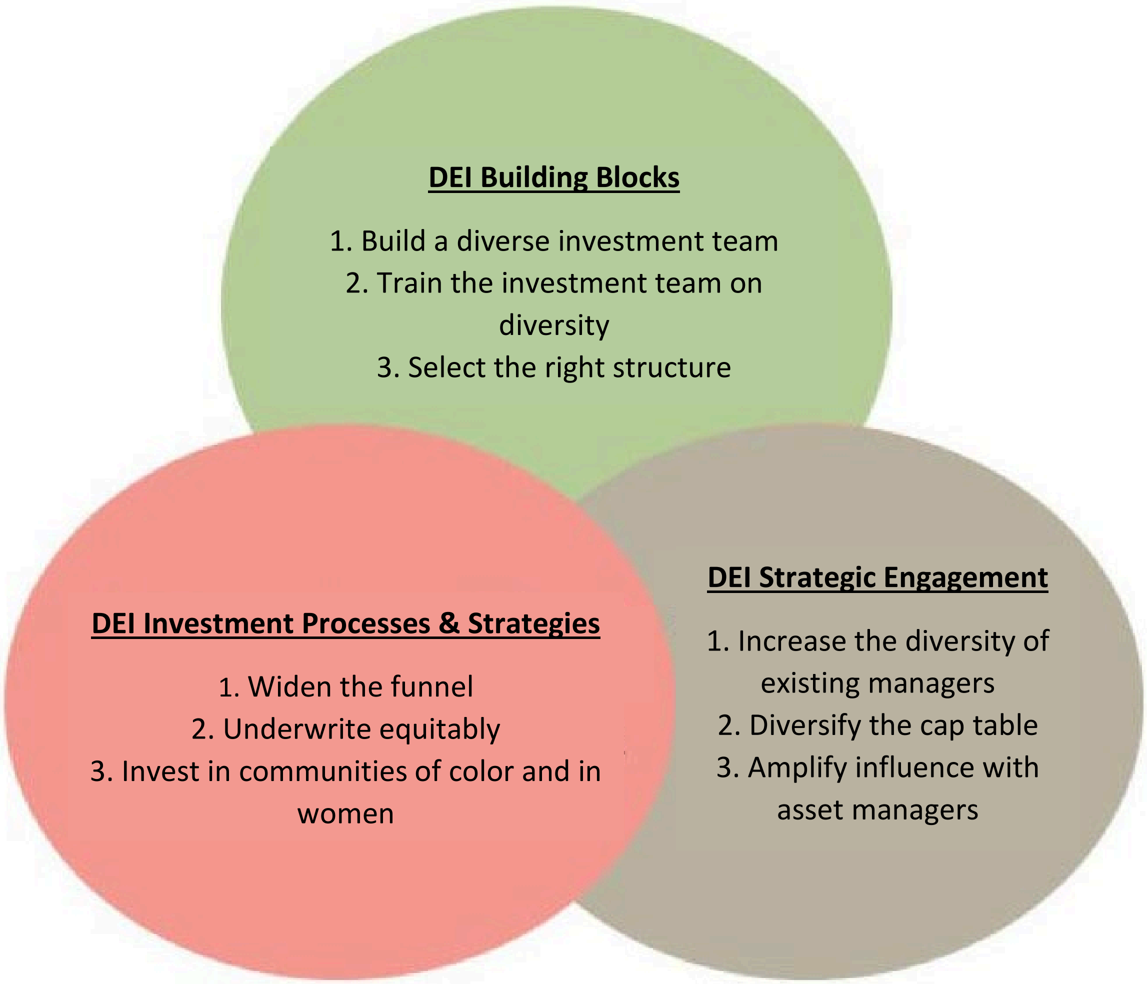
SELECTING FOR AND PROMOTING DEI IN INVESTMENT PORTFOLIOS TOOLKIT



IADEI's Selecting for and Promoting DEI in Investment Portfolios Toolkit provides nine practical and evidence-based recommendations for selecting for and promoting diversity, equity, and inclusion in investment portfolios. This and other IADEI Toolkits are the product of multi-stakeholder discussion among the leadership of numerous nonprofits focused on diversity, equity, and inclusion in investing facilitated by IADEI. We have distilled these discussions into nine recommendations into three essential ingredients: DEI building blocks, DEI investment processes and strategies, and DEI strategic engagement.

Essential Ingredient One: DEI Building Blocks

1. **Build a diverse investment team.** According to Susanna Gibbons from the University of Minnesota's Carlson School of Management, and member of the Investment Advisory Council of the Minnesota State Board of Investment, "If we want to build diverse, high-performing investment teams, we need to expand the lens through which we evaluate individuals. Recruiters establish interview or experience requirements that eliminate a lot of diverse talent. A team with only strong technical skills typically generates beta, while a diverse investment team with similar technical skills can be a source of alpha." Institutional Allocators for Diversity,

Equity, & Inclusion (IADEI) supports this effort by curating an open-source list of over 65 organizations to help institutional allocators and the managers in their portfolios to source talent at junior, mid-, and senior levels.

When recruiting, the Rooney Rule, a National Football League policy that requires teams to interview at least one ethnic minority candidate for head coaching or senior football operation jobs is a good start but does not change behavior. Indeed, according to Harvard Business Review research, if there's only one woman in your candidate pool, there's statistically no chance she'll be hired. When there were two minorities or women in the pool of finalists, the status quo changed, resulting in a woman or minority becoming the favored candidate.

Diversity of the investment team can generate diversity in the investment portfolio. At the seed and Series A stage, female venture capital partners lead nearly twice as many rounds in female founding teams as their male counterparts. Accolade Founder and Managing Partner and Empowerment Fund Portfolio Manager Joelle Kayden explains, "Intuitively, we expect diverse managers to back more diverse teams. We have seen diverse managers in our portfolio leverage their diverse networks to find differentiated deal flow, which can give them an edge."

2. **Train the investment team on diversity.** Anti-bias training could be helpful, as could training that frames lack of diversity, equity, and inclusion as a systemic risk. The events following the deaths of George Floyd and Breonna Taylor bring this to bear. In the absence of such training, W.K. Kellogg Foundation Director of Investments and IADEI Steering Committee Member Reginald Sanders explains: "When someone is a champion of DEI, the burden of proof is often on the champion when it really should be on the skeptic of DEI. Not only is diversification the only free lunch in finance, but the benefits of diversity are also a universal first principle that applies to all walks of life. Therefore, the responsibility rests with the DEI skeptic, not the champion, as to why an exception has to be made when the diversity conversation pivots to race and gender."

3. **Select the right structure.** Some asset owners develop separate dedicated emerging manager programs, while others integrate it and have one portfolio with diversity as a mandate. There are arguments on both sides. An argument for integrating diversity into the core portfolio is increasing the priority with which diverse managers are treated and with it their likelihood of achieving scale.

<u>Essential Ingredient Two: DEI Investment Processes and Strategies</u>

4. Widen the funnel. Comparing notes with a broader range of peers and using nontraditional channels is critical for sourcing diverse-owned and diverse-led managers. The hard work of industry participants and the DEI ecosystem to develop open-sourced diverse manager databases and host events to connect asset owners with diverse asset managers is already driving diversity. This can create a snowball effect: investing in diverse managers can catalyze greater diversity if those managers refer other diverse managers as prospective investments.

5. Underwrite equitably. According to Head of Diverse Manager Research at Cambridge Associates Jasmine Richards, setting targets is not enough: "applying an equitable underwriting process" is also critical.

Getting to the root cause of why women- and minority-owned firms control only 1.4% of the over $82.2 trillion managed by the US asset management industry involves examining the manager evaluation process to gauge whether the standards that it uses to judge skill and track record are biased. According to former State of Illinois Chief Investment Officer Rodrigo Garcia, minimum fund sizes, minimum track records, minimum check sizes, minimum GP commitments, minimum team experience, and investment styles that may not perfectly fit into portfolio construction and design are all common hurdles that have an unequal impact on diverse managers. Emerging managers often may not have legal rights to their track records. As an example of a more an equitable alternative to reviewing criteria like minimum track records, Cambridge Associates also follows individual managers through their careers; this potentially uncovers new talent that otherwise may have been missed.

Examining how prospective managers are discussed with investment committees is also critical. Providing the investment team with anti-bias training and increasing the gender and racial and ethnic diversity of the investment team may also facilitate equitable underwriting.

6. **Invest in communities of color and in women.** Increasing capital invested in diverse-owned and diverse-led managers is not sufficient. Investing in asset managers that use DEI as a strategy is also important. This could mean investing in underserved communities of color or investing in the care economy. Investing in the care economy disproportionately benefits women who do 31.7 hours of unpaid care work each week vs. 19.3 hours per week for men according to the Organization for Economic Cooperation and Development (OECD).

<u>Essential Ingredient Three: DEI Strategic Engagement</u>

7. **Increase the diversity of existing mangers.** Investing in diverse-owned and diverse-led managers is important, and it's also important to encourage large asset managers to increase the diversity of their senior people and to encourage all asset managers to increase the diversity of their staff.

Harvard Business Review research shows that cognitive diversity, defined as differences in perspective of information processing styles, helps teams solve problems faster. W.K. Kellogg Foundation Director of Investments and IADEI Steering Committee Member Reginald Sanders observes: "Optimizing cognitive diversity is about leveraging how people experience the world differently. Women and people from different racial and ethnic backgrounds experience the world differently. You cannot optimize the benefits of cognitive diversity without incorporating and valuing how women and people of color experience the world differently."

8. **Diversify the capitalization table.** The Diversity Rider, used in term sheets by 91 venture capital firms, codifies founder and GP efforts to ensure a diverse capitalization table. The theory of change is that diverse capitalization tables drive diverse boards and the benefits that they bring. To implement the Diversity Rider, startups often set up special purpose vehicles designated for underrepresented minority investors.

9. **Amplify influence with asset managers.** According to CFA Institute Global Head of DEI Sarah Maynard, asset managers range from fully engaged supporters of DEI to having mastered the art of opposition to DEI. Asset owners can encourage asset managers to increase their focus on DEI

through strategic engagement, as well as offer them resources that will help them build more diverse, inclusive, and equitable teams and investment portfolios.

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. Engagement requests are more likely to succeed when the shareholder engaging holds a larger share of the targeted company. Dimson, Karakaş, and Li find that a group of investors engaging has more influence when the engagement is spearheaded by an investor who is from the same country as the company being engaged, 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 sums it up: “AUM matters and so does location.”

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.

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