

Diversity in the Investment Industry

October 2021

Dell|arche

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Abstract

Similar to the Northern Lights reflecting every color of the rainbow, money management is represented by every race, gender and ethnicity. The authors believe in today's market environment, more clients have become interested in considering the inclusion of diversity within their investment management lineup. After a close review of the progression of diverse investment managers, it appears clients can invest in diverse managers without having to give up return or accept an increased amount of risk.

Shifting Industry Perceptions

Historically, new investment ideas have been met with the predominant belief that looking at the world differently would result in either accepting higher risk or lower returns. In the infancy of Environmental, Social and Governance (ESG), this was also the prevailing belief. ESG investing incorporates environmental factors such as those that provide conservation of the natural world, social factors that include consideration of people and relationships, and governance factors that consider standards for running a company.

Starting with Socially Responsible Investments (SRI), an argument had been made that an investor would be required to accept a measurable amount of increased risk (as measured by a strategy's standard deviation) or give up return in order to meet a social mandate. Over time the definition of these mandates have evolved from SRI to ESG to Impact investing. As the industry has seen an increased acceptance of investment managers incorporating ESG characteristics into their investment process often in order to reduce event risk, the consideration of investing in ESG no longer has the negative performance perception as it did during its infancy.

Evolution of ESG into Diversity

Similar to ESG's introduction to asset management, Diversity Equity and Inclusion or DEI, is also dealing with a similar perception. With that said, it is the authors' opinion that Diversity in and of itself is challenged to provide alpha in the institutional marketplace. Institutional investors tend to look at longevity and assets under management (AUM) as key metrics to stability. However, we the authors believe that the inclusion of Diversity does not add risk nor does it guarantee lower returns.

Diversity is the one true thing we all have in common. Celebrate it every day.

- Winston Churchill

Diversity Defined

In order to measure the impact of Diversity within the investment management industry, DeMarche considers each firm's entity type, the diversity in its ownership structure, and reviews the diversity within the members of the firm's board, senior management team and investment team. It is important to understand that we rely on the self-reporting by Money Managers. We first identify investment firms that employ an ownership structure that supports the ability to offer equity ownership across a diverse group.

This criteria typically includes those companies that are privately held with a majority of firm ownership held or controlled by individual persons. Second, we consider each firm’s board of directors and senior management. Thereafter, the investment team of each strategy is considered. Investment managers receive three diversity codes including one for the level of diversity within their equity structure, another for diversity within the board of directors and senior management and a third for the diversity within the investment team. Each of the three diversity codes range from a low code for those with no diversity to a high code for those with diversity exceeding 50% within each category. After an investment strategy is assigned a diversity code, DeMarche consultants can utilize such data to help clients incorporate the diversity data to match their investment philosophy.

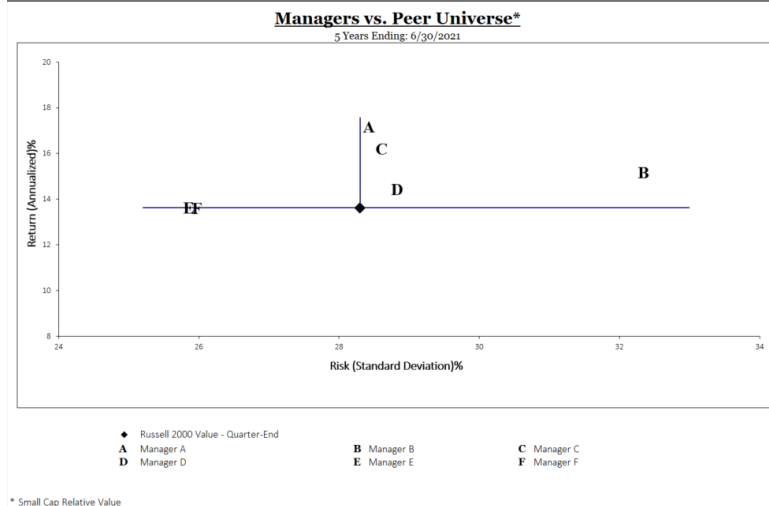
Upon reviewing whether diverse managers offer the potential for outperforming their benchmark and peer group, we utilized the DeMarche proprietary database of Manager Products, which includes over 3,300 investment managers. We also reviewed one of the industry’s largest money manager data providers, eVestment Alliance, which collects data on over 25,000 strategies from 4,000+ asset management firms, and looked at products that self-identified as Diverse Managers. eVestment Alliance states roughly 27% of their 2,045 U.S. based equity asset managers are able to self-report as having minority or women owners, which is likely inflated since upon a closer review these percentages also include managers with no equity ownership diversity. This compares to 26% having reported no diversity in ownership and the remaining 47% that elected not to report data on firm ownership. As a result, clients need the assistance of their consultant to determine the accuracy of each manager’s reported diversity statistics.

Small Cap Diverse Managers

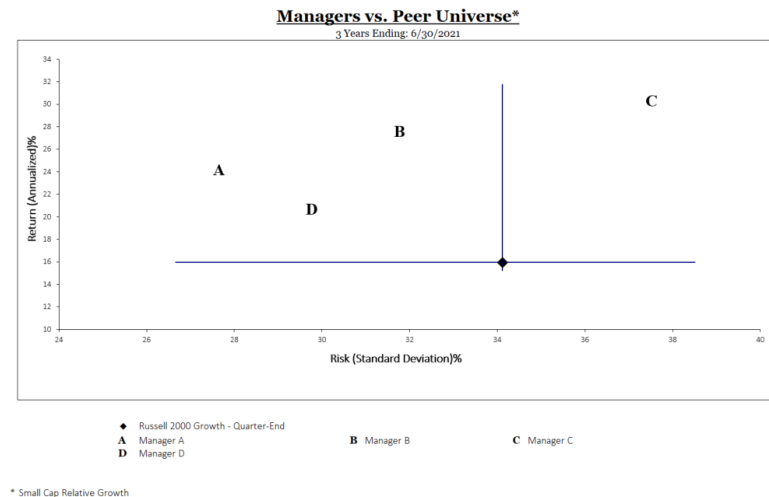
While taking into consideration the incomplete nature of data available, we noted that a number of diverse managers were present in the U.S. small cap equity asset class. Therefore in order to analyze the potential impact of diversity on performance, we limited our analysis to managers specializing in the domestic small cap equity space. Within DeMarche’s small cap universe, only ten managers qualify as being diverse while also meeting our definition of an institutional quality manager. These are investment strategies with sufficient assets and years of history that generally invest in companies included in the Russell 2000 Index whose equity holdings include companies with a market capitalization ranging from approximately \$250 million to \$3.6 billion. We then looked at those small cap managers over a three, five and ten-year time horizon and compared their risk and return to our small cap universe composed of 298 investment strategies from 250 investment management firms.

In the scatter diagram right, we have outlined six small cap relative value and four small cap relative growth managers, all of which having surpassed the DeMarche minimum requirement of \$100 million in strategy assets and at least one year of investment

DeMarche Associates, Inc. 5 Year Risk/Return Analysis



DeMarche Associates, Inc. 3 Year Risk/Return Analysis



history for small cap managers. Over the long-term, the majority (five of six) of the small cap relative value managers were able to outperform the benchmark while providing a standard deviation either slightly over or lower than the benchmark for the last three and five years. In addition, they provided competitive performance in up markets with several also offering down-side protection in more volatile markets.

The small cap relative growth managers displayed even more compelling performance with all four managers outperforming the benchmark for the three and five year time periods and with three of the four experiencing a lower standard deviation than the benchmark during both time periods. In addition, all four relative growth managers provided both competitive up-side performance while providing down-side protection. The small cap growth managers also have over five years of history and strategy assets in excess of \$150 million with an average of \$548 million. The six small cap relative value managers have over five years of history and strategy assets in excess of \$250 million with an average of \$995 million.

Judging a Book by Its Cover

We realize the level of interest in diversity within investment managers differs for every client. DeMarche is interested in identifying the best performing investment managers and strategies for each asset class, including those that have demonstrated diversity across equity ownership, senior management and investment team members. Since an increasing amount of clients have become interested in incorporating diverse managers in their investment lineup, DeMarche has added a diversity review to our due diligence process. For those clients that are interested in pursuing diversity within their investment goals, we would recommend you discuss DeMarche's research in this area with your consultant.

Put Research to Work

with the DeMarche Team



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Sources Utilized:

- *DeMarche*
- *eVestment Alliance*
- *CFA Institute*



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