in communities of color and moves the needle on closing the wealth gap between white and minority populations in the United States.** According to the Foundation Center's list, "Top 100 U.S. Foundations by Asset Size," this elite group of institutions collectively represents approximately $260 billion in endowment assets. The Foundation Center used similarly sized public pensions as a model for determining fees paid to managers (these plans are required to disclose this information). The Center found that implied manager fees for the top 100 U.S. foundations alone reached $2.7 billion. This is a conservative estimate. Private foundations tend to allocate more assets to alternative investments than public plans allocate (44 percent versus 24 percent), and these alternative strategies command considerably higher fees than traditional fixed income and equities. Furthermore, all of the top 25 hedge fund managers in the United States are white males. These hedge fund managers, who represent some of the wealthiest people in the world, collectively earned $24.3 billion in 2013. Although very few will ever reach this level of financial success, access to opportunities in the financial services industry increases the income and wealth of underrepresented groups substantially.[9]
- **Firms owned by minorities and women often hire and train other women and people of color.** Managers of diverse ethnicity and gender tend to tap their equally diverse networks to identify and attract talent to their firms, thus creating pipelines for future diverse investment talent and future trustees for foundations and other nonprofit organizations.
- **Minority managers are often philanthropists and critical high impact donors in their respective communities.** In March 2015, the Association of Black Foundation Executives (ABFE) conducted a survey of investment management firms on the Progress Investment Management Company manager-of-manager platform. Of all responding firms, 64 percent identified as either a Minority Business Enterprise (MBE) or a Women Owned Business Enterprise (WBE)—indicating majority ownership of the business. When asked whether their firms had made charitable contributions over the past three years, these firms' response indicated an aggregate total contribution of $2,063,316 from 2012 through 2014. Seven firms reported that their programs matching employee giving had leveraged an additional $263,256 in 2014. When asked which groups their philanthropy targeted, 35 percent had given to African Americans and 32 percent had funded women and girls. A significant majority of asset management firms had supported education. The outcome of the study was the finding that managers can and do give.[10]

Barriers to Inclusion

With all of these potential benefits to individual foundations, and to the field as whole, why aren't foundations clamoring to access these underutilized managers? And what can be done to shift the paradigm?

[9] Foundation Center "Top 100 U.S. Foundations by Asset Size," *http://foundationcenter.org/findfunders/ topfunders/top100assets.html*.
[10] ABFE/Progress Investment Management Company Survey of Funded Managers, March, 2015

In September 2011, ABFE released its first publication on the lack of diversity among endowment asset managers: "Foundation Investment Manager Practices: Thoughts on Alpha and Access in the Field." The survey revealed very specific structural barriers that prevent foundations from engaging asset management firms owned by minorities or women. Focus group meetings with managers and foundation decision makers revealed the following barriers to inclusion:

- Foundation policies and practices, and the policies and practices of their investment consultants, prevent the identification and hiring of qualified minority managers.
- Foundation and consultant decision makers mistakenly perceive that focusing intentionally on engaging minority managers results in higher cost of investments or institutional risk of compromised returns.
- Foundations have limited access to avenues for sourcing vetted minority investment talent in different asset classes.
- Investment firms owned by people of color have limited marketing resources, inhibiting their visibility and their access to potential foundation clients and to their key decision makers.
- Foundations' efforts to engage minority managers may require the reappropriation of existing investments and disinvestment from larger firms, or from firms with long track records or existing relationships with institutional investors.[11]
- Implicit bias and a reliance on external investment consultants have also impeded progress of those attempting to institutionalize inclusive hiring of endowment managers.

In February 2014, Dr. Emmett Carson, President and CEO of the Silicon Valley Community Foundation, and Michael Miller, Managing Director of Colonial Consulting, published an insightful case study on this subject: "Investment Manager Diversity: The Hardest Taboo to Break." Carson writes: "Unfortunately the hidden bias is that some think that identifying a diverse pool of quality investment managers is somehow contradictory to the goal of maximizing returns . . . it is mistakenly assumed that a focus on hiring diverse firms will result in compromising investment returns."[12]

Given the complexities of foundation investment and the degree of specialization required for sound asset management, neither CEOs nor most board members of foundations are equipped to oversee the investment portfolio—nor do they have time to do so. Carson suggests that, as a result, senior executives defer to "the recommendations of the external investment consultant about identifying and selecting the best investment managers." In fact, says Carson, "Investment consultants hold considerable influence in the process."[13]

[11] Association of Black Foundation Executives (ABFE), "Foundation Investment Manager Practices: Thoughts on Alpha and Access in the Field" (New York, September 2011), *www.emergingmanagermonthly.com/wp-content/uploads/2012/10/Inclusive%20Foundation%20Investment%202012%20 rev%20-1.pdf*.

[12] Emmett Carson and Michael Miller, "Investment Manager Diversity: The Hardest Taboo to Break"(case study, Association of Black Foundation Executives, New York, February 2014), *www.siliconvalleycf.org/sites/default/files/publications/investment-manager-diversity-hardest-taboo-to-break- casestudy.pdf*.

[13] Carson and Miller, "Investment Manager Diversity: The Hardest Taboo to Break."

Call to Action

Several foundations have responded to the call for inclusivity and diversity in the field of asset management. Diversity initiatives undertaken by these foundations have determined on a number of best practices that philanthropic investors can implement if they want to engage a more diverse cohort of asset managers.

Best Practices: Start With Your Board

Foundation leaders who are seeking to hire more asset management firms owned by minorities and women, or to recruit more women and minority asset managers, must begin with their board of directors. Discussions centering on diversity are not always the easiest conversations to have. In this case, the board must also address the sensitive topic of who will manage the foundation's endowments. However, when an organization's board of directors champions diversity, that organization is galvanized to move forward and to take calculated risks.

Given the sensitivities and complexities of boards, the courage of foundation board members who have raised this issue and have worked with their executives to prioritize hiring of minority asset managers is all the more laudatory. Their efforts range from taking simple steps, such as measuring the organization's use of minority-owned asset management firms, to more fundamental changes that institutionalize inclusivity in the organization's policies and practices. An example of the latter is the National Football League's (NFL's) "Rooney Rule," which the League employs during its hiring process to ensure that every search for talent includes an asset management firm owned by a member of a minority group.

Coordinate Within Your C-Suite

Having launched a diversity initiative, foundation leaders must remain in constant communication and coordination with their senior executives and staff. Although the board president or chief executive officer may have worked to garner the necessary support
to launch an initiative to create diverse asset management, the chief investment officer and other staff members who support the investment committee will most likely be responsible for implementing it.

Foundation executives need to engage in conversations about what they mean when they mean by inclusivity and diversity, especially in regard to hiring asset managers and asset management firms. They need to set clear goals for the organization to ensure that their diversity initiative is part of the foundation's wider strategy, rather than a side project with no sustainability and no measurable impact. A diversity initiative succeeds when senior management embraces it, drives it, and lives its values.

Engage Your Investment Consultants

Conversations among foundation leaders and staff members should clearly outline expectations regarding inclusivity and diversity in hiring asset managers. Establishing these expectations can also help the organization's leadership give better direction to its investment consultants. As the gatekeepers of information, investment consultants play a critical role in presenting asset managers to philanthropic investors. If a foundation's leadership directs its investment consultants to actively seek asset managers who are women or minorities, then the investment consultants' duty is to follow these instructions. The most straightforward way for foundation leaders to find and hire minority asset managers and asset management firms owned by minorities is to enlist their investment consultants in the process.

The third item of "The Investment Manager Diversity Pledge" offers guidance on how to encourage investment consultants to take steps to hire managers of diverse gender and ethnicity. Foundation executives should encourage transparency and accountability from their investment consultants, requiring them to produce regular reports on inclusive practices and on the diversity of the foundation's asset managers. Reports should include:

- the number of diverse managers actively researched and tracked over the last year
- the number of diverse managers recommended to all clients over the last year
- the number of diverse managers hired by all clients over last year
- improvements in inclusive sourcing, engagement, and reporting practices
- constructive feedback provided in response to the inquiries or rejections that managers receive

Fund Research

Although foundation leaders play a critical role in promoting diversity in the asset management field, they have lacked substantive research to support their efforts. Some available studies explain how foundations reach the decision to hire more firms owned by women and members of minority groups. For the most part, these are case studies that demonstrate the strong performance and return on investment achieved when organizations prioritize inclusivity and diversity in hiring asset managers.

Still lacking is a comprehensive study that canvases foundations to determine how much of their investment budget they are allocating to minority asset managers. Such a study would lend support to those who are holding conversations with their boards about inclusivity and diversity in their hires of asset managers.

Network and Mentor

The field of asset management is difficult to understand, making diversity initiatives in that industry harder to tackle. Opportunities to learn about the investment field are not available to everyone. Luckily, several initiatives seek to help institutional investors understand how to begin changing their practices and policies, so that they can transform the field of asset management into a more diverse and inclusive field. These initiatives, including 100 Women in Hedge Funds, Association of Asian American Investment Managers (AAAIM), Diverse Asset Managers Initiative (DAMI), National Association of Investment Companies (NAIC), National Association of Securities Professionals (NASP), New America Alliance (NAA), and The Consortium, all aim to connect asset managers with institutional investors. One of these initiatives, Diverse Asset Managers Initiative (DAMI) even convenes institutional investors to share approaches to this work with one another. DAMI hopes to make investors aware that their peers are working to create a more diverse and inclusive field of asset management.

Learning from and sharing experiences with institutional investor peers will help philanthropic investors jump the next hurdle, enabling us to diversify the field of asset management and to build a more diverse and inclusive economy. Let us take advantage of all opportunities available to communicate our experiences with one another as we join together in our efforts to transform our own institutions and to show the financial industry and our society that inclusivity and diversity in management engenders strong and sustainable investment performance.