DECEMBER 2022

THE PATH TO INCLUSIVE CAPITALISM

An Asset Owner Guide for Investment Portfolios

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The Milken Institute's Inclusive Capitalism Program aims to create a business environment that produces long-term value to benefit all stakeholders, including businesses, investors, employees, customers, governments, and communities. Our work focuses on the importance of diversity, equity, and inclusion across the business community and works toward greater diversity across the board in asset management, from entry to the C-suite level.

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CONTENTS

EXECUTIVE SUMMARY

Women- and diverse-led firms control only 1.4 percent of the more than $82 trillion[1] managed by the US asset management industry. The road to achieving a diverse, equitable, and inclusive (DEI) investment value chain is long. As the ultimate owners of capital, asset owners have the ability and responsibility to drive DEI within investment management teams and portfolios and across the asset management industry.

There are four components on the path to inclusive capitalism: incorporating diversity and inclusion into governance; sourcing diverse talent; underwriting equitably; and committing to equitable monitoring and engagement. This guide is for asset owners that are considering or have committed to taking this path, consultants who advise them, and asset managers that seek to become part of their investment portfolios. Let's explore the four pillars immediately below and again in greater detail in the body of the report.

- **Pillar One: Incorporate Diversity, Equity, and Inclusion into Governance** includes diversifying investment committee composition and culture, training the team on diversity, incorporating DEI into investment beliefs, adding DEI to investment policy statements, inserting DEI clauses into limited partnership agreements and side letters, designing and implementing a plan to collect diversity metrics, signing diversity pledges, reporting and publicly disclosing diversity, and establishing a structure and incentives conducive to diversity.

- **Pillar Two: Source Diverse Talent** consists of building diverse investment teams, sourcing diverse investment firms, and investing in diverse portfolio companies. This includes expanding the search beyond traditional talent pools, as well as reporting on the progress of hiring diverse talent.

- **Pillar Three: Underwrite Equitably** considers a new risk paradigm that involves lowering and/or forgoing minimum general partner (GP) and limited partner (LP) commitments, minimum track records, and fee breaks when underwriting and negotiating with diverse emerging managers. Investors should holistically assess inclusion at the investment team, investment portfolio, and service provider levels.

- **Pillar Four: Commit to Equitable Monitoring and Engagement** entails establishing an asset manager baseline for LPs and measuring their progress over time, thus increasing the diversity of existing asset managers and amplifying their overall influence.

INTRODUCTION

The Milken Institute defines diversity, equity, and inclusion (DEI) as follows:

- Diversity refers to all aspects of human difference, social identities, and social group differences, including but not limited to race, ethnicity, creed, color, sex, gender, gender identity, sexual identity, socioeconomic status, language, culture, national origin, religion/spirituality, age, (dis)ability, military/veteran status, political perspective, and associational preferences.

- Equity refers to fair and just practices and policies that ensure all community members can thrive by acknowledging and addressing structural inequalities—historic and current—that advantage some and disadvantage others.

- Inclusion refers to a community where all members are and feel respected, have a sense of belonging, and are able to participate and achieve to their potential.

"The current leadership and workforce in the asset management industry often do not adequately reflect the composition of those individuals investing in or contributing to the funds which are managed," Richard Ditizio, president and chief operating officer of the Milken Institute, remarked in a statement. "We're hoping to analyze the existing paths to success in this industry and understand how we can change that dynamic."[2]

There may be significant challenges due to perceived lack of definitive research for public and private pension plans, family offices, foundations, and other allocators that are leading the effort to establish diversity, equity, and inclusion within their own institutions. Our goal is to aggregate widely available research on DEI in asset management to clarify the practices that can most easily be adopted to make an impact on an allocator's intentions.

PILLAR ONE

Incorporate Diversity, Equity, and Inclusion into Governance

Institutional investment teams and committees seeking research on inclusive capitalism can choose from countless studies that detail the benefits of various forms of diversity in specific contexts or circumstances—or the negative effects of a lack of diversity. Gompers, Mukharlyamov, and Xuan (2016)[3] found that investors with the same ethnic, educational, and career backgrounds were more likely to syndicate with each other. This homophily reduces the probability of investment success, and its detrimental effect is most prominent for early-stage investments. A variety of studies show that the cost of affinity is most likely attributable to poor decision-making by high-affinity syndicates after the investment is made. The "birds-of-a-feather-flock-together" approach to collaboration can be costly.

In some settings, greater diversity in the composition of boards and management teams translates to faster growth, wider margins, and improved decision-making. However, this finding is not always replicable, and there is no clear evidence of a constant relationship between increases in ethnic or gender diversity and subsequent improvement in operating metrics. More broadly, existing research suggests that the impact of diversity on company and investment performance depends on context.

Studies of the impact of diversity often begin by pooling different companies or portfolios on the basis of the ethnic or gender composition of the key decision-makers at the company or fund. The pools are then compared cross-sectionally over some fixed time horizon based on fundamentals (sales or earnings growth) or investment performance (internal rates of return, gross return on money invested, or a risk-based return measure).

Even though these studies often reveal that more diverse companies statistically significantly outperform less diverse companies, their design invites accusations of omitted variable bias. In other words, it may not be that diversity explains the difference in performance across companies; rather, it may be that the best companies tend to be more diverse or place greater emphasis on diversity. This subtle distinction helps explain the failure to generalize these findings to alternative samples or to document a precise relationship between diversity and investment returns. However, criticism of existing research on this basis feels like a red herring.

Perhaps diversity is not a "silver bullet" such that a given increase in the ethnic diversity of a management team would predictably accelerate company earnings growth in all circumstances. Studies that purport to prove such a relationship are rightly criticized. However, rather than conclude that diversity therefore exerts no provable impact on performance, wouldn't it make more sense to explore why many of the best companies place a greater emphasis on diversity? Or how these businesses create the conditions necessary for diversity to yield the hoped-for improvements in decision-making, strategic positioning, and risk management? Company culture seems to play a pivotal role in mediating diversity's impact. Therefore, the next generation of research must not only regress company or investment-specific data on to diversity metrics, but also identify the "soft" variables that explain the discrepancies bedeviling prior research.

Fortunately, some of this research is already underway. A study by Alex Edmans, professor of finance at the London Business School,[4] showed that the 100 Best Companies to Work for in America delivered shareholder returns that beat their peers by 2.3–3.8 percent per year during 1984–2011 (89–184 percent cumulative). Although the Best Companies List measures employee satisfaction in general, rather than diversity and inclusion in particular, several of the five dimensions it captures (credibility, fairness, respect, pride, and camaraderie) are linked to diversity and inclusion.[5] In addition, as Edmans noted in his February, 2018, response to the UK Financial Reporting Council's consultation on the Corporate Governance Code, "Diversity is highly desirable in its own right, and firms should pursue it even in the absence of a target and evidence showing that it instrumentally improves performance. It would be a sad world if the only reason firms increased diversity were to obtain higher performance or meet a regulatory target."[6]

Let's briefly examine the legal case for diversity. Some professionals have reported resistance to their deliberate attempts to diversify investment portfolios, capital markets, and corporate executive suites as running counter to their fiduciary duty. This resistance is based on a narrow definition of fiduciary duty. By way of background, the fiduciary duty of loyalty, or acting in the best interest of beneficiaries at all times, is subject to a range of interpretations.

On one end of the spectrum, companies and investors presume that diversity depresses maximum benefits and therefore cite fiduciary duty to justify a lack of investment in diverse-owned and diverse-led asset managers. Some investment teams are constrained from surveying the managers in their portfolio for diversity. Some investment teams for state university endowments are prohibited by their legal departments from incorporating non-financial factors, such as diversity, into investment processes or even from identifying diverse managers during manager due diligence. On the other end of the spectrum, as the Diverse Asset Manager Initiative describes, companies and investors believe that "a lack of diversity undermines the fiduciary responsibility to generate the highest returns because it reflects a failure to fully consider the range of options for generating the best risk-adjusted returns."[7]

Regarding diversity in investment portfolios, the US Department of Labor recently announced plans to better recognize the important role that environmental, social, and governance (ESG) integration can play in the evaluation and management of plan investments, while upholding fiduciary duty.[8] Regarding diversity at companies, new research[9] by Brummer and Strine shows that corporate fiduciaries are bound by their duties of loyalty to take affirmative steps to ensure that corporations comply with important civil rights and anti-discrimination laws and norms designed to provide fair access to economic opportunity. These authors also explain that corporate law principles, such as the business judgment rule, not only authorize but encourage American corporations to act to reduce racial and gender inequality and to increase inclusion, tolerance, and diversity, given the sound connection between good DEI practices and corporate reputation and sustainable firm value.

The interpretation of fiduciary duty is influenced by the mindset and composition of the investment committee and whether DEI have been included in the investment beliefs. There are organizations that have been intentional about incorporating DEI frameworks to influence the representation of multiple perspectives on their boards. Let's examine each strategy in turn, with examples of organizations leading the charge on adopting them.

Strategy 1: Diversify Investment Committee Composition and Culture

According to Kerin McCauley, senior associate director of the New York University Stern Center for Business and Human Rights, ensuring that investment committees include talented women and people of color—and value their voices—strengthens decision-making and the ability to identify high performance across more diverse networks. In general, investment committees should include at least two diverse members to amplify their voices and offset broader resistance to DEI. The California Public Employees' Retirement System (CalPERS) board proactively increased its gender diversity, transitioning from one to four female members out of 13 members during the fiscal year 2014–2015.[10] Non-diverse committee members should also raise diversity issues, which broadly benefits the investment committee's work.

A study by the investment management company, Vanguard, found that increasing diversity can enhance an investment committee's effectiveness. Although cueing a team is likely to reveal differences of opinion, the results indicated that when conflicts arise, simply having a diverse team may improve conflict resolution. The investigators concluded that when compared with uniform groups, diverse committees bring fresh perspectives and often a greater level of deliberation before reaching decisions.[11]

Strategy 2: Train the Investment Team on Diversity

Anti-bias training could be helpful, as could training that frames lack of DEI as a systemic risk. Among companies offering corporate training, Frost Included offers inclusive leadership and unconscious bias training, as well as strategy, data, governance, systems, and leadership analysis and support to build inclusive work environments. Blue Level offers experience-based DEI and anti-racism training.

In a study published in 2017 by the Harvard Business Review, participants were encouraged to "perspective-take" by describing the challenges a marginalized minority might face. In addition, participants were set specific, measurable, and challenging yet attainable goals related to diversity in the workplace. The results showed that both exercises produced positive effects on behavioral outcomes, including showing more support and less disparagement of marginalized minorities.[12] Providing an internal investment team with anti-bias training and increasing the gender and racial/ethnic diversity of the investment committee and investment team could facilitate equitable underwriting.

Strategy 3: Incorporate DEI into Investment Beliefs

Some asset owners name diversity as an investment belief or develop diversity statements. For example, CalPERS states diversity as one of its 10 investment beliefs.[13] According to Chief Diversity, Equity, & Inclusion Officer Marlene Timberlake D'Adamo, "Diversity of talent (including a broad range of education, experience, perspectives, and skills) at all levels (board, staff, external managers, corporate boards) is important; and CalPERS may engage investee companies and external managers on their governance and sustainability issues, including diversity."

Strategy 4: Add DEI to Investment Policy Statements

Institutional Allocators for Diversity, Equity, and Inclusion (IADEI) is a consortium of 610 endowments, foundations, pensions, family offices, and other institutional investors that seeks to drive DEI within institutional investment teams and portfolios. A recent IADEI survey found that 91 percent of asset owners agreed with the business case to incorporate DEI into selection and monitoring of managers. Twenty-eight percent of IADEI members have incorporated DEI language in their investment policy statements (IPS), although such language tends to the general. For example, diversity of ownership and leadership, whether the firm has a compelling DEI initiative and has made progress toward DEI, and the degree to which the firm's business activities benefit marginalized communities may be noted as considerations in IPS. However, even such nonspecific language can shape investment funnels and the composition of investment portfolios.

Regarding asset owners that are leaders in DEI governance, research by the Intentional Endowments Network notes that DEI language in IPS covers a vast range: Examples include a statement by the Rockefeller Brothers Fund, a leading force in philanthropy, which equates advancing diversity in asset management with its fiduciary duty to preserve its endowment in perpetuity, and the policy of Warren Wilson College, a small, liberal arts school in rural North Carolina, that identifies diversity in management and board membership of portfolio companies as a positive screening tool in the process of identifying investment candidates. For investment committees and investment teams that are not yet ready to incorporate DEI into their IPS, a DEI investment team mission statement is a step forward.

Strategy 5: Design and Implement a Plan to Collect Diversity Metrics

Diversity definitions and thresholds vary across the marketplace. In the early 2000s, asset owners used thresholds ranging from 25 percent to 51 percent to determine diverse ownership. This was an apparent trend away from the 51 percent threshold previously used toward a broader definition of substantially diverse ownership. The Harvard Business School economist Josh Lerner defines diverse-owned asset managers as 25–49 percent and numerous investors use a 33+ percent threshold to define a diverse-owned firm.

Numerous organizations outsource assessment of the diversity of their portfolio to data science organizations such as Lenox Park Solutions. In addition, to ease the burden on asset managers and facilitate peer comparisons, the Institutional Limited Partners Association (ILPA) maintains a standardized diversity reporting framework[14] for institutional investors to use with the asset managers in their portfolios. A common definition of diversity facilitates the measurement of progress in diversity over time, as well as peer comparisons. The current best practice in gauging portfolio diversity is to request that employees of asset managers self-identify.

Diversity metrics vary by region: For example, some asset owners monitor locals versus expatriates in Africa, and First Nations representation is important in Canada. Accordingly, some asset owners measure only gender diversity outside of North America. Asset owners have expressed enthusiasm about the breadth of the facets of diversity covered by the CFA

Institute's DEI code and its principles-based approach. More specifically, the code considers generation, citizenship status, and neurodiversity as parts of the spectrum of human attributes, perspectives, identities, and backgrounds.

Asset owners tend to prioritize diversity of ownership for all asset classes and of carried interest allocation for alternative investment managers. They generally gauge the diversity of leadership and the investment team as secondary matters. Some asset owners also assess the diversity of the next layer of leadership and ownership in the firm to discern the diversity of ascending leaders.

Some asset owners describe sourcing asset manager diversity data as the largest challenge to expanding the diversity of their investment portfolios. At least one large asset owner considers the termination of managers for refusing to respond to diversity surveys, and several asset owners plan to be more assertive about asking asset managers to diversify their investment teams within a particular timeframe. Because self-reporting data is the current best practice, manager buy-in is critical. Asset owners report greater resistance to responding to surveys from non-US managers than from US managers.

Several large asset owners reported baseline diversity statistics to their investment committees for the first time in 2021 or planned to do so for the first time in 2022, according to multiple discussions at private convenings of institutional investors.

Strategy 6: Commit to Diversity Pledges

According to an Institutional Limited Partners Association (ILPA) survey, 44 percent of asset owners have signed DEI pledges, most commonly becoming ILPA Diversity In Action signatories,[15] which requires signatories to (1) have a public DEI strategy or statement and/or communicate a DEI policy to employees and investment partners that addresses recruitment and retention; (2) track internal hiring and promotion statistics by gender and race/ethnicity; (3) set organizational goals for more inclusive recruiting and retention; and (4) request that LPs and GPs provide DEI demographic data for any new commitments or fundraises. The initiative lists nine optional activities that participating organizations can choose to adopt.

Other asset owners have signed the CFA Institute's new DEI Code, which commits them to (1) promote DEI and improve DEI outcomes; (2) increase measurable DEI results in the investment industry; (3) measure and report on progress in driving better DEI results to senior management, the board, and the CFA Institute; (4) expand the diverse talent pipeline; and (5) design and implement inclusive and equitable hiring, onboarding practices, and promotion and retention practices. A number of UK-based asset owners have signed the Asset Owner Diversity Charter, which commits signatories to include diversity questions in manager selection and ongoing monitoring and to identify diversity and inclusion best practices.

Strategy 7: Report and Disclose Diversity Metrics

A critical mass of the top 25 university endowments publicly disclose data on the diversity of the managers in their portfolios, mostly by congressional request. The Knight Foundation endeavored to measure the representation of women- and diverse-owned investment firms among those used by the country's top 25 private and top 25 public college/university endowments. The endowments collectively hold $587 billion in assets, more than two-thirds of the nation's higher education endowment dollars. Only 12 of the 50 eligible endowments provided their asset manager roster and only three made asset manager rosters publicly available on their websites. Knight Diversity of Asset Managers (KDAM) studies show that firms led by white men are significantly less likely to employ diverse portfolio management teams than those owned by women and people of color. Openly reporting and disclosing the diversity of asset managers can accelerate access to women- and diverse-owned firms and encourage diversity within firms owned by white men.[16]

Strategy 8: Incentivize Diversity

The Teacher Retirement System (TRS) of Texas runs one of the largest emerging manager programs in the country, having committed $5.9 billion to 204 emerging managers across 342 investments since 2005. This program was instrumental in catalyzing the success of leading diverse-owned and diverse-led managers such as Vista and generated three-year annualized net return of 12.2 percent as of June 30, 2022.

TRS has taken a novel approach to incentives in its emerging manager program. Relating its development to an invited peer group, Chair of the Board of Trustees Jarvis V. Hollingsworth explained in an interview: "The entire trust is incentivized to be engaged with the Emerging Manager Program, as the program's performance is integrated into the Total Plan's performance. The program is focused on three objectives: performance, diversity, and graduation. The program's structure allows engagement from the relevant asset classes for each of these objectives. The asset classes form the advisory board for the program, leading to increased collaboration as we continue to search for alpha-generating strategies. The diversity objective is being achieved, as more than half of the program's assets are with diverse managers. Graduation has been a challenge for many programs, but the trust has implemented an innovative system to aid in this process. Emerging Manager (EM) Select allows the program and the asset class heads to collaborate at an even greater level and objectively identify the best-performing managers in the portfolio. The EM Select portfolio was put in place in 2019 and has already seen two graduations from the managers selected to participate."

PILLAR TWO
Source Diverse Talent

As McPherson, Smith-Lovin, and Cook noted in 2001, similarity breeds connection.[17] This principle of homophily structures network ties of every type, including marriage, friendship, work, advice, support, information transfer, exchange, co-membership, and other types of relationships. The result is that people's personal networks are homogeneous in terms of many sociodemographic, behavioral, and intrapersonal characteristics. Homophily limits people's social worlds in a way that has powerful implications for the information they receive, the attitudes they form, and the interactions they experience. Homophily in race and ethnicity creates the strongest divides in our personal environments, with age, religion, education, occupation, and gender following in that order.

Let's examine homophily and strategies to overcome its negative effects on three levels: individual investment professionals, investment firms, and portfolio companies.

Strategy 9: Build Diverse Investment Teams

The Kresge Foundation improves decision-making by purposefully building a more diverse and inclusive team. In 2019, the Kresge Investment Office launched a formal three-pronged commitment to DEI: people, process, and pulpit. Specifically, Kresge aims to expand its talent pipeline to create a more diverse and inclusive team, purposely seek out the best diverse-owned firms across all asset classes, and intentionally champion DEI initiatives within the investment industry. At the onset of the initiative, the Kresge investment team was approximately 71 percent male and 93 percent White. Today, the team is 46 percent male and 69 percent White.

EY research notes that hedge funds and private equity firms have been male-dominated since their formation by White men with investment banking or consulting backgrounds about 35 years ago.[18] The inclination to recruit peers has resulted in a homogeneous workforce. According to the 2021 Preqin Impact Report, only 20.3 percent of employees and 12.2 percent of senior staff in alternative investing are female.[19] Because no more than 31.5 percent of junior staff are female, gender parity is only achievable by sourcing talent from outside the industry.[20]

Private equity and asset management firms have traditionally sourced their talent from premier investment banking programs and consulting firms. Although these institutions are increasingly focused on recruiting and retaining diverse talent, it will take time for them to reflect greater diversity. In the interim, widening the funnel, considering a broader range of backgrounds and experience for investing roles, and mitigating bias in the screening process will increase diversity.

According to a report in *Harvard Business Review*, if only one woman is in a pool of three finalists, there is statistically no chance she will be hired. When two minorities or women are in the candidate pool a woman or minority becomes the favored candidate.[21]

Some asset managers modify job postings to attract a more diverse set of candidates or request that recruiters source diverse candidate slates. Others remove candidate names and even candidate schools from resumés prior to screening. Further, others conduct blind first-round interviews or ask a diverse set of colleagues to screen candidates.

Strategy 10: Source Diverse Investment Firms

Some asset owners set minimum diversity thresholds for manager searches in consultant contracts. Although progress is slow, widening of funnels at the consultant level is already contributing to more diverse investment portfolios. In particular, Cambridge Associates committed in 2020 to double the number of diverse-owned managers and the percentage of assets under management (AUM) invested in those managers by 2025, as Carolina Gomez, the company's director of strategy for diverse manager research, observed at a private investment conference sponsored by IADEI. Asset owners, in turn, can propel increasing diversity in consultant funnels by setting diversity goals.

Comparing notes with a broader range of peers and using nontraditional channels are critical approaches to sourcing diverse-owned companies and diverse-led managers. The hard work of industry participants and the DEI ecosystem to develop open-sourced diverse manager databases, and to host events connecting asset owners with diverse asset managers, has driven diversity efforts for decades. Performing diligence on and investing in diverse managers can create a snowball effect: It can catalyze greater diversity, as diverse asset managers refer other diverse asset managers to asset owners. The Milken Institute has begun to organize and participate in diverse-themed convenings around asset management alongside ILPA and the National Association of Securities Professionals (NASP).

As shared previously, we acknowledge that some investment teams are constrained from surveying the managers in their portfolio for diversity, and some risk management officers prohibit investment teams of state university endowments from incorporating non-financial factors, such as diversity, into investment processes, or even from identifying diverse managers during manager due diligence. On the other side of the coin, more progressive asset owners are reluctant to set diversity targets because they do not want to halt work on diversity once they achieve the target. In other words, they do not want the "floor" to become the "ceiling."

Some asset owners mandate that every short list of managers include a diverse manager or explain why it does not. For example, Fairview Health Services requires the identification of at least one diverse-owned manager finalist in public equity and fixed-income manager searches, according to Investment Director Casey Plante. Likewise, the W.K. Kellogg Foundation sets a target minimum percentage of meetings with diverse managers across all asset classes, with the intention of achieving diverse manager exposure across asset classes, according to Managing Director Reginald Sanders.

In 2019, the Kresge Foundation pledged to invest 25 percent of its US assets under management in female- and diverse-owned firms by 2025. By January 2022, 16 percent of Kresge's $4.2 billion portfolio was diverse-owned.[22] According to Knight Foundation research, 100 percent of investment commitments made by Princeton University (managed by PRINCO) in 2021 were awarded to diverse-owned firms.[23]

Strategy 11: Invest in Diverse Portfolio Companies

Results of studies show that homophily also affects portfolio company selection. Women fill 13.7 percent of senior roles in venture capital,[24] only 10–15 percent of venture capital-based entrepreneurs are women,[25] and from 1999 to 2013, less than 5 percent of all ventures receiving equity capital had women on their executive teams.[26] The Diana Project found that many fundable women entrepreneurs had the requisite skills and experience to lead high-growth ventures.[27] Nonetheless, women were consistently excluded from the networks of growth capital finance and appeared to lack the contacts needed to break through. Research suggests that providing women entrepreneurs with more exposure to venture capitalists may not be enough to eliminate the gender gap; instead, networking opportunities should be encouraged or even formalized, particularly in the realm of new venture competitions and accelerators.[28]

PILLAR THREE

Underwrite Equitably

Getting to the root cause of why women- and diverse-owned firms control only 1.4 percent of the more than $82 trillion[29] managed by the US asset management industry requires examining the manager evaluation process to gauge whether the standards used to judge skill and track record are biased. According to one large state pension fund in an interview, minimum GP commitments, minimum fund sizes, minimum track records, minimum check sizes, minimum team experience, and investment styles that may not perfectly fit into portfolio construction and design are all common hurdles with unequal impacts on diverse managers. Let's examine strategies to overcome two of these hurdles.

Strategy 12: Forgo Minimum General Partner and Limited Partner Commitments

Understandably, consultants and LPs use GP commitments as a proxy for the seriousness of portfolio managers and their alignment with LPs. At the same time, the varying thresholds of GP commitment that are considered "skin in the game" by different consultants and LPs create confusion.

In addition, higher thresholds are a de facto wealth test or barrier for new entrants. Being independently wealthy has become a prerequisite for making the size of GP commitment to a new fund that institutional allocators consider meaningful. Coupled with the wealth gap between Black and White individuals in the US, these higher thresholds limit diversity within investment portfolios.

It is challenging for LPs that must deploy billions of dollars to conduct diligence efficiently on new and small funds at scale. Rather than innovating on how to underwrite and allocate to smaller, newer managers at scale, many LPs rely on their peers' underwriting: Some have concentration limits of 10-20 percent of a fund's capital, while others require other similar investors to be already invested in a fund. Such requirements can lead to over-concentration in a few asset managers—with the top five asset managers holding 23 percent of externally managed assets and the top 10 holding 34 percent.[30] To support emerging managers, if they become comfortable with a fund's team and investment process, LPs may consider serving as the first institutional investor or representing a larger percentage and even the majority of a fund's capital.

Strategy 13: Develop Equitable Alternatives to Minimum Track Records

It is generally accepted that LPs prefer emerging managers that have track records. For most LPs, GPs with legal rights to track records are a first filter. However, established asset managers rarely provide portfolio managers with the legal rights to their track records. Some institutional allocators to private equity managers make the effort to call portfolio companies and extrapolate the track records themselves.

Unless LPs develop standards that look beyond track records with attribution, high-quality emerging managers may be overlooked. As an example of a more equitable alternative to reviewing minimum track records, Cambridge Associates also follows individual managers through their careers, which potentially can uncover new talent that might otherwise be missed.

Strategy 14: Negotiate Equitable Fees

Because smaller asset managers have higher expenses as a percentage of assets under management, they require higher fees to break even. Requiring emerging managers to accept lower fees and lower valuations can starve them of the revenues that they need to attract and retain talent and build successful businesses. LPs may consider forgoing fee breaks from diverse emerging managers. LPs should also ensure alignment of consultant and fund-of-fund incentives with DEI. Side letters in which consultants and funds of funds require fee breaks or no-fee or no-carry co-investments when engaging with diverse and emerging managers can deter some of the strongest emerging managers from continuing to grow and scale their firms.

Strategy 15: Assess Inclusion Holistically

As an asset manager example, Illumen Capital, a California-based venture capital firm that invests in funds of people from disadvantaged backgrounds, requires the GPs it invests in to incorporate anti-bias training into their investment processes. Similarly, Trident, an institutional asset manager that uses proprietary technology and a systematic approach to invest in high-potential small businesses, incorporated leveraging of greater inclusivity of Black American firms, suppliers, and professionals in its commercial-first strategy and pledged that 13 percent of the value created by its American Dreams Fund would be realized through increased opportunity, conditions, access, wealth, and representation for Black Americans.

Regarding portfolio diversity, the investment team at Trinity Church Wall Street gauges three facets of the diversity of the managers' underlying holdings: (1) the range of ways in which managers promote diversity at investees; (2) the diversity status of portfolio companies, which indicates a manager's ability to source and screen for inclusive investments; and (3) the momentum of manager efforts to promote diversity and inclusion at investees, as well as the diversity and inclusion momentum of the investees themselves.

PILLAR FOUR

Commit to Equitable Monitoring and Engagement

Conventional wisdom is that for asset owners that try to minimize manager churn, earnest commitment to increasing allocations to diverse-owned and diverse-led managers takes time to implement, and for asset owners that favor concentration, it can be challenging to add new managers to a portfolio, which slows the rate of progress.

The conventional wisdom is not enough: Asset owners can accelerate equity and inclusion in their investment portfolios through monitoring and engagement.

Strategy 16: Increase the Diversity of the Pool of Existing Managers

Investing in diverse-owned and diverse-led managers is important, as is encouraging large asset managers to increase the diversity of their senior staff, and indeed, encouraging all asset managers to increase staff diversity. ILPA's Diversity Metrics Template[31] considers both diversity status and diversity momentum in its staff movement tab.

Sometimes majority-owned asset managers are thoughtful about current and emerging diverse leadership. Commonfund and other institutional allocators consider ownership, executive team status, and carry allocation when gauging leadership diversity, as the Commonfund Managing Director, Caroline Greer, explained at a meeting of investment professionals. "The broader goal," she said, "is to gauge the development of diverse portfolio managers, rather than simply focusing on the executive level."

IADEI maintains a database of organizations that aim to increase diversity in the investment management industry at the junior, middle, and senior levels. Similarly, the W.K. Kellogg Foundation focuses on diverse-led strategies for managers that are not diverse-owned: Its belief is that the long-term growth of diverse managers starts with the promotion of more diverse people into senior decision-making roles across all firms. More specifically, since 2009, the Kellogg Foundation has invested more of its $4.2 billion diversified portfolio (excluding the portion of the portfolio that is Kellogg stock) in firms where people of color and women have significant decision-making authority.

Strategy 17: Amplify Influence with Asset Managers

Asset owners can encourage asset managers to increase their focus on DEI through strategic engagement, as well as offer resources that will help them build more diverse, equitable, and inclusive teams and investment portfolios. CFA Institute Global Senior Head of DEI, Sarah Maynard, has noted the influence asset owners can have on DEI by asking asset managers about their human capital management and investment portfolios. Supporting that observation, Anne-Marie Laberge, senior director of external portfolio management for the Caisse de Dépôt et Placement du Québec (CDPQ) has observed that CDPQ engages in dialogue with managers whose diversity statistics lag those of their peers.

First, strategic engagement is the most reliable type of sustainable investing for investors seeking impact, in the sense that it has been clearly demonstrated empirically. Academic research finds that success in strategic engagement has a number of drivers. First, the chances of success decrease as the costs of the requested reform rise. Corporate governance requests, including DEI requests, have the highest rate of success in part because reforms in the environmental domain are likely to be costlier than those in the governance domain.

Second, the greater the investor influence, the more likely strategic engagement requests are to succeed, particularly when the shareholder engaging holds a larger share of the targeted company. Dimson, Karakaş, and Li found that a group of investors engaging has more influence when the engagement is spearheaded by an investor from the same country as the company being engaged.[32] Linguistic and cultural elements may play a role as well. The chances of success rise when asset managers that are large and internationally renowned are part of the group of investors engaging. Silicon Valley Foundation Investment Committee Member Kate Mitchell summed it up for an IADEI investors' discussion group: "AUM matters, and so does location and leadership."

Third, the success rate of engagement is higher with organizations that have previously complied with engagement requests. It follows that collective engagement or even repeated and uncoordinated engagement with GPs is likely to yield success.

BlackRock CEO Larry Fink's annual letters to companies are widely publicized. In March 2020 a group of large asset owners sent a letter of their own, titled "Our Partnership for Sustainable Capital Markets," addressed to BlackRock and all other asset managers. It was signed by Christopher Ailman (chief investment officer of the California State Teachers' Retirement System), Hiromichi Mizuno (executive managing director and chief investment officer of the Japanese Government Pension Investment Fund [GPIF]), and Simon Pilcher (CEO of UK USS Investment Management Ltd).[33] Since the Our Partnership letter was published, 10 more asset owners have signed on, including the Netherlands government and education pension fund manager ABP, which has $650 billion of AUM.

In "Three Asset Owners Send a Sustainability Message," reporters Gillian Tett and Patrick Temple-West of the *Financial Times* asked: "Why are asset managers so much more outspoken on ESG topics than the ultimate asset owners?" They perceived this asset-owner letter as the answer to their fair question because it "calls on the asset managers they use to adhere to sustainability standards and observe long-term goals that respect the interests of stakeholders, not just shareholders."[34] GPIF's Mizuno is a strong proponent of the importance of the value that asset managers create through strategic engagement and of asset managers' transparency on their level of strategic engagement. He has often asked companies which asset managers are most effective in strategic engagement as part of manager diligence and monitoring.

According to Robert Eccles, a tenured Harvard Business School professor now at Oxford, "There is an important structural difference between Our Partnership and Fink's letters. As the largest asset manager in the world with around $9.6 trillion in assets under management as of March 2022, BlackRock owned stocks in over 15,000 companies all over the world. When BlackRock says it wants reporting according to SASB and TCFD, it is in a good position to get it. In contrast, although GPIF is the largest pension fund in the world with some $1.6 trillion in AUM, it only uses around 45 asset managers. BlackRock is one of them, as are Legal & General Investment Management and State Street Global Advisors, so the changes that these large investors make in their strategic engagement in response to asset owner pressure should travel down the investment value chain to companies."[35]

State Street is a case in point. Following the release of the asset-owner letter, and building on State Street's longstanding focus on gender diversity and its 2017 Fearless Girl campaign, State Street Chief Investment Officer, Rick Lacaille, sent a letter in 2020 to the board chairs of the 10,000 public companies in its portfolio, asking them to disclose the following details about the diversity of their boards and workforces in 2021:

- **Strategy:** Articulate diversity's role in broader human capital management practices and long-term strategy.

- **Goals:** Describe any diversity goals, how they contribute to the firm's overall strategy, and how these goals are managed and progressing.

- **Metrics:** Provide measures of the diversity of the firm's workforce and board. With respect to workforce, US companies can use the disclosure framework set forth by the United States Equal Employment Opportunity Commission's EEO-1 Survey, and non-US companies are encouraged to disclose diversity information according to SASB and nationally appropriate frameworks. The EEO-1 survey focuses on employee diversity by race, ethnicity, and gender, broken down by industry-relevant employment categories or levels of seniority, for all full-time employees. At the board level, portfolio companies should disclose diversity characteristics, including racial and ethnic makeup, of the board directors.

- **Board:** Explain goals and strategy related to board racial and ethnic representation, including how the board reflects the diversity of the company's workforce, community, customers, and other key stakeholders.

- **Board oversight:** Detail how the board executes its oversight role in diversity and inclusion.[36]

In an interview, State Street Global Advisors Global Head of Asset Stewardship Ben Colton explained, "Consistent with our stewardship approach to other long-term issues, we will be engaging with companies and assessing the data as it becomes more readily available. These are complex, long-term issues, and we appreciate that companies may need time to reach their ultimate goals from a diversity perspective. While we will provide some degree of flexibility, we are prepared to hold companies accountable."

In 2021, State Street voted against the Chairs of Nominating and Governance Committees at companies in the S&P 500 and FTSE 100 that do not disclose their boards' racial and ethnic composition. In 2022, State Street voted against the Chairs of Compensation Committees at companies in the S&P 500 that do not disclose their EEO-1 Survey responses and against the Chairs of Nominating and Governance Committees at companies in the S&P 500 and FTSE 100 that do not have at least one director from under-represented communities on their boards.

Few would argue with Tom Gosling, formerly a senior partner at PwC, now an executive fellow at London Business School with expertise in corporate governance and responsible business, who has stated that inclusion in the broadest sense demands "profound changes to working practices, culture, and the design of jobs that is required to make diverse teams effective."[37]

CONCLUSION

The road to achieving a diverse, equitable, and inclusive investment value chain is long. As the ultimate owners of capital, asset owners have the ability and responsibility to drive DEI within investment management teams and portfolios, and across the asset management industry.

This report frames four key components of inclusive capitalism—incorporating diversity, equity, and inclusion into governance; sourcing diverse talent; underwriting equitably; and committing to equitable monitoring and engagement—and provides many examples of how investors implement them.

The mechanisms to accelerate change are available in the industry. For example, investment consultants have traditionally met with asset managers and provided the initial investment memo. Investment officers for asset owners may consider inverting the traditional process by meeting with diverse asset managers for the initial screening and providing the first draft of the investment memo to the investment consultant.

We recognize that only a limited number of institutions have the internal capacity to execute on this strategy, but by inverting the process, investment advisors who are not informed or interested in responsible investing strategies, including impact investing, can look to other LPs for guidance on diverse managers where the diligence has already been conducted. The power to enforce this strategy and the others laid out in the industry rests in the purview and power of asset owners.

As the landscape of diversity, equity, and inclusion continues to evolve, an open exchange of ideas about best practices for inclusive investing is critical to increasing the percentage of the US asset management industry that is controlled by women- and diverse-owned firms.

To further our efforts on DEI in Asset Management, the Milken Institute will follow this report with seven specific action steps for the asset management industry to effect change.

A turnkey, grand diversity plan will not yield results. Instead, we believe real change comes from a series of sustainable, micro actions by multiple stakeholders across the asset management industry.

As an allocator, if you haven't executed any of the pillars listed above, this is the opportunity for you to catch up.

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ACKNOWLEDGMENTS

We thank the following individuals for sharing their insights and expertise.

Jake Barnett, Director of Sustainable Investment Services, Wespath Institutional Investments

Michael Barry, Chief Investment Officer, Georgetown University Investment Office

Joanne Bauer, Co-Founder, Rights CoLab

Aron Betru, Chief Strategic and Operating Officer, Trident

Jennifer Choi, Acting Chief Investment Officer, Institutional Limited Partners Association

Benjamin Colton, Global Head of Asset Stewardship, State Street Global Advisors

Marlene Timberlake D'Adamo, Chief Diversity, Equity, & Inclusion Officer, California Public Employees' Retirement System

Daryn Dodson, Managing Partner, Illumen Capital

Georges Dyer, Executive Director, Intentional Endowments Network

Robert G. Eccles, Visiting Professor of Management Practice, Saïd Business School, University of Oxford

Alex Edmans, Professor of Finance, London Business School

Stephen Frost, Chief Executive Officer, Frost Included

Susanna Gibbons, Managing Director and Chief Investment Officer, David S. Kidwell Funds Enterprise

Carolina Gomez, Director of Strategy for Diverse Manager Research, Cambridge Associates

Tom Gosling, Executive Fellow, London Business School

Allen He, Research Director, FCLTGlobal

Jarvis V. Hollingsworth, Chair of the Board of Trustees, Teacher Retirement System of Texas

Keon T. Holmes, Managing Director, Cambridge Associates

Matthew Illian, Director of Responsible Investing, United Church Funds

Meredith Jenkins, Chief Investment Officer, Trinity Church Wall Street

Joelle Kayden, Founder and Managing Partner, Accolade Partners

Anne-Marie Laberge, Senior Director of External Portfolio Management, Caisse de Dépôt et Placement du Québec

Dana Lanza, Chief Executive Officer, Confluence Philanthropy

Victoria Tellez Leal, Impact Associate, Y Analytics

Albert Lee, Director of Investments, University of California Office of the Chief Investment Officer

Josh Lerner, Jacob H. Schiff Professor of Investment Banking, Harvard Business School

Maria Long, Research and Content Director, Standards Board for Alternative Investments

Sarah Maynard, Global Senior Head of Diversity, Equity, & Inclusion, CFA Institute

Kerin McCauley, Senior Associate Director of Center for Business & Human Rights, New York University

Kate Mitchell, Investment Committee, Silicon Valley Foundation; Steering Committee Member, Institutional Allocators for Diversity, Equity, & Inclusion

Adrian Ohmer, Investment Director, Kresge Foundation; Steering Committee Member, Institutional Allocators for Diversity, Equity, & Inclusion

Casey Plante, Investment Director, Fairview Health Services

Robert Raben, Founder, Diverse Asset Managers Initiative

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Jenny Sorin, Director of Programs and Operations, IDiF

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