Racial and ethnic diversity

Materiality and the role of investors
UBS Asset Management, member of the 30% Club UK Investor Group

Introduction

The benefits of corporate diversity, equity and inclusion have been brought to the fore in recent years, leading to increased stakeholder interest. In response, companies are strengthening their racial and ethnic diversity efforts and progress has been indicated, however, this is the beginning of the journey. For instance, according to an ISS study looking at board composition in Russell 3000 companies from January 2019 to January 2023, directors who self-identify as racial and ethnic minorities now occupy more than 20% of all board seats, for the first time. Even though Black/African Americans saw the highest increase in directorships (a rise of more than 90%), it is noted that Black/African American CEOs and board chairs continue to be around 1% of the total. Analysis of board diversity in S&P 500 companies in 2022 shows 22% of all S&P directors being from historically underrepresented racial and ethnic groups[1]. According to the same analysis, 50% of S&P 500 company boards reported having a policy like the "Rooney rule" to include individuals from underrepresented groups in the candidate pool for new directors, an increase from 39% last year.

Racial and ethnic diversity is critical for our socioeconomic system. The aim of this whitepaper is to provide an overview of why corporate racial and ethnic diversity should be considered material to businesses and the wider system, how investors can catalyse progress through active ownership activities and what investors see as the main challenges today in this regard.

1 Defined as Black or African American, Asian, Hispanic or Latino/a, two or more races/ethnicities, American Indian/Alaska Native, and Native Hawaiian or other Pacific Islander

Why corporate racial and ethnic diversity should be considered material to businesses and the wider system

1. The business lens

Although the evidence is mixed, various studies (examples of which are provided below), have found that companies with more racially and ethnically diverse workforces tend to perform better financially, be more innovative, and are more likely to attract and retain top talent. In parallel, companies lacking racial and ethnically diverse, equitable and inclusive working environments could be more exposed to reputational and litigation risks.

Financial Performance

Although we should be careful not to overstate any causation, there is increasing research evidence that suggests a positive correlation between racial and ethnic diversity and corporate financial performance.

In a series of reports beginning in 2015, McKinsey has presented results of its analysis investigating the business case for diversity. The studies conclude that companies with more ethnic diverse executive teams are more likely to outperform less diverse peers on profitability (EBIT margin). According to their latest analysis, encompassing data from 15 countries and more than 1,000 large companies, "in the case of ethnic and cultural diversity, in 2019, top-quartile companies outperformed those in the fourth one by 36% in profitability, slightly up from 33% in 2017 and 35% in 2014". The study also analyzed gender diversity data. Increased likelihood of financial outperformance for companies with more gender diverse executive teams was observed in this case too, however, the likelihood of outperformance is found to be higher for diversity in ethnicity than for gender. Again though, while supportive of our thesis, these areas require deeper and further study in order to ascertain causation from mere correlation.

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Another 2022 study from Calvert, a unit of Morgan Stanley Investment Management, analyzed the relationship between racial and ethnic diversity on corporate boards of large-caps and stock price in various geographies. The most significant impact on stock price was found in the US, where "the difference in returns between stocks of companies with the highest number of people of colour on their boards and those with the least was 1.5%".

Also, according to research by Vontobel Asset Management, published in 2020, "the most ethnically diverse boards among the 150 largest companies in the S&P, generated higher earnings per share growth than companies with the least diverse boards".

Again though, these areas require deeper and further study in order to ascertain causation from mere correlation. Categorically proving the diversity dividend remains an important challenge of our time. In the meantime, we can fall back on intuition (for example, the benefits of reduced groupthink[2] and so on) and that having leadership that more closely reflects our societies is simply the right thing to do.

Innovation, creativity, unlocking market opportunities

Diverse teams can offer a wide array of viewpoints and opinions, thus are more creative and better positioned to unlock innovation that drives growth. Applying new technologies and concepts to existing processes and creating novel products and additional revenues also depends on creative thinking.

A 2018 study from Boston Consulting Group, showed that there is a strong and statistically significant correlation between the diversity of management teams and overall innovation. The study found that "companies with above-average diversity produced a greater proportion of revenue from innovation (45% of total revenue) than companies with below-average diversity (26% of total revenue)". All the six dimensions of diversity considered[3] showed a correlation with innovation, however, it is worth noting that the most significant effects came from changing the composition of the leadership team in terms of national origin, followed by the range of industry backgrounds, gender balance and career paths.

Furthermore, diversity powers the ability to recognize new and different market opportunities. Having a diverse team of professionals increases the chances that products and services are more relevant to the needs and preferences of a wide range of customers, while the cost of not being innovative and able to serve a wide range of customer needs in a period of rapid change and global markets will likely increase.

Decision-making

People from different backgrounds bring different perspectives to the table, thus the team is more likely to consider a wider range of viewpoints which can lead to more effective decision-making, and the avoidance of groupthink.

Talent attraction and retention

Employers who do not focus on diversity and inclusion, will potentially miss out on talent, as employees tend to prefer and stay longer at diverse and inclusive workplaces, and they expect their employers to step up their transparency around diversity and inclusion, which can lead to more competitive advantage in the talent market. Diversity is an important indicator of company culture.

A 2020 Glassdoor survey in the US indicated that "more than three in four employees and job seekers (76%) see workplace diversity as an important factor when considering employment opportunities, and that about one in three employees and job seekers (32%) would not apply to a job at a company where there is a lack of diversity among its workforce". The 2020 Manifest Recruitment survey also found that "most job seekers (70%) value a commitment to diversity in potential employers". This is expected to become a greater focus in the coming years as the workforce becomes increasingly made up of Millennials and Gen Z. Deloitte's Global 2022 Gen Z and Millennial survey found that "nearly two in five said they have rejected a job or assignment because it did not align with their values. Meanwhile, those who are satisfied with their employer's societal and environmental impact, and their efforts to create a diverse and inclusive culture, are more likely to want to stay with their employer for more than five years".

Reputation, brand value, purchase decision

When businesses promote diversity, equity and inclusion, they are often perceived as more relatable and socially responsible. This can improve the company's reputation, leading to new customers, partnerships, and markets. Conversely, a perceived lack of diversity can damage brand value and reputation.

End-customers are also increasingly sensitive to social issues, and purchase decisions are influenced by social values. In October 2021, a survey by McKinsey showed that "the shopping choices of two out of three Americans are influenced by their social values. 45% of respondents (well over a hundred million shoppers) believe that retailers should actively support Black-owned businesses and brands". Also, younger generations of consumers tend to be particularly attuned to social issues. According to the 2020 5W Public Relations Consumer Culture Report, "83% of Millennials say it is important for the companies they buy from to align with their beliefs and values".

Regulation and voluntary guidelines

Regulation around corporate diversity is growing around the world and legal requirements for corporates to report on their diversity and inclusion efforts increase. For example, in 2022, the UK Financial Conduct Authority (FCA) announced rules requiring listed companies to annually disclose against targets regarding the representation of women and ethnic minorities on their boards and executive management and provide a numerical diversity data disclosure. According to amendments to the Canada Business Corporations Act (CBCA) in 2022, incorporated companies are required to disclose diversity policy, targets and representation of four designated groups[4] on their board of directors and senior management teams. In the US, according to the federal Equal Employment Opportunity Commission (EEOC), US companies with more than 100 employees are required to report to the US government demographic workforce data, broken down by race/ethnicity, gender, and job category (EEO-1 report). Pay data breakdowns are likely to be included in the EEOC reporting requirements, while some states such as California and Illinois are already requiring pay data reporting. Mandatory quotas for ethnicity and race on boards may also be expected, following the expansion of gender quotas over the last years.

Furthermore, guidelines for voluntary targets around ethnic diversity on boards also exist. In the UK, the Parker Review recommends that all FTSE 100 companies should have

2 Groupthink in psychology is the mode of thinking in which individual members of small cohesive groups tend to accept a viewpoint or conclusion that represents a perceived group consensus, whether or not the group members believe it to be valid, correct, or optimal. Groupthink reduces the efficiency of collective problem solving (Britannica)
3 Gender, age, nation of origin, career path, industry background and education
4 Women, Indigenous people, people with disabilities, and members of visible minorities

appointed at least one director from an ethnic minority background by 2021 ("One by 2021"), and FTSE 250 companies by 2024 ("One by 2024"), while also recommending annual disclosure of the ethnic diversity of the board and senior management. In 2023, the Parker Review announced new targets for 2027: each FTSE 350 company is required to set a percentage target for senior management positions that will be occupied by ethnic minority executives, and 50 of the private companies in the UK need to have a minimum of one ethnic minority director on the main board, while also setting a target for the percentage of ethnic minority executives within their senior management team. In terms of ethnicity pay gap, in April 2023, the UK government issued guidance on ethnicity pay gap reporting, which is voluntary in the UK. The guidance covers the following main topics: collection of employees' ethnicity data; gathering payroll data; ethnicity pay calculations; analysis of the results and development of an action plan to address identified disparities. Even though these targets and guidelines are not legally binding, the adoption thereof by companies signals their commitment and demonstrates their efforts towards diversity, equity and inclusion.

2. The system lens

Corporate diversity is material to our society too, as it promotes equal opportunities and can boost economic growth. Focusing on diversity contributes to deconstructing systemic bias, reducing discrimination, and advocating for meritocracy and the provision of opportunities regardless of individuals' backgrounds.

According to this study from the Economic Policy Institute, economic theory suggests that labor market discrimination may impede effective matching in the labor market between employers and workers. Economies are much more productive when jobs are allocated on the basis of skills and ability instead of ethnicity for example. Also, as greater numbers of people from different racial and ethnic backgrounds enter the workforce, the share of talent, along with the unique skills they bring, significantly increases for employers. Given the interconnected and pressing challenges that our world faces today, the competence of innovative and creative thinking, which in turn relates to decision-making and problem-solving skills, is critical for the contemporary global workforce.

Furthermore, racial inequality costs significantly to the economy. The National Equity Atlas in the US estimates that the national GDP could have been USD 3.1 trillion more in 2019 with racial equity in income. The Citi Global Perspectives & Solutions report in 2020 estimated the lost GDP in the US due to discrimination against African Americans to be USD 16 trillion since 2000. Findings from a study from McKinsey in 2019, suggest that if the racial wealth gap is closed, real GDP in the US could be 4-6% higher by 2028, translating to an increase of USD 2,900-USD 4,300 per capita. In the UK, the McGregor-Smith review in 2017, Race in the workplace notes that "the potential benefit to the UK economy from full representation of BME[5] individuals across the labour market through improved participation and progression is estimated to be GBP 24 billion a year, which represents 1.3% of GDP".

By building a more racially and ethnically diverse and inclusive workforce, companies can contribute to addressing inequalities and creating a stronger and more resilient economy.

How investors can fuel progress on corporate racial and ethnic diversity through active ownership

UBS Asset Management's work with clients has shown that racial and ethnic diversity has risen higher on the investors' agenda due to its material benefits at both the business and system levels. Asset managers, on behalf of their clients, are well positioned to influence investee companies through active ownership activities.

1. The Theory of Change for active ownership on racial and ethnic diversity

Inputs

– Research, engagement and voting resources.

Activities

– *What:* Investors encourage investee companies to increase racial and ethnic representation at the board level and the wider workforce, to enhance DEI policies, practices, and disclosure.
– *How:* Through bilateral / collaborative engagements[6] and voting practices.
– *Why:* Due to the associated benefits and risks at the company and system levels.

Outputs

– Companies increase racial and ethnic representation at the board level and across the wider workforce, develop and implement best-in-class strategies to build racially and ethnically diverse, equitable and inclusive working environments across the wider workforce and in their supply chains.

Outcomes

– Racially and ethnically diverse, equitable and inclusive working environments.

Impacts

– *Company:* Racial and ethnic diversity is associated with financial performance, innovation, employee productivity, creativity and problem solving, effective decision making and identification of opportunities, while it can also contribute to reputational and litigation risk mitigation. Engaging on racial and ethnic diversity, equity and inclusion is therefore expected to benefit engaged companies on these fronts.

– *System:* Racial and ethnic diversity is of fundamental importance for our society; it promotes equal opportunities and contributes to deconstructing systemic bias, reducing discrimination, and advocates for meritocracy and the provision of opportunities regardless of individuals' backgrounds. The characteristics associated with diversity, such as innovative thinking and creativity benefit the global workforce which impacts economic growth. Engaging on racial and ethnic diversity, equity and inclusion is therefore not only the right thing to do, but also, through addressing systemic risks, can contribute to reducing volatility in the market, from which the returns of long-term investments could benefit.

5 Black or Minority Ethnic background
6 The 30% Club UK Investor Race Equity Working Group actively facilitates voluntary investor collaborative engagement on race equity in order to deliver long-term value for investors in line with the group's terms of reference and Race Equity investor statement.

Figure: Active Ownership activities on racial and ethnic diversity through the Theory of Change framework

Inputs	Activities	Outputs	Outcomes	Impacts
Research, engagement and voting resources	Bilateral/ collaborative engagements and voting practices	Increased racial and ethnic representation, development and implementation of strategies towards racially and ethnically diverse working environments across the workforce and supply chain	Racially and ethnically diverse, equitable and inclusive working environments	Company: innovation, financial performance, effective decision-making etc System: fairness, productivity, economic growth etc

2. Main challenges for investors

A key challenge for investors is the lack of available racial or ethnic diversity data, as in many cases, corporate disclosure is not sufficient.

However, analyses show that companies respond to investors' requests about enhanced racial or ethnic disclosure, especially in the US. An analysis from JUST capital indicated that "the number of Russell 1000 companies that publicly disclose intersectional data detailing gender, race, and ethnicity by job category from their EEO-1 reports or equivalent – has grown substantially, from 3% in 2019 to 34% in 2022".

Also, the ISS study looking at board composition in the Russell 3000 from January 2019 to January 2023 notes that "more and more companies are disclosing directors' ethnicity and race, as the number of unknown/undisclosed directors decreased by 58% over the period and accounted for less than 3% of all director positions sampled in 2023". The researchers postulate that this change was likely driven by the recent NASDAQ disclosure rule, requiring companies to publicly and annually disclose board-level diversity statistics using a standardized template.

The 2022 analysis of board diversity in S&P 500 notes that "boards have not only responded to calls for increased disclosure about the racial and ethnic diversity of their composition but are beginning to go above and beyond, electing to disclose the race/ethnicity of individual directors. Nearly all S&P 500 boards (93%) disclosed their racial/ethnic composition, with 41% of those boards identifying directors from underrepresented racial and ethnic groups by name for those who volunteered to self-identify".

It is important to note that legal limitations around data collection and corporate disclosure also exist in some countries. For example, in Switzerland, companies are not allowed to collect this type of data and employees in Switzerland can disclose only on a voluntary basis.

In issues of race and ethnicity, it is also important to consider the local context, as what constitutes a minority race or ethnicity varies by country, thus making action but also data collection significantly more challenging than for gender alone. Although racism, bias and discrimination against minority ethnic groups is a global issue, it is reflected differently per region. In the UK, the focus may be on Black and Asian ethnic minorities, while in the US the focus may be on Black, Asian, Hispanic, Latino and Indigenous populations due to these regions being majority White. In other regions, the minority and majority make up will differ. Investors need to be aware of such nuances when exercising their active ownership activities with investee companies to make sure objectives and outcomes pursued are in line with local specificities.

Despite increasing awareness about the importance of diversity, equity and inclusion, the phenomenon of tokenism remains another persistent hurdle to progression. Organizations may rely on token gestures, such as the appointment of individuals from underrepresented groups to demonstrate diversity, while lacking strategies to create genuine diverse, equitable and inclusive working environments. Symbolic representation fails to address the underlying structural barriers that contribute to underrepresentation of certain groups, resulting in the perpetuation of a disadvantaged status and hindering true inclusion. Investors need to distinguish symbolic action from genuine commitment. Through their active ownership activities, they should encourage a comprehensive corporate approach that addresses the root causes of inequality and discrimination and seek outcomes that will contribute to achieving real progress and systemic change.

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