Asset Owners and Investing in Diversity: Intention versus Action

How Attitudes at the Intersection of Diversity and Investing May Be Holding Asset Owners Back From Maximizing Returns
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Morgan Stanley has been at the forefront of publishing data-backed research and offering actionable recommendations to address the systemic inequities within the financial services industry, including identifying the “Trillion-Dollar Blind Spot” that women and multicultural-owned businesses face.

To complement our research around investors’ and venture capitalists’ views and approaches around diversity, this year we surveyed asset owners — investment decision-makers at large U.S. pension funds, endowments, foundations and insurance companies — to better understand their perspectives on the role of diversity in their investment decisions and choice of external managers.

THE STAKES ARE HIGH: Our research shows that asset owners consider diversity and inclusion to be the top environmental, social and governance (ESG) factor regarding their organizations’ investment decisions, and there is a near-consensus that more diverse investment teams help yield strong financial returns. However, the different approaches that asset owners (and the external investment teams they hire) can take toward diversity can have a significant impact on what percentage of their billion-dollar portfolios are invested in women and multicultural-founded companies, which often face structural barriers to attract funding.

ACCOUNTABILITY IS KEY: While some public pension funds face government and regulatory oversight on issues related to diversity, there are few meaningful entities holding private-sector asset owners accountable. In those private organizations, it is often individual senior leaders who, of their own volition, choose to hold external managers accountable for meeting certain diversity requirements within organizations investments or to push organizations teams to work with more women or multicultural managers. The absence of external accountability around diversity targets in these organizations lends itself to complacency and falling into familiar, “safer” patterns — investing in the same types of managers that have a longer track record or have more assets under management — which means promising diverse external management firms which are earlier in their lifespan are often overlooked.

WHY THIS RESEARCH IS DIFFERENT: This research was designed to cut through asset owners’ stated priorities and intentions around these issues and uncover some stark truths about the extent to which they truly value diversity in their investment decisions, when the rubber hits the road. The survey — as well as in-depth interviews with senior members of public pension funds — also sheds light on how some asset owners are leading the way on diversity and inclusion in their investment priorities, including their use of Emerging Manager Programs to identify high-upside, diverse, external managers that they may not have been exposed to otherwise.

This report summarizes these findings and outlines prescriptive steps that the industry can take to showcase the tangible benefits of a diversity-based investment approach.
Executive Summary

To better understand how asset owners incorporate diversity into their investment priorities and selection of external managers, Morgan Stanley conducted an inaugural poll of large U.S. asset owners. The results point to an important challenge for the industry: While asset owners say that diversity is important, most — especially white investment professionals — perceive a negative financial trade-off that comes with prioritizing diversity. The exception is with public pension funds that are setting the standard for action.¹

¹ We supplemented the survey findings by interviewing two senior members of public pension funds and one CIO of a corporate pension fund.
Key Insights

Our findings reveal four key insights among asset owners:

1. **Diversity is a top priority for investment decisions**
   Asset owners recognize the importance and impact of incorporating diversity into investment decisions, with diversity and inclusion (D&I) becoming an even higher priority over the last year.

2. **Perceived financial trade-off presents a hurdle**
   Despite the prioritization of diversity and recognition that diversity can improve investment performance, most asset owners say that incorporating diversity into their investment decisions comes at the expense of returns.

3. **Public pension funds are leading the way**
   The industry can look to public pensions for evidence of impact and inspiration for how to diversify external managers.

4. **Need for stronger accountability**
   There is room for more formalization, standardization, best practice sharing and accountability measures when it comes to diversifying external managers.
Key Finding 1:
Diversity is a top priority for investment decisions.

Asset owners recognize the importance and impact of incorporating diversity into investment decisions, with diversity and inclusion (D&I) becoming an even higher priority over the last year.

According to our poll results, D&I is the top ESG factor that asset owners consider for their organizations’ investment decisions, and 89% of asset owners say that the diversity of external managers specifically is important or a top priority.

Asset owners appear to be putting this prioritization into practice, with 67% saying their organizations have policies that incorporate diversity as part of an ESG requirement for making investment decisions.

Which of the following ESG factors are a top priority for your organization’s investment decisions? [Select up to five]

- Diversity and inclusion: 49%
- Human rights: 48%
- Human capital: 43%
- Climate change and carbon footprint: 43%
- Health and well-being: 32%
- Corporate tax responsibility: 29%
- Board accountability: 29%
- Inequality and poverty: 25%
- Community relations and development: 22%
- Labor standards: 21%
- Data protection and privacy: 19%
- Energy efficiency/renewable energy: 19%
- Artificial intelligence/automation: 11%
- Resource scarcity: 11%
- Executive compensation: 10%
- Environmental degradation: 10%
- Supply-chain risks: 6%
- Air and water pollution: 6%
- Deforestation: 3%
There is evidence that diversity is becoming increasingly important to asset owners. Over the last year, more than two-thirds say that both gender and racial/ethnic diversity have become more important factors for their organizations in terms of the representation of their investment teams, working with diverse portfolio managers, and investing in diverse-owned funds and businesses. Among the ways to diversify investments, working with investment teams with sufficient multicultural representation is the factor that has grown the most in importance, with 79% of asset owners agreeing.

“[Diversifying our investment teams] is a major priority for us,” said a senior member of a state public pension fund. “The regulatory requirements have been in place for a while, but our D&I priorities have moved past just what is required of us. We do the systematic work across every asset class, manager and transaction. This takes concerted time and effort. You’re not going to have all the answers right away — you have to continue to prioritize it and be willing to evolve over time.”

Moreover, an overwhelming majority of asset owners report that diversifying investment teams yields strong financial returns: Nearly nine in ten (87%) say that investment teams with sufficient women representation improve the performance of their investments, and 86% say the same for multicultural representation.

However, there is a stark divide in terms of the intensity with which different types of asset managers agree with this sentiment. Public pension funds are much more likely than university endowments, insurance companies and other types of asset owners to say that diverse investment teams significantly improve investment performance as opposed to somewhat improve performance. For example, 63% of public pension funds say that investment teams with sufficient multicultural representation significantly improve investment performance, compared to 6% of university endowments, 20% of insurance companies and 14% of other types of asset owners.
Key Finding 2:
Perceived financial trade-off presents a hurdle.

Despite the prioritization of diversity and recognition that diversity can improve investment performance, most asset owners say that incorporating diversity into their investment decisions comes at the expense of returns.

A majority (56%) of asset owners agree that they must choose between financial gains and incorporating diversity into their investment decisions, revealing there may be deep-seated skepticism about diverse external managers yielding strong returns. There is a sizable perception gap by race, with 70% of white asset owners agreeing, compared to just 35% of multicultural asset owners.
A contributing factor for this difference may be that white asset owners’ organizations have only recently started prioritizing diversity and therefore have yet to see its benefits. Eighty-six percent of white asset owners say the diversity of investment teams has been a priority for their organization only in the last few years, with 11% saying it has always been a priority, and 3% unsure. Multicultural asset owners are three times more likely to say it has always been a priority (35%).

This is not the first time that investors have perceived a trade-off with certain types of investments. For years, there was a prevailing sentiment among investors that impact investing meant sacrificing returns. However, there is a growing body of empirical evidence that refutes this assumption and has led to the mainstreaming of sustainable investing. For example, a Sustainable Reality report published by the Morgan Stanley Institute for Sustainable Investing found that sustainable investing funds — defined as funds incorporating environmental, social and governance (ESG) criteria — outperformed traditional funds and reduced investment risk throughout 2020.

As it relates to the perceived trade-off with diverse-focused investments, there are indications that the tide appears to be turning among select investment professionals. A survey commissioned by Morgan Stanley in 2020 found that three-quarters of venture capitalists believe that it is possible to have an investment strategy that intentionally invests in women and multicultural entrepreneurs while still maximizing returns (up from 59% in 2019).

Despite this sign of progress among VCs, our current poll suggests that we have yet to reach a similar point where asset owners perceive the benefits of diversity as outweighing the doubts. Senior members of public and corporate pension funds we spoke with cited a few possible explanations for this perceived trade-off, including resentment about needing to meet certain diversity quotas in investments (and potentially missing out on more lucrative investments) and the extra time and resources spent trying to find diverse-owned firms that are large enough, and have a long enough track record, to produce strong returns.

“If people can go about their day doing things the way they have always been doing them, inertia wins out and nothing changes,” said a senior member of a state public pension fund.

Continuing to share data-backed evidence with asset owners, including performance metrics for diverse external managers, will help to dispel this belief and motivate more progress.²

² White Paper: Diversity in the asset management industry (Willis Towers Watson)
NAIC Performance Study Shows Diverse Asset Managers Continue to Beat Benchmarks (NAIC)
The Other Diversity Dividend (Harvard Business Review)
Key Finding 3:
Public pension funds are leading the way.

The industry can look to public pensions for evidence of impact and inspiration for how to diversify external managers.

Public pension funds are much more likely than their peers to value diversity in investment decisions, perhaps due in part to their own diversity and longer exposure to diverse investment teams. The public pension fund asset owners we surveyed are more diverse by gender and race, compared to other types of asset owners. Further, nearly half (47%) of public pension fund asset owners say the diversity of investment teams has always been a priority for their organizations, compared to 7% of other asset owners.

They also benefit from more established processes around diversity: 63% of public pension fund asset owners say their organizations always include questions about diversity in their due diligence processes when deciding to invest with an external manager, compared with 30% of other asset owners. They are especially likely to ask questions about external managers’ formal mentorship programs, retention rate for women and multicultural employees, and diversity of new hires.

Said a senior member of a public pension fund: “We did a massive benchmarking exercise across our managers last year, and asked very specific questions: What are their D&I programs, from the internship level all the way up to leadership, their portfolio companies, etc — We put their CEOs through the paces on this...We’re tracking progress, we’re rolling it into every commitment we’re willing to make. We ask them what they’ve done in the last 12 months, or about their transactions in the last month. Investment by investment, refresh call by refresh call.”

Pension funds’ longer track record in prioritizing diversity may be reinforcing their view that it can help yield higher returns. Three-quarters (75%) of public pension fund asset owners say that investment teams with sufficient women representation significantly improve the performance of their investments, compared to 15% of other asset owners. Similarly, 63% of public pension fund asset owners said the same of investment teams with sufficient multicultural representation, compared to 13% of other asset owners. They are also less likely to agree that there is a trade-off between financial gains and diversity (44% versus 60% of other asset owners).

At the same time, they are less likely than other asset owners to be satisfied with their organizations’ levels of investment in diverse external teams and diverse-owned funds and businesses, suggesting they are not willing to settle for their advancements to date.
To what extent are you satisfied with your organization’s level of investment in the following? (Showing total satisfied)

<table>
<thead>
<tr>
<th>Service Description</th>
<th>Public Pension Funds</th>
<th>Others (University endowments, insurance, investment consultants)</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working with investment teams or firms with sufficient women representation</td>
<td>44%</td>
<td>74%</td>
<td>-30</td>
</tr>
<tr>
<td>Investing in women-owned businesses</td>
<td>44%</td>
<td>74%</td>
<td>-30</td>
</tr>
<tr>
<td>Working with investment teams with sufficient multicultural representation</td>
<td>44%</td>
<td>64%</td>
<td>-20</td>
</tr>
<tr>
<td>Investing assets in women-owned funds</td>
<td>50%</td>
<td>70%</td>
<td>-20</td>
</tr>
<tr>
<td>Working with multicultural portfolio managers</td>
<td>56%</td>
<td>72%</td>
<td>-16</td>
</tr>
<tr>
<td>Working with women portfolio managers</td>
<td>56%</td>
<td>66%</td>
<td>-10</td>
</tr>
</tbody>
</table>

One potential differentiator is that asset owners at public pension funds are much more likely to use Emerging Manager Programs to increase the diversity of the investment teams and asset managers in their portfolios.

Senior officials we spoke with from public pension funds pointed out that because diverse external management firms may be earlier in their lifespan or have lower AUM, and consultants tend to turn to managers they have worked with before, those firms sometimes struggle to gain access to the larger asset owners. Emerging Manager Programs can mitigate this gatekeeper problem by increasing direct exposure to lucrative opportunities with newer, smaller and more diverse investment firms that other asset owners may be overlooking. This is reflected in real-world data, including an analysis from VC firm Greenspring Associates, which found that in their experience, “Investing across approximately 180 partnerships, emerging managers have outperformed relative to their established counterparts.”

According to a public pension fund executive, “Our Emerging Manager Program, which we’ve had in place for a while, allows us to access a market that we otherwise couldn’t based on our size, scale and process.”

3 Venture Capital’s Access Myth (Greenspring Associates)
What approach, if any, has your organization taken to increase the diversity of the investment teams and asset managers in its portfolio? Please select all that apply.

- Emerging Manager Program: 69%
- A direct approach: 69%
- Fund of funds approach: 38%
Key Finding 4:
Need for more accountability.

There is room for more formalization, standardization, best practice sharing and accountability measures when it comes to diversifying external managers.

Just 38% of asset owners always ask questions about diversity in their due diligence processes when deciding whether to invest with an external manager, with another 49% saying they sometimes ask. Further, only 43% of asset owners use a formal measurement tracking system to keep tabs on their external managers’ progress on their D&I targets.

Another challenge to address is that over one-third of asset owners report having difficulty investing with diverse managers (38% for multicultural managers and 35% for women managers), with few differences by respondent gender and race/ethnicity.

The most prominent reasons cited for this are that multicultural/women managers have insufficient assets under management (AUM), they do not have a long enough track record, or that asset owners can’t find diverse external managers or don’t have the relationships, which was confirmed in our supplemental conversations with executives.

While most asset owners take measures to ensure their external managers are prioritizing diversity, many do not have standard practices or formal processes to ensure consistent results.
Most firms (84%) report having some measures in place when it comes to holding their external managers accountable for meeting diversity requirements, but there is room to increase the uptake of standardized metrics. Over one-third of asset owners either do not have a set policy in place on external managers’ diversity requirements and evaluate firms on a case-by-case basis (22%) or do not have diversity requirements for their investment partners (13%). Further, only a portion are willing to hold them accountable monetarily: 17% report being willing to reduce the amount of money it has allocated to a firm if its team is insufficiently diverse, and 11% say that their organizations are not willing to work with firms based solely on the fact that their teams are insufficiently diverse. Progress may be slow until more asset owners are willing to signal their seriousness on the issue.

Our research suggests that while public pension funds are often held accountable by government regulations on diversity, it is uncommon for corporate pension funds or other organizations to set hard targets for themselves, let alone be held accountable by an external player. An investment professional told us that the hesitancy to act is often because there is no mandate from the top to put more of their assets to work with minority managers. The extent to which these organizations enact change is largely dependent on the values, buy-in and motivation from their senior leaders.

According to a CIO of a state public pension fund, “To effect real change, somebody’s got to have the leadership to push it, and then eventually it’ll become ingrained in the culture.”
Forward Accountability: The Morgan Stanley Playbook for Asset Owners

For more asset owners to recognize the benefits of a diversity-based investment approach, the industry can:

1. **Publish industrywide data** highlighting returns from diverse external managers. For example, a recent assessment of diversity and performance outcomes by Towers Watson shows that investment teams with diversity, in particular ethnic diversity, tend to generate better excess returns. Building this body of evidence will be critical.

2. Showcase real-world financial benefits of using **Emerging Manager Programs** (e.g., the recent expansion of the Illinois Teachers pension fund) to identify new opportunities with newer, smaller and more diverse investment management firms. It is vital to show evidence that Emerging Manager Programs are yielding strong returns, and that it is scalable.

3. Establish **standardized practices** to formally track external managers’ progress on meeting diversity targets, and to hold them monetarily accountable for failing to reach said targets. If monetary accountability is not a realistic option, add pressure on external managers to improve their diversity practices by consistently asking them for updates on their hiring, retention and leadership, and putting a formal measurement system in place to track progress.

4. Encourage asset owners to instill **additional transparency measures** around how much of their own organizations’ AUM are invested with diverse external managers.

5. **Elevate leaders** who have shown a commitment to investing the time, resources and effort into creating meaningful change around diversity within the organization, including instituting formal policies.

6. **Require consultants to maintain a list of diverse managers** for consideration, similar to the way corporations require recruiting agencies to present diverse candidates for senior positions.

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* White Paper: Diversity in the asset management industry (Willis Towers Watson)
* Buyouts: Illinois Teachers expands emerging manager program, seeks diversity-measurement tool
Methodology

Morgan Stanley’s inaugural survey of Asset Owner Attitudes Toward D&I was conducted by Brunswick Group between January 12 and April 28, 2021, in the U.S. The survey was conducted online and via telephone interviews among 63 senior investment decision-makers primarily from public pension funds, college or university endowments, insurance companies and investment consulting firms. To qualify for the survey, respondents must work for organizations that have at least $500 million in assets under management (AUM). Supplemental interviews with senior leaders of pension funds were conducted from June 15 through July 16, 2021, in the U.S.