RACIAL EQUITY INVESTING: THE TIME IS NOW


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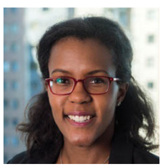
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As we all grapple with the COVID-19 pandemic alongside widespread protests after the deaths of George Floyd and others, many asset owners are trying to determine how they can activate their investment portfolios to advance racial and social equity more broadly. In 2018, we reviewed the state of social equity investing, with a focus on racial equity investing.[1] The themes we highlighted then are even more relevant today. In this paper, we discuss the renewed sense of urgency around racial equity investing and put forward three actions investors can take to address the inequities inherent in our society.

Why Now?

The legacies of systemic racism and racial barriers are deep and complex across the world. Data highlight that inequities across many areas, whether it be education, healthcare, criminal justice, or financial inclusion, are more pronounced for people of color and those from minority backgrounds. The COVID-19 crisis has brought this fact into starker view. The unemployment rate for black Americans stood at 16.8% in May 2020 (versus 12.4% for whites), and historically, black Americans have recovered more slowly than other racial or ethnic groups from recessions, which has exacerbated the impact of job losses on the black community. Black and Latinx Americans have also been hit by the effects of the disease more profoundly, an outcome driven in part by long-standing imbalances in access to quality healthcare.

Inequities throughout the criminal justice system have underpinned the protests and calls for change in the United States and across the world. In the United States, sentencing policies and implicit racial bias contribute to systemic disparities; African Americans are more likely to be arrested than white Americans and when convicted, face harsher sentences. For African Americans, the negative impact of a criminal record is twice as large than for other groups. The effects of incarceration are long lasting, setting up a path to diminished job prospects and earnings potential that ravages a community.

1 Please see Ashley Cohen and Erin Harkless, “Social Equity Investing: Righting Institutional Wrongs,” Cambridge Associates LLC, 2018.

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These racial inequities are also manifested in the asset management industry, particularly when we consider how implicit bias impacts the investment decision-making and capital allocation processes. In venture capital (VC), only 6% of investment partners are black or Latinx and 1% of VC-backed start-ups have a black founder, highlighting the limited diversity in the industry. According to a Stanford research study, evidence of racial bias has also been found in the investment decisions of asset allocators that have trouble assessing the competence of racially diverse teams. These biases are believed to impact how investors evaluate fund managers and compound the lack of capital flowing to minority investors.

What Can You Do?

Investors should take three key steps in their investment practices and portfolios to help address racial inequities: (1) make racial equity an investment priority and codify it in the investment policy; (2) start allocating capital to racial equity investments; and (3) put racial equity at the center of the investment selection process. These actions are no doubt insufficient to fully overcome the challenges facing the investment industry specifically and society at large, but we believe if these steps are widely adopted, they could help reduce some of the imbalances that permeate investment programs.

#1 Make Racial Equity an Investment Priority and Codify it in the Investment Policy

For all forms of impact investing, we encourage investors to define three pillars of strategy before they implement impact investments: purpose, priorities, and principles.[2] All investors benefit from unified decisions regarding values and goals and that should be paramount when embracing a new investment theme. This is equally true for investments aimed at racial equity and will help to ensure a strong directional platform for ongoing investment decisions.

Start conversations at the investment committee level on racial equity and establish a plan to learn more. This strategy could involve bringing in external advisors with necessary expertise or leveraging the knowledge of peer networks that are already actively engaging with racial equity investments. Families and foundations should also consider their broader philanthropic and programmatic activities and how these investments may complement or even enhance efforts to address racial inequality that are already underway. Finally, once investors reach a decision on how they will tackle racial equity investments, they should codify these principles and priorities in the investment policy statement and communicate these preferences to advisors and investment managers.

2 Please see Rebecca Carland and Erin Harkless, "The Foundation of Good Governance for Family Impact Investors: Removing Obstacles and Charting a Path to Action," Cambridge Associates LLC, 2016.

#2 Start Allocating Capital to Racial Equity Investments

There are myriad approaches investors can take to invest capital with a racial equity lens. We encourage investors to focus on two related areas that could have the greatest impact. The first is increasing capital access by allocating to racially diverse managers and/or those managers that back diverse founders and management teams. The second is intentionally seeking managers that invest in businesses with products and services that benefit and empower communities of color. The former aims to address the historic and continued capital gap facing minority-owned businesses, entrepreneurs, and managers. The latter seeks to ensure that products, services, and policies are positively supporting and creating opportunities in these communities (i.e., a manager that invests in healthcare access businesses that disproportionately benefit minority communities).

As investors begin to deploy capital across one of these areas (or both—in practice, we have found they often overlap and intersect depending on the investment opportunity), it is important to dig deep and tease out the specific type of impact each investor is seeking with the investment.

For example, in the United States, investors can focus on deploying capital to investment firms or managers that are owned and/or led by African Americans. We recommend a 33% hurdle to define a diverse firm or team and encourage investors to consider both ownership and leadership of firms/strategies when allocating capital. These opportunities exist across asset classes and thus could be activated throughout the entire portfolio.

Beyond just having a policy to support diverse managers, investors might be well served to articulate further the specific goal they aim to achieve. Is it supporting new, emerging managers in the earliest stages, investing in an established, long-standing, diverse-owned fund manager to create more growth within those firms, allocating capital to an African American portfolio manager within a larger asset management organization, or potentially a mix of all three? Each of these approaches could serve the priority of driving capital towards African American investment managers, creating greater wealth and opportunity in the community, but if the goal is to catalyze and support emerging talent, an investment in a firm or strategy earlier in its life cycle could be more catalytic and bolster the pipeline of talent within the investment management industry.

#3 Put Racial Equity at the Center of the Investment Selection Process

We encourage investors to consider the following points as they engage with their investment managers throughout the investment due diligence and ongoing monitoring processes. This list is not exhaustive, but a starting point for questions asset owners and staff members can ask of their investment managers and advisors; careful analysis of the responses to these questions can help ensure investments are supportive of minority communities and not exacerbating the very issues the investor seeks to address.

- ☑ **CULTURE.** What is your policy on diversity, equity and inclusion? Beyond the policy itself, what steps does the firm take to adhere to these commitments in their operational and investment practices? How does the firm systematically address implicit bias in decision-making in both investment and management contexts?
- ☑ **COMPETENCY.** Do you have the cultural competency to address the needs of racially diverse communities? What evidence can you offer that the solutions or products you are providing are grounded in the reality and needs of the community?
- ☑ **COMMUNITY.** How are the needs of the community you want to impact considered in the investment decision-making process?

Racial equity investing offers investors an opportunity to advance solutions to what we believe is one of the most pressing social issues facing countries around the world. The time to address structural racism around the world is now. We encourage investors to share their knowledge and experiences to support the growth of racial equity investing so we can promote a more equitable society together. ■

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