Diversity in the foreground

“Diverse” is a powerful word. A criterion, a compliment and a justification, its meaning in the corporate world is undergoing an evolution from a ‘politically correct’ and sometimes cynically applied descriptor of differences to a positive, inclusive and essential characteristic of corporate boards. Defined by the Oxford English Dictionary as “widely varied”, ‘diversity’ encompasses all aspects of demographic characteristics, backgrounds and experiences. The term resonates with broad globalisation of the commercial world; in order to thrive, it seems intuitive that a company board should reflect the environment in which it operates. As such, diversity is instrumental to the development of well-run, sustainable companies.

The definition and measurement of the benefits of diversity have become the subject of a number of recent studies, although the majority of research available has, so far, been focussed upon women; most of the data in this article relates, therefore, to women in business, but we would like to stress that at Newton, we adopt a broader interpretation of ‘diversity’, as set out above. In addition to research by various consultancies, diversity in the workplace has become a priority of the UK government, leading most recently to a high-profile report by Lord Davies of Abersoch. Lord Davies’s report addresses the paucity of female representation on corporate boards, and sets out detailed recommendations for steps to be taken by companies to remedy the situation.1 Action by individual countries throughout Europe to impose quotas for the percentage of women on corporate boards has pushed diversity to the foreground of both commercial and public awareness.

In the wake of corporate scandals such as that of Enron, and following the global credit crisis, a renewed emphasis has been placed on issues of corporate governance. It cannot but be wondered whether, for example, RBS would have pursued such aggressive expansion strategies prior to the credit crisis, culminating in the over-priced acquisition of ABN Amro in 2007 and resulting in a loss of £4 billion,2 had there been more than a single female member on the 18-strong all-white board of directors at the time.3 As corporate credibility became undermined, board structures and the knowledge, skills and experience of board

members came under close scrutiny; questions abounded as to whether a uniform white-male dominated assembly is really the optimal forum for robust decision-making. It is interesting to note that RBS has since decreased the size of its board while raising female representation to 25%.

In the aftermath of the credit crisis, which was, arguably, fuelled in part by the short-term focus of financial-market and economic participants, a fresh light has been cast on the benefits of a long-term approach, with a strengthened focus upon corporate sustainability.

Significant disparities persist, however, between the characteristics of the global business landscape and the composition of corporate boards. In this article, we explore the effects of diversity within companies and explain why, as investors and as a company, we think that diversity at both board and senior-management level is an essential hallmark of successful businesses.

At Newton, we believe that in a global business environment, diversity is not simply an optional extra or a distraction from operational business matters; a company which ignores issues that have the potential for significant detrimental effects upon its costs and reputation is unlikely to be well-equipped to create value for shareholders. Newton has recently updated its own responsible investment policies and principles which address, among other matters, the issue of board diversity. From our perspective as long-term investors, we believe it is vital that companies’ boards evolve to reflect their operations and client bases if they are to maintain their competitive strength. As population and workforce demographics change, companies that do not make a concerted effort to attract and recruit from the widest possible talent pool may risk placing themselves at a competitive disadvantage. For example, in the UK, women achieve 56% of first-class honours degrees, but make up only 14% of FTSE 100 board positions. Such statistics are evidence that much intellectual talent is being squandered in today’s business world.

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Diversity dividends

As investors, we recognise the significance of companies’ approaches to corporate governance in relation to long-term performance and sustainability. Investors also wield a considerable amount of influence in terms of demanding high standards of corporate governance. We prioritise active engagement with individual companies, through which we aim to exert a positive influence and obtain an in-depth understanding regarding policies and decisions in these areas. Our corporate governance research is a crucial part of our investment process, not merely an adjunct; it helps us to assess the viability of companies as long-term investment opportunities.

Many of the arguments in favour of diversity are perhaps intuitive; the Orwellian term ‘groupthink’ is sometimes used to describe the dangers of a mono-culture board, and it is acknowledged that diversity is instrumental in providing challenges, new viewpoints and a variety of opinions. Active discussion and challenge are crucial to effective decision-making, and diverse groups are more likely to identify creative solutions, and to offer a
greater range of perspectives. It has been suggested that firms which are more ‘progressive’ may have more diverse board composition, in addition to better performance; such findings emphasise the importance of in-depth corporate governance analysis for investors.

It is only through relatively recent studies that the economic benefit to companies with a diverse composition of board members has come to light. A report by McKinsey revealed that companies with a higher proportion of women in their top management have better financial performance than the industry average. Separate research has demonstrated a positive relationship between gender and ethnic board diversity and corporate performance. As diversity is portrayed and measured increasingly for its financial impact upon companies, it is likely that companies will come under closer scrutiny in relation to issues of recruitment and promotion. The chart below demonstrates that listed ASX500 (Australian stock exchange) companies which have women on their boards achieved ROE (return on equity) of 11.1% higher over five years and 10.7% higher over three years than those companies with no female board members.

EXHIBIT 1: ASX500 AVERAGE ROE FOR COMPANIES WITH AND WITHOUT FEMALE DIRECTORS

Diversity is not an end in itself, but is a piece in the jigsaw of company success.

Diversity is emerging as a measurable feature of corporate performance, and a tangible factor in companies’ ability to deliver returns for shareholders. It is, of course, impossible to prove a causal link between diversity and positive performance, but an expanding body of supportive research findings should not be overlooked. Indeed, diversity itself should not be the goal, but should instead help to improve company performance by enlarging the net to be cast when seeking to hire talented individuals. While it would be short-sighted to regard diversity alone as the primary driver of company performance, there is growing evidence of a positive correlation between a diverse board membership and financial returns. Companies which remain in either wilful or accidental oblivion of this correlation may be prone to increasing challenges from investors and the public, and may limit their potential for success.

9. Ibid. p.11.
The question of quotas

The use of quotas presents something of a dilemma for both companies and governments. On the one hand, those concerned about the slow rate of progress towards female representation on boards present quotas as an effective, measurable and enforceable way to redress the balance. On the other hand, however, there is a danger that the people to whom quotas relate are perceived to have achieved their positions on the basis of ‘box-ticking’, rather than on merit, which may in turn undermine their credibility in the eyes of other board members. It has been suggested, indeed, that, in the absence of quotas, board members from under-represented demographic groups may in fact have had to be especially strong performers in order to have overcome challenges in attaining higher-level positions.13

Ironically, it may be that these achievements would be overlooked, were quotas to be enforced.

Following the implementation in Norway of regulations stipulating that a minimum of 40% of positions on corporate boards must be filled by women,14 there has been much debate about the appropriateness of quotas as a step towards change. This action, as demonstrated in the chart below, has placed Norway statistically far ahead of other European countries in terms of female representation, as shown in Exhibit 2. Spain, France and the Netherlands are following suit in introducing quotas, and the European Parliament has passed a resolution demanding legislation to implement quotas for women on listed company boards.15

EXHIBIT 2: AVERAGE PERCENTAGE OF WOMEN ON BOARDS IN EUROPE

![Average Percentage of Women on Boards in Europe](chart.png)


Past performance is not a guide to future returns. Please see important information at the end of this document.

Despite Norway’s statistical accomplishment regarding female board membership, it is predominantly an increase in non-executive director appointments which have boosted numbers: only 2% of CEOs and only 10% of executive committee members are women.\(^\text{16}\)

A strong argument against the use of quotas to increase representation of minority groups on boards is that such targets do not address the issues that prevent such candidates rising through the ranks to reach these positions. McKinsey concludes that the strongest barriers to the advancement of women come in the form of corporate models and business culture,\(^\text{17}\) neither of which could be amended through the use of quotas. While the perception remains that in order to succeed, one must have accumulated a particular set of experiences and a wall-display of specific qualifications in order to reach executive roles, talented candidates with varied but nevertheless valuable CVs will continue to be overlooked. Equally, the perception that 24-hour availability is an essential characteristic for senior positions will hamper progression of diversity,\(^\text{18}\) while paradoxically illustrating the need for it, as such a narrow focus is unlikely to bring fresh perspectives, new approaches and dynamic initiatives.

A further and perhaps more obvious risk of the use of quotas is that inappropriate employees are wrenched prematurely up to senior roles in order to fulfil artificial regulatory requirements. Research has demonstrated that Norway’s quotas have led to younger, less-experienced board members, an increase in leverage and acquisitions and deterioration in operating performance.\(^\text{19}\)

In the UK, the percentage of graduate level entry into the workforce is fairly evenly split between men and women, but the balance swings dramatically in favour of men beyond junior management positions.\(^\text{20}\) This suggests a marked failure to retain talented female employees, which must be remedied in order to create sustainable developments in terms of diversity. Whether through training, work experience, opportunities, cultural adjustments, or most likely a mixture of such strategies, the responsibility lies largely with individual companies to implement initiatives to support women and other minority groups at every stage of the career path. Otherwise, these employees will remain at a disadvantage in terms of acquiring valuable experience and qualifications, and a void of suitable, experienced candidates with the skills and creativity to improve company performance will persist.

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\(^{18}\) Ibid.

\(^{19}\) Valeria CRISCIONE, “Norway eyes female boardroom quota”, FTIM, 22 August 2011, p.5.

It appears, nevertheless, that the mere threat of quotas can have an impact upon corporate behaviour; the increased focus on the topic of diversity is arguably encouraging companies to take a more active role in supporting meaningful action. Government involvement may also have a significant impact: in the UK, senior cabinet ministers have written to all chairmen and chief executives of FTSE 350 companies to remind them to set targets for increasing the percentage of women on their boards. Following Lord Davies’s recommendations in the UK, 30% of FTSE100 board appointments over the first half of 2011 were awarded to women.

The 2010 UK Corporate Governance Code also incorporates specific recommendations regarding diversity, within the context of appointments to the board, which should be made “on merit, against objective criteria and with due regard for the benefits of diversity.” Through this wording, a clear effort has been made to reconcile potentially conflicting forces of individual skills and experiences with a wider collective requirement for diversity. The Financial Reporting Council has since published a consultation document asking for views on whether the UK Corporate Governance Code should be amended to incorporate specific guidance on the issue of gender diversity. Among its recommendations is the suggestion that companies should formulate a gender diversity policy, “including any measurable objectives that [have been] set for implementing the policy, and progress on achieving the objectives.” The Corporate Governance Code sets out acknowledged and recommended standards of best practice, although it is not legally enforceable. However, the strength of the “comply or explain” approach and its aspect of self-regulation is relied upon successfully for a variety of corporate activities in the UK, not least in the form of the City Takeover Code on mergers and acquisitions; while forming a fundamental set of standards, such codes also allow a degree of flexibility where it is appropriate for a particular company. In this way, they provide an alternative and effective method by which to implement and measure change. In Australia, for example, a “report or explain” approach to increase the number of women on boards has been implemented since July 2010, accompanied by support from the Australian Institute of Company Directors to design initiatives to train women for board positions. Subsequently, the percentage of new female director appointments has increased substantially, as demonstrated in Exhibit 3. Companies themselves, of course, are not the only element in the equation; a study by the Cranfield University School of Management has highlighted the role of recruitment consultancies in promoting diversity when compiling short lists.

Codes of conduct provide an alternative to quotas, and can be an effective method by which to implement and measure change.

At Newton we believe that quotas are an inadequate method of effecting long-term, meaningful change. Ironically, they contradict a central aim of diversity, which is to eliminate ‘special treatment’ of particular groups. A fundamental view underpinning our investment philosophy is that “there is no monopoly on great ideas”. Diversity should be approached in the spirit of inclusion, and thereby enable companies to find the best candidates by widening the pool of talent from which to choose, instead of becoming an instrument of artificial division.

Mind over matter

Despite the growing evidence in favour of the positive economic effects of diversity, there is still much work to be done. In the US, among Fortune 500 companies, 94.9% of board chairmanships are held by white men, and among Fortune 100 companies roughly 18% of seats on the board are held by women, and only 9.1% are held by ethnic minority men.28

Diversity is not an end in itself; it is one of a number of jigsaw pieces which combine to deliver company success. The guidance on board effectiveness produced by the Financial Reporting Council, the regulator and standard-setter responsible for corporate governance and financial reporting in the UK, states explicitly that “an effective board should not necessarily be a comfortable place”, and cites diversity in board composition as integral to encouraging challenge, bringing new viewpoints and cracking the cement of monotony.29 The influence of board diversity also permeates company culture and employee career development in more subtle ways. Research has demonstrated that the dearth of female role models in senior positions reinforces perceived barriers to advancement;30 diversity in the boardroom may form an important indication to employees that membership of a particular social grouping is not a hindrance to career progression.31

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As increasing research into the benefits of diversity comes to light, attitudes are shifting away from viewing diversity as merely a manifestation of social justice, or a box-ticking public relations exercise, towards exploring the opportunities for business development, growth and recruitment that result from a varied and talented workforce.

As with many wider aspects of corporate culture, diversity occupies the awkward hinterland beyond mere regulation. Its essence is variety, and as such there is no ‘optimum’ combination of board composition; it is equally important that relevant skills, qualifications and experience are not overlooked in favour of diversity for diversity’s sake. A significant responsibility lies with companies themselves to create, implement and maintain policies and procedures to promote diversity at all levels of their businesses.

At Newton, we believe that companies which take active steps to improve and monitor diversity will be better prepared not merely to survive, but to flourish in a global, varied and challenging market place.

Important information

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