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WHITE PAPER

THE INVESTMENT CASE FOR BOARD DIVERSITY

A Review of the Academic and Practitioner Research on the Value of Gender and Racial/Ethnic Board Diversity for Investors

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Introduction

In the enduring quest among investors, scholars, and business professionals to identify what attributes or human phenomena contribute to successful companies, board diversity stands out. The diversity of a company's board of directors has received immense attention over the years. Academics and practitioners seek to determine whether and to what extent different diversity characteristics – which may include diversity of gender, race, ethnicity, age, religion, class, sexual orientation, personality, political ideology, skill sets, professional experience, or disability status, among others – impact group dynamics, board effectiveness, and ultimately, the financial performance of companies.

This level of attention is warranted given the fact that "good corporate governance can create and preserve value for investors… and good governance begins with a great board of directors."[1] Boards of directors wield immense influence over the governance, management, business strategy, and financial performance of corporations. They also serve as the direct representatives of a company's shareholders, which further ensures that boards are focused and legally bound to protect and grow shareholder value. Given this level of influence and materiality to investors, it is clear why corporate leaders, financial analysts, institutional investors, and other stakeholders devote so much time and attention to the composition of corporate boards, including the diversity of board members.

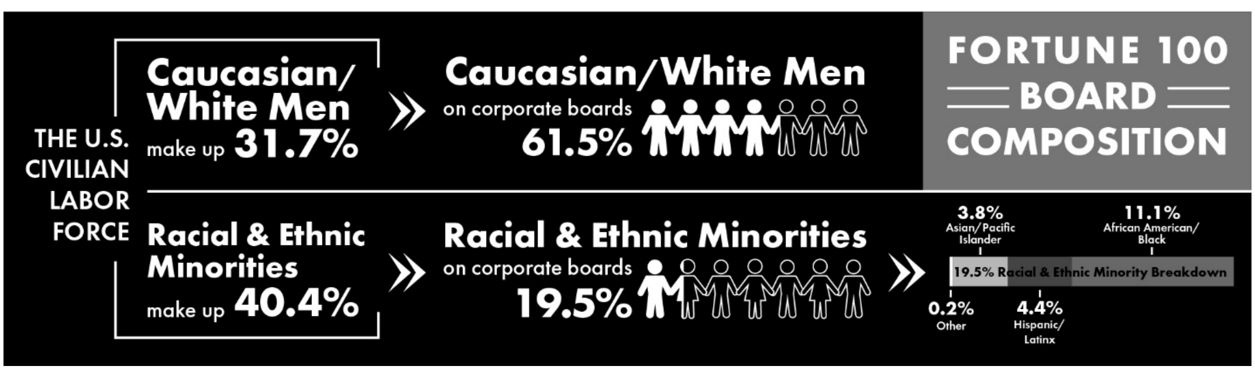
While diversity comes in infinite stripes, many of which are ripe for analysis, significant attention has focused on corporate board diversity as constituted by the gender and racial/ethnic composition of board members. While there is clearly an ethical and principled case for board diversity in the interests of equity, inclusion, and social justice, many academics and practitioners in the investment space focus on the business case for board diversity. To that end, a plethora of studies examine whether and to what extent gender and racial/ethnic diversity affect the functioning of corporate boards and the performance of the companies they oversee, with performance chiefly defined by financial and operating metrics.

This paper seeks to examine the wealth of literature on this subject to provide further insight and render a judgment on the investment case for gender and racial/ethnic diversity on corporate boards. In summary, this paper concludes that the gender and racial/ethnic composition of corporate boards does indeed have a material and relevant impact on company performance and investors.

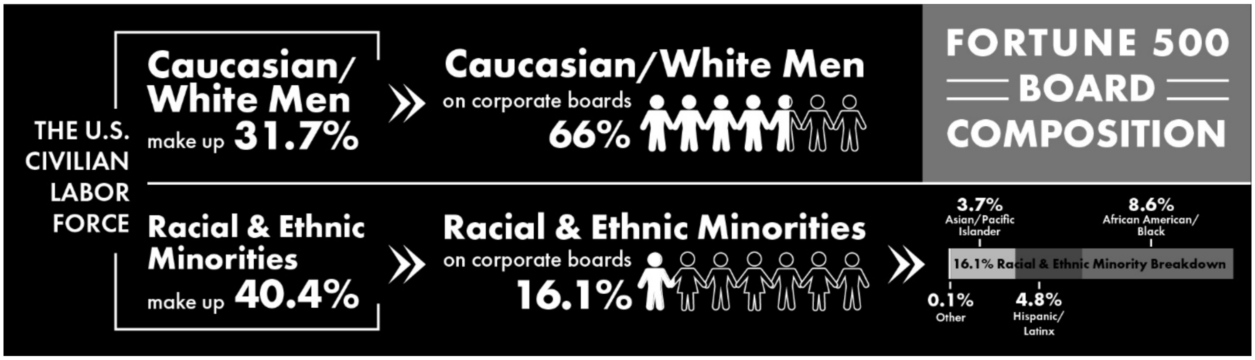
While research is notably abundant regarding gender diversity, this examination finds that the investment case for racial/ethnic board diversity holds true as well, despite the lack of disclosure from many companies on the racial/ethnic composition of their board members. In summary, extensive empirical research on board diversity and effective board governance demonstrates a positive relationship between the percentage of diverse individuals on boards and firm value and performance. Companies with a diverse board, inclusive of gender and race/ethnicity, are better positioned to execute good governance, effective risk management, and optimal decision-making, as well as enhanced customer alignment, employee engagement, and transparency, as compared to those with laggard board diversity.

Current Levels of Diversity on Boards

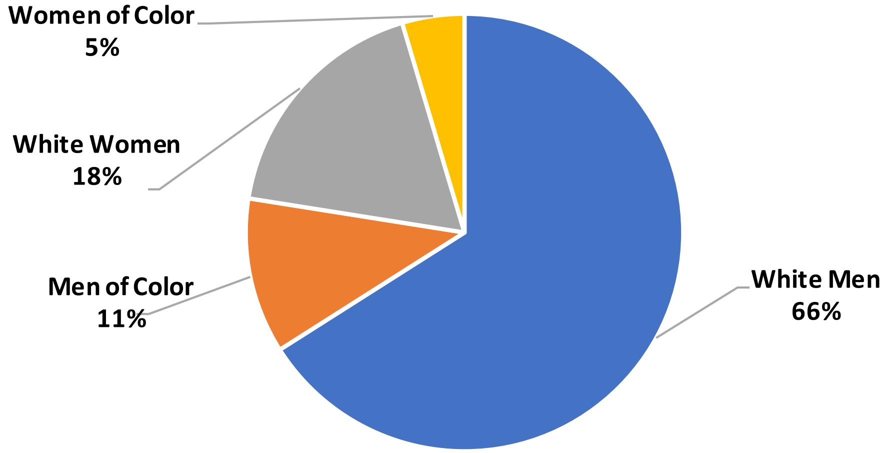
When boards are diverse, they benefit from a "richer level of discussion, debate and perspective each and every time they come together."[2] However, over 61 percent of board members among the Fortune 100 are non-Hispanic White men.[3] This is significantly higher than the group's 31.7 percent representation in the civilian labor force.[4]



This disparity is more glaring when looking at Fortune 500 companies. In the Fortune 500, 66 percent of board seats are held by non-Hispanic White men.[5] Persons of color only hold 16 percent of board seats.[6]



Fortune 500 Board Seats By Race and Gender



> **Persons of Color Represent 16%**
> **of Board Seats among Fortune 500 Companies**
>
> - 8.6% African American
> - 3.8% Hispanic/Latinx
> - 3.7% Asian/Pacific Islander
> - 0.1% Other
>
> **Women Represent 23%**
> **of Board Seats among Fortune 500 Companies**

In 2019, the Government Accountability Office (GAO) produced a report similarly noting that women and persons of color are underrepresented on corporate boards.[7]

The push for racial diversity on corporate boards is challenged by a lack of company-level disclosure and demographic reporting. Companies are not required to report on the racial composition of their board and few voluntarily report. According to Bloomberg, "the number of Black corporate directors has stalled or even declined."[8] However, the paucity of data also prevents academics from studying the performance impact of racially diverse boards. Studies that have been conducted utilizing survey data, among other voluntarily disclosed data, have reiterated shortfalls in the racial and ethnic representation on boards as compared to the general U.S. population.[9, 10]

A frequently quoted management adage, “what gets measured, gets managed,” is relevant here. A board that is not measuring its level of diversity is not appropriately assessing all of the factors that contribute to an effective board. It is also nearly impossible to make progress and seize opportunities on a particular variable without sufficient data. In this case, transparent and voluntary disclosure from companies is vital so analysts and investors can determine whether and to what extent companies are capitalizing on the benefits of board diversity.

The Business Case for Board Diversity

Over the years, a myriad of academic and practitioner studies have been conducted that analyze – and demonstrate – the performance advantages of diversity, inclusive of gender, race and ethnicity, in the context of corporate boards and senior leadership teams. These studies underscore the fact that companies with enhanced diversity attributes are better positioned to reap financial and operational benefits for their investors.

Gender and Racial Diversity
In May 2020, McKinsey and Company released a report titled “Diversity Wins – How Inclusion Matters.” After conducting an analysis of 1,000 large companies, they note that “the business case for inclusion and diversity is stronger than ever.” Companies with a higher likelihood to outperform also had higher levels of diverse representation among executives. The paper asserts that this data also substantiates the importance of diversity in contributing to better all-round board performance and increased corporate performance for shareholders.

- **Racial/Ethnic Diversity** – Researchers found that companies with the highest levels of racial and ethnic diversity at the executive level outperformed by 36 percent in terms of profitability.[11]

- **Gender Diversity** – There was a profitability differential of 48 percent between companies with the highest gender diversity at the executive level and companies with the least. Further, boards in the top quartile of gender diversity have a statistically significant correlation with financial outperformance.[12]

Companies with the highest levels of ethnic and racial diversity at the executive level outperformed by

36%

A 2015 McKinsey study of 366 companies found that corporate leadership groups in the top quartile for racial and ethnic diversity were 35 percent more likely to have financial returns above their national industry median. The study also found that companies with gender-diverse boards are 15 percent more likely to outperform the median in their industry.[13]

Numerous additional studies provide evidence and strong support for the investment case for board diversity:

- A 2016 recent report from MSCI found that companies with increased representation of women leaders had higher same-year return on equity than those without – and an examination of a five-year sample period showed that companies that added women to their boards had consistent correlations with stronger financial metrics.[14]
- A study by PwC in 2017 found that 79 percent of board directors believe that diversity enhances board performance, and more than half believe it enhances company performance.[15] Also in 2017, PwC released a report noting that managing diversity is considered a matter of overseeing reputational risks and opportunities that cannot be ignored.[16]

79% of board directors believe diversity enhances performance.

- A study by Catalyst found that "companies with the highest representation of women on their top management teams experienced better financial performance than companies with the lowest women's representation. This finding holds for both financial measures analyzed: Return on Equity (ROE), which is 35 percent higher, and Total Return to Shareholders (TRS), which is 34 percent higher."[17]
- Case studies in a white paper commissioned by the California Public Employees' Retirement System (CalPERS) illustrated that large companies generated a return on investment directly due to addressing diversity blindspots within their organization.[18]

The call for board diversity and its associated benefits for companies and investors has been reaffirmed by prominent business leaders as well. The Business Roundtable calls on corporate boards to "develop a framework for identifying appropriately diverse candidates that allows the nominating/governance committee to consider women, minorities, and others with diverse backgrounds as candidates for each open board seat."[19]

Gender Diversity

The push for gender diversity on corporate boards has been aggressive and successful, albeit at a gradual pace.[20] Given the comparable paucity of data on race and ethnicity, many studies have focused on gender diversity. A large body research demonstrates that a more diverse board of directors improves performance.[21, 22, 23, 24, 25, 26]

For example:

- A 2017 report by State Street Global Advisors indicates that companies with strong female leadership experience a 36 percent higher return on equity than companies without gender-diverse leadership teams.[27]
- A 2012 Credit Suisse Research Institute evaluated the performance of 2,360 companies globally over six years and found that companies with one or more women on boards delivered higher average returns on equity, lower leverage, better average growth, and higher price/book value multiples.[28]

> **Companies with one or more women on boards delivered higher average returns on equity, lower leverage, better average growth, and a higher price/book value multiples.**

Additional studies note that greater gender diversity can lead to a better mix of leadership skills, improved corporate governance, and a more risk-averse management style.[29] This coincides with studies demonstrating that women's participation on corporate boards favorably impacts a firm's risk profile.[30]

Groupthink

One challenge facing companies without sufficient board diversity is groupthink. Groupthink is a mode of thinking in which team members strive toward agreement and solidarity and override the motivation to assess alternative options.[31] There is also research demonstrating that groups composed of similar individuals have a tendency to refrain from challenging the views of the group, indicating that diversity of background has positive impacts on decision-making, risk oversight and innovation.[32] In short, groupthink can be highly detrimental to problem-solving, critical thinking, risk management, and optimal decision-making. This in turn poses material issues for shareholders.[33, 34]

Studies have found that diverse teams are more likely to reexamine facts, remain objective, and encourage greater scrutiny.[35, 36] A 2018 article published by researchers at the University of Wisconsin noted that a group of "high-functioning diverse individuals tends to outperform a non-diverse group of the best performing individuals".[37, 38] This clearly presents benefits in the context of boardrooms, where careful analysis, independent scrutiny, and varied perspectives can contribute to optimal decision-making and improved company performance.

Customer Alignment, Employee Engagement, and Transparency

Boards that are more diverse may also have a better understanding of their employees, customers, and communities in which they operate.[39] Not only does board diversity demonstrate to employees, customers, policymakers, and other stakeholders that the company cares about equity, diversity, and inclusion and embodies those principles, but it better positions companies to more acutely understand the values, behaviors, and interests those vital stakeholder groups.[40]

Maintaining a diverse slate of individuals at all levels of an organization, including in the boardroom, presents business opportunities to develop more targeted, tailored, and value-producing products and services.[41] U.S. population statistics indicate that 40 percent of the country is comprised of diverse individuals (non-white ethnicity).[42] A report by the Selig Center for Economic Growth estimates that minority groups have been making the fastest gains in increased buying power.[43] The $1.5 trillion Hispanic market includes one out of every six people and is the second-fastest growing minority market in the U.S.[44] Black consumers represent $1.3 trillion in annual buying power.[45] Between 2000 and 2017, Asian buying power has grown 222 percent to $891 billion, and Native American buying power has grown by 164 percent.[46]

Consumers are also increasingly urging companies to take action on racial inequity and promote inclusion.[47] Equileap, a data provider, notes that there can be a divergence between company commitments and disclosure.[48] The onus is on firms to demonstrate that they are following through on their stated commitments to equity, diversity, and inclusion, which can be accomplished through transparency and disclosure. A company that does not maintain a positive reputation on issues of equity, diversity, and inclusion risks consumers switching to a competitor or boycotting their product.[49] In September 2020, following Wells Fargo CEO Charlie Scharf's racist comments on diverse hiring, claiming "there is a very limited pool of black talent to recruit from," people took to social media to boycott Wells Fargo and closed accounts at the bank.[50] In June 2020, as part of a campaign titled "Stop Hate for Profit," various brands announced that they would limit advertising on Facebook due to the lack of progress it had made on issues of racial justice and hate speech.[51]

There is also increased attention on how firms manage their most valuable asset, their employees. State Street Global Advisors notes in a recent letter that "companies that promote workforce diversity and inclusion through transparent hiring, promotion and wage practices have seen improved productivity, revenues, and market share," based on a reports published in 2011 and 2013.[52, 53, 54] A positive reputation on diversity can make a company a more appealing place to work, thus attracting better talent.[55] Diverse boards are more likely to adopt management-level programs for employees that foster greater engagement and satisfaction.[56] Employee engagement is higher in companies that exceed the industry average in revenue growth.[57] A Gallup analysis found that work units in the top quartile of employee engagement outperformed 22 percent in profitability when compared to the bottom quartile.[58] Numerous additional studies support the link between employee engagement and corporate performance.[59, 60]

Calls for Racial Equity and Board Diversity

Over the last decade, institutional investors around the globe have devoted increased attention on issues of equity, diversity and inclusion, and particularly on the issue of board diversity, given the relevance to performance. Outside the U.S., regulatory agencies and leadership bodies have adopted requirements and recommendations to increase action and disclosure on corporate board diversity:

- In 2010, the Corporate Governance Council of the Australian Stock Exchange recommended that listed entities disclose goals related to gender diversity and the proportion of men and women at various levels of the organization, including the board.[61]

- In 2012, the Singapore Exchange revised its Code of Corporate Governance to require companies to comply with governance principles, including board diversity, or explain in their annual report why they departed from such principles.[62]

- In 2014, the Canadian Securities Administrators recommended that entities listed on the Toronto Stock Exchange include targets for female board representation and policies on board gender diversity, with those that do not disclose instructed to provide their reasoning.[63]

- In 2014, the European Parliament amended the Directive on Disclosure of Non-Financial and Diversity Information to require companies to disclose their board diversity policy, inclusive of age, gender, educational, and professional backgrounds.[64]

The push for board diversity and increased disclosure manifested in the U.S. as well. In 2015, institutional investors with over $1 trillion in assets under management petitioned the SEC to require new disclosures related to nominees for corporate board seats. The petition specifically asked that the SEC require disclosure on nominees' gender, race, and ethnicity, as well as nominees' mix of skills, experiences, and attributes needed to fulfill the corporation's mission.[65]

While the SEC did not adopt the requirement sought in the petition, momentum continued to swell with more and more institutional investors calling on companies to increase board diversity, adopt diverse search policies, and enhance disclosure. Large institutional investors, like the New York City Comptroller began introducing shareholder proposals, which would receive successful majority votes, calling for companies to "include women and minority candidates in the pool from which Board nominees are chosen," and report to shareholders on "efforts to encourage diversified representation on the board."[66] Large asset managers, such as BlackRock, also took action, revising their proxy voting guidelines to potentially oppose a board members' reelection for reasons including "insufficient attention to board diversity."[67]

More recently, the Black Lives Matter movement and the outrage sparked in May 2020 with the murder of George Floyd has created a national conversation on the issues of racial equality and opportunity. Numerous companies have issued statements in support of racial justice and announced responsive efforts at their operations.[68] In response to these statements, in July 2020, the New York City Comptroller called on 67 companies within the S&P 100 to affirm their commitments by disclosing EEO-1 Report data (which provides a breakdown of the gender and racial demographics of a company's workforce).

This level of disclosure enables investors to evaluate diversity, workforce and human capital practices, and benchmark companies against their peers to better understand risks and opportunities within their investment portfolio.[69] Recognizing the importance of transparency in diversity metrics, already 34 companies agreed to publicly disclose this data, as of September 2020.[70]

In 2019, investors representing $1.88 trillion in assets requested greater access to and transparency of workplace equity data, including data specific to diversity.[71] This was in response to concerns that companies make promises related to workplace equity but do not provide data to corroborate their efforts. The request noted that "abnormal returns exist for momentum-based strategies associated with improving human capital management," thus making it difficult for investors to understand risks and identify this alpha factor when there is a lack of transparency.[72]

Large asset managers have also begun to speak out as well.[73] In recognition of the positive correlation between diversity, board effectiveness, and long-term performance, beginning in 2021, State Street Global Advisors will seek information on company goals for increasing racial diversity and metrics related to the makeup of their workforce and boards.[74] Legal and General Investment Management (LGIM), the largest fund manager in the UK, announced a new campaign focused explicitly on the racial/ethnic composition of corporate boards. Starting in 2022, LGIM will vote against all-white boards that fail to diversify, given that accountability for this issue rests with the board.[75]

In light of heightened attention on issues of racial equity, there is increased pressure on corporations to demonstrate that they are supporting an equitable and inclusive workplace.[76] S&P Global Rankings released a statement noting that "racial injustice is becoming a material issue that has the potential to change our ESG evaluations and credit perspectives."[77] This includes actions taken at the top of the organization, including the racial and ethnic composition of board members.

Increasing Regulatory Action and Reputational Risks

A number of states have introduced or are considering legislation related to the makeup of corporate boards, ranging from increased disclosure requirements to the establishment of quotas for women and persons of color. For instance:

- In the State of Illinois, Public Act 101-0589 was signed into law on August 27, 2019, requiring publicly held companies headquartered in Illinois to report the self-identified gender and race/ethnicity of each member of its board of directors.[78]

- The State of New York recently enacted a law that mandates a study of the number of women directors on boards of companies doing business in New York. The law also requires disclosure of women board directors.[79]

- The State of California enacted a law, SB 826, in 2018 mandating gender diversity on the boards of companies principally located within the state. The law has phased requirements, thus by the end of 2019 each company must have added at least one woman director, and by 2021 each company with greater than six directors must have at least three female directors.[80] On September 30, 2020, Governor Newsom signed AB 979, which requires that every publicly held company principally located in California include a director from an underrepresented community by December 31, 2021. AB 979 defines "director from an underrepresented community" as an "individual who self-identifies as Black, African-American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual or transgender." The law also increases diversity requirements over time with fines for those that fail to comply. [81, 82]

Further, at least eleven states have introduced legislation on board diversity or are in the process of doing so.[83]

Given this slew of actions at the state-level, companies that do not effectively manage the issue of board diversity will face increasing regulatory risks – as well as reputational risks – that may impact their social license to operate and financial performance.

Members of the U.S. Congress are also exploring action on the board diversity front. In 2017, several members of the House of Representatives sent a letter to the U.S. Securities and Exchange Commission (SEC) seeking action to address the lack of diverse representation on corporate boards.[84]

Within the SEC itself, concerns related to diversity are also reviewed by the Office of Minority and Women Inclusion, which is responsible for all matters related to diversity in management, employment, and business activities at the SEC. This office is committed to ensuring that diversity and inclusion are leveraged throughout the agency to advance the SEC's mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.[85]

The aforementioned policies and activities clearly demonstrate increased attention on disclosure requirements and corporate action related to equity, diversity and inclusion, with specific attention on board diversity. To wit, in a recent statement related to changes to Rule S-K and ESG disclosure, SEC Commissioner Allison Lee noted that it would be questionable to assume that the lack of disclosure means that diversity is not material and relevant to a business, particularly given extensive and decisive research illustrating the benefits of diversity.[86] She underscores the "growing body of research showing the strong business case for diversity" and the significance of this issue to institutional investors.[87]

Investor Initiatives

Board diversity has been identified as a critically important attribute of a well-functioning board by both the world's largest asset managers and asset owners. Accordingly, investors from across the globe have devoted, and continue to devote, more resources to investment analysis, corporate engagement, and proxy voting initiatives focus on corporate board diversity. This further testifies to the fact that board diversity is a relevant and material issue for institutional investors.

Investor Coalitions

There are several large investor coalitions explicitly focused on the issue of board diversity. Founded in 2011, the Thirty Percent Coalition is a national organization historically advocating for gender diversity on corporate boards, and recently changed its mission statement to reflect its growing focus on promoting women and people of color to corporate boards. Representing more than $6 trillion in assets under management, membership includes public companies, private equity, institutional investors, state treasurers, professional services firms and advocacy groups working together for the first time.

Aligned with that mission, the Midwest Investors Diversity Initiative (MIDI), representing $820 billion in assets under management and advisement, is a coalition of institutional investors dedicated to increasing racial, ethnic, and gender diversity on corporate boards of companies headquartered in Midwestern states

Another coalition with a similar regional focus, committed to increasing gender, racial, and ethnic diversity is the Northeast Investors Diversity Initiative (NIDI). NIDI is a group of 11 investors based in the Northeast with more than $283 billion in assets under management.

Campaigns by Asset Management Firms

Beyond these notable coalitions, several of the world's largest asset managers actively speak out about the importance of racial and ethnic diversity on boards, including State Street, Blackrock, and Vanguard.[88, 89] Some demonstrate this commitment through dissenting proxy votes, in a clear signal to companies that laggard board diversity is unacceptable and remedial efforts are required.

In October 2020, LGIM sent a letter to the FTSE 100 and S&P 500 companies to provide advance warning that beginning in 2022, they will vote against all-white boards that fail to diversify.[90] Prior to that, in 2019, LGIM voted in support of 24 shareholder proposals related to corporate board diversity.[91]

In the summer of 2020, State Street Global Advisors announced a new campaign wherein they will engage portfolio companies to request information on company goals for increasing racial diversity, including metrics related to the makeup of their workforce and boards.[92]

In 2017, New York City Comptroller Scott Stringer launched the Board Accountability Project to call on publicly-traded companies to adopt a policy requiring the consideration of both women and people of color for every open board seat and for CEO appointment. Further, this campaign requests that companies disclose the skills, race/ethnicity and gender using a matrix developed by the Comptroller office.[93]

The Need for Self-Disclosure on Board Diversity

In 2019, Ernst and Young interviewed some of the world's largest institutional investors seeking information on key priorities and challenges facing today's fiduciaries. Their report underscores that investors face difficulties evaluating board performance and effectiveness due to in part to the lack of disclosure on diversity attributes, including race and ethnicity.[94] While the report noted that more companies are disclosing the racial and ethnic composition of their boards explicitly in response to investor pressure,[95] many companies still neglect to disclose said information or are slow to do so.[96]

Historically, many institutional investors have advocated for gender diversity on corporate boards through proxy voting policies and through direct shareholder-company engagement. In 2020, Institutional Shareholder Services, a large proxy advisory firm adjusted its policy to vote against or withhold from directors at companies in the Russell 3000 where there were no women on the board.[97] These actions, now broadly adopted by investors across the world, have helped generate an increase in gender diversity on corporate boards. The lack of data on racial/ethnic composition, however, makes it difficult to apply the same tools and creates unnecessary barriers to investment analysis and academic study.

Given the wealth of support and evidence demonstrating the investment case for board diversity, inclusive of race and ethnicity in addition to gender, investors have a material and relevant reason for asking companies to voluntarily disclose the racial/ethnic composition of their boards of directors. Looking at it another way, companies should capitalize on this moment and the momentum on gender diversity to publicly report the racial/ethnic composition of their board of directors in their proxy statements. Doing so will not only provide companies with an important way to self-assess the quality of their board and position boards for optimal performance, but it will provide long-term investors with greater access to the total mix of information that better enables them to protect and grow their investments.

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