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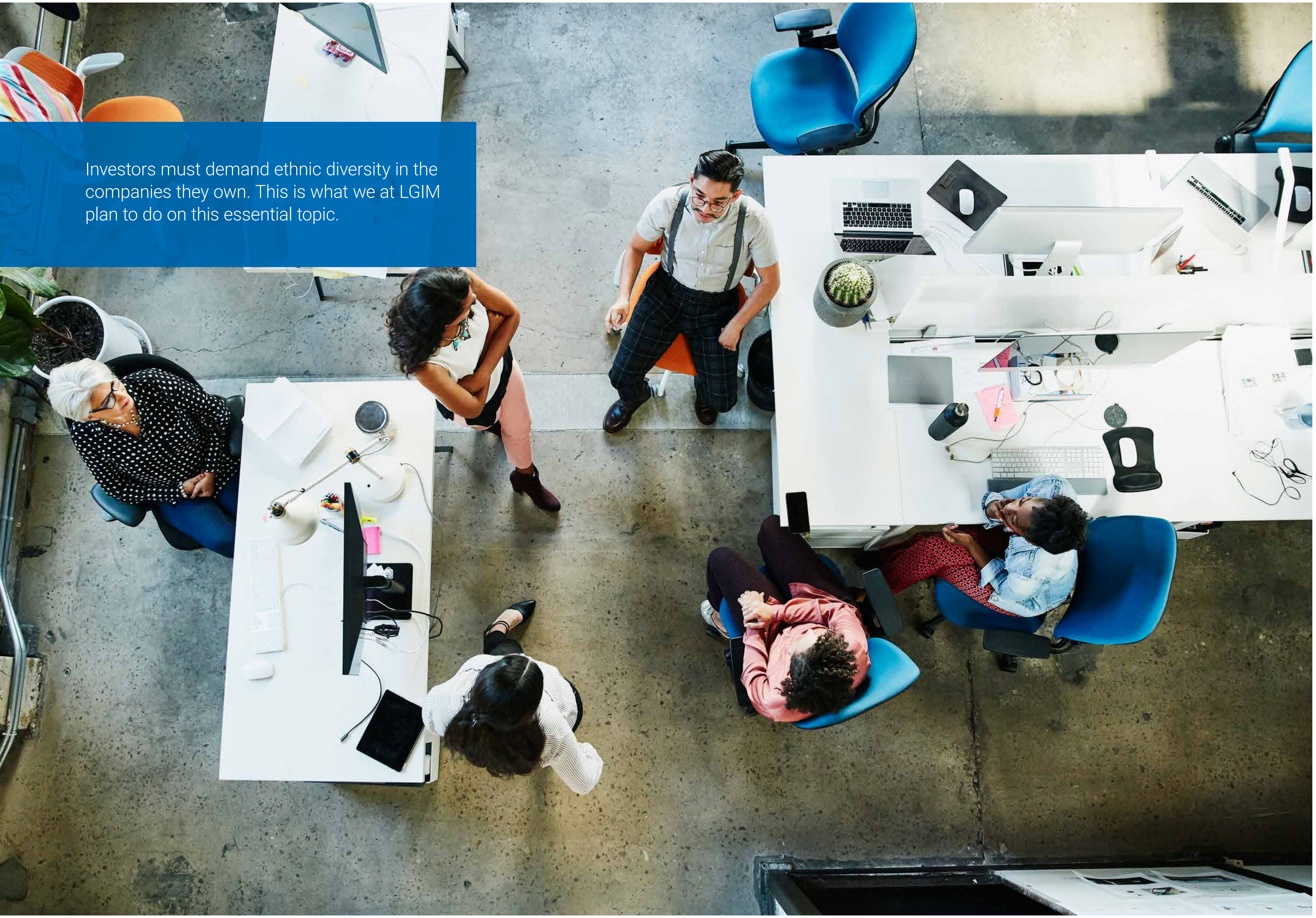
Ethnic diversity

Financially material, socially imperative

Legal & General
INVESTMENT MANAGEMENT

2020 | Ethnic diversity: financially material, socially imperative



Investors must demand ethnic diversity in the companies they own. This is what we at LGIM plan to do on this essential topic.

We recognise distinct differences between racial and ethnic diversity qualifiers. For ease, this report uses “ethnic diversity” to encompass both racial and ethnic diversity.

The horrifying killing of George Floyd and so many others has led many institutional investors to think much more seriously about structural racism and inequality. At LGIM, we believe asset managers must go further – now is the time for action.

We have been longstanding advocates for cognitive diversity in the companies in which we invest, and have spent a lot of time improving the gender balance of those companies, through both engagement and voting, with great success in the UK and in the US. In the FTSE 350 index, women now hold 32% of board seats on average, up from 9.5% in 2010.[1] In the US, there are no longer any all-male boards in the S&P 500 index. Institutional investors are only one voice, yet we are confident that with intentional and focused action it is possible to bring about additional, sustainable change at companies and we will use our experience to broaden our engagement and voting strategies.

Our focus on ethnicity to date has been to push for more consistent and reliable disclosure, as set out in our corporate governance and responsible investment principles. However, recent societal tragedies have made clear that we must now expedite our work and that to wait for perfect data is not an option, so we will be engaging more forcefully on companies’ commitments to ethnic diversity and demanding transparent reporting.

Our expectation is that companies set ambitions related to the ethnic composition of their organisation, throughout the workforce, with a particular emphasis at the board level, which generally sets the tone from the top. For companies that fail to meet our transparent and rules-based minimum expectations, there will be voting and investment consequences.

1. 30% Club, BoardEx, 1 July 2020

Why diversity matters

Driving diversity at corporations is a strategy that we believe is directly linked to value creation and is a concrete action that investors can encourage.

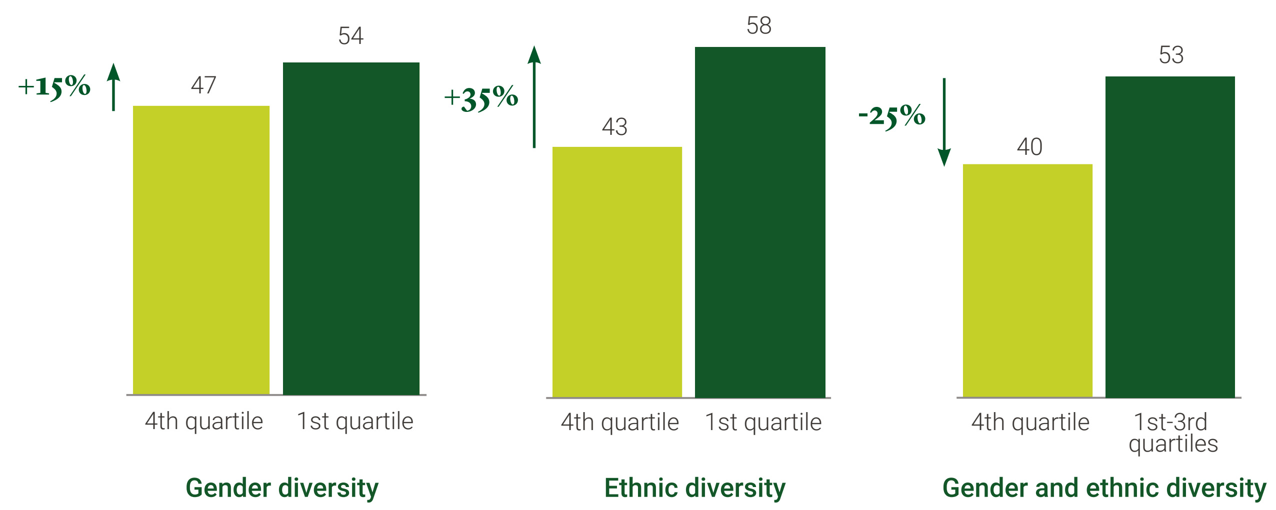
As society's expectations continue to evolve, we want to ensure we evolve alongside them. The issue of intersectionality has increased in importance. This means that as each diversity element intersects, siloed approaches from organisations no longer make sense. Organisations need to work to avoid simplistic thinking and to consider diversity holistically.

Our view is that improving cognitive diversity is financially material. More diverse organisations make better strategic decisions, show superior growth and innovation, and exhibit lower risk – all significant measures for investors.[2] Diversity can also help a brand's image and reputation: consumers increasingly expect companies to be both fair and transparent. We believe that global organisations, with highly diverse consumers, benefit from a diverse employee base across all levels. By using all the talent available to them, companies and economies can be more successful and build more resilient organisations and societies.

We must also not forget that employees are pushing change within the companies at which they work, as they typically want to work for an organisation that supports a diverse and inclusive culture.

How diversity correlates better with financial performance

Likelihood of financial performance above national industry median, by diversity quartile (%)



Source: McKinsey Diversity Database

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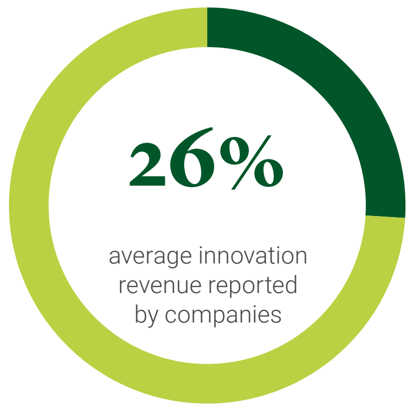
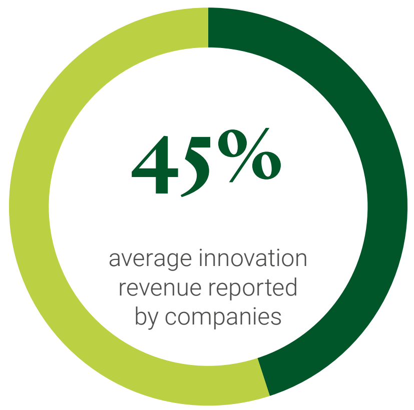
Companies with more diverse leadership teams report higher innovation revenue

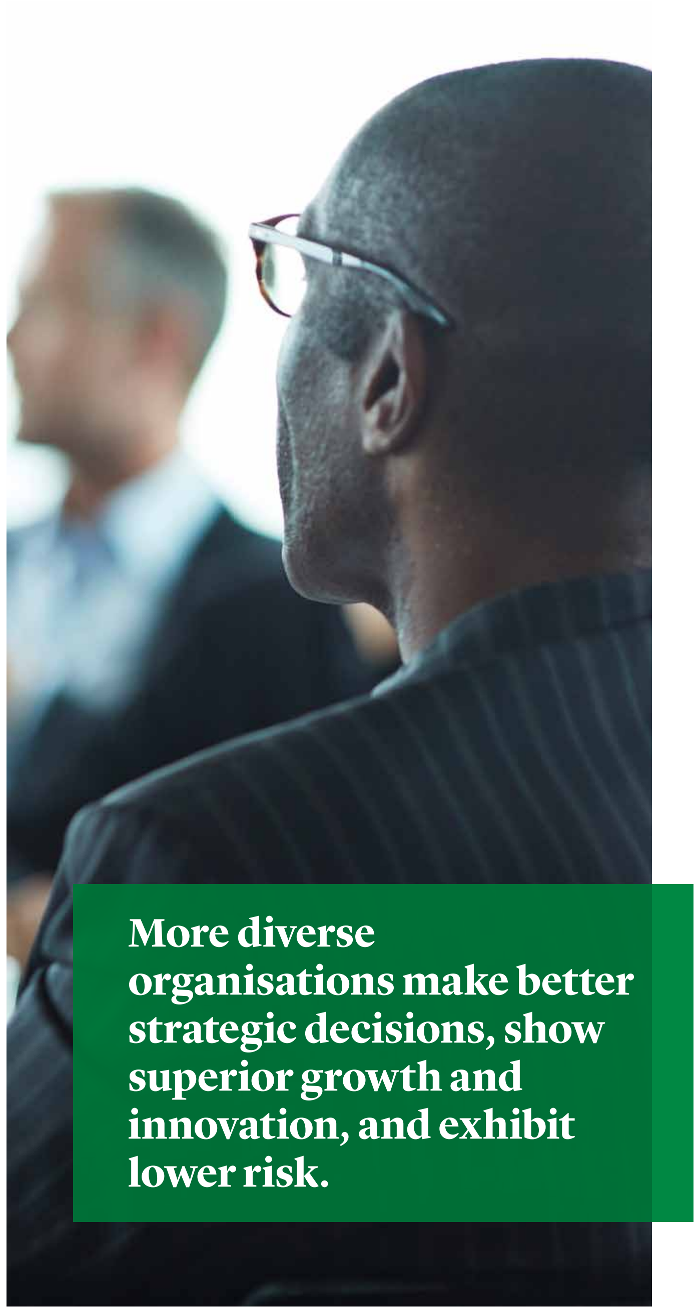
Companies with below-average diversity scores



Companies with above-average diversity scores



Source: BCG diversity and innovation survey, 2017 (n=1,681)
Note: Average diversity score calculated using the Blau index, a statistical means of combining individual indices into an overall aggregate index.



More diverse organisations make better strategic decisions, show superior growth and innovation, and exhibit lower risk.

Moreover, responsible asset managers can instigate genuine change at the companies in which they invest. The progress made towards greater representation of women on corporate boards proves that improvement is possible – if investors act forcefully. We can use our influence to insist upon higher standards on everything from diversity to climate change across capital markets – first through demanding corporate transparency and disclosure, and then through informed and targeted action.

We know this process of transparency and targeted interventions can be effective: 51 of the 72 US companies we targeted for engagement on gender diversity over the past three years have now appointed at least one woman to their board.[3] Transparent data enable these actions.

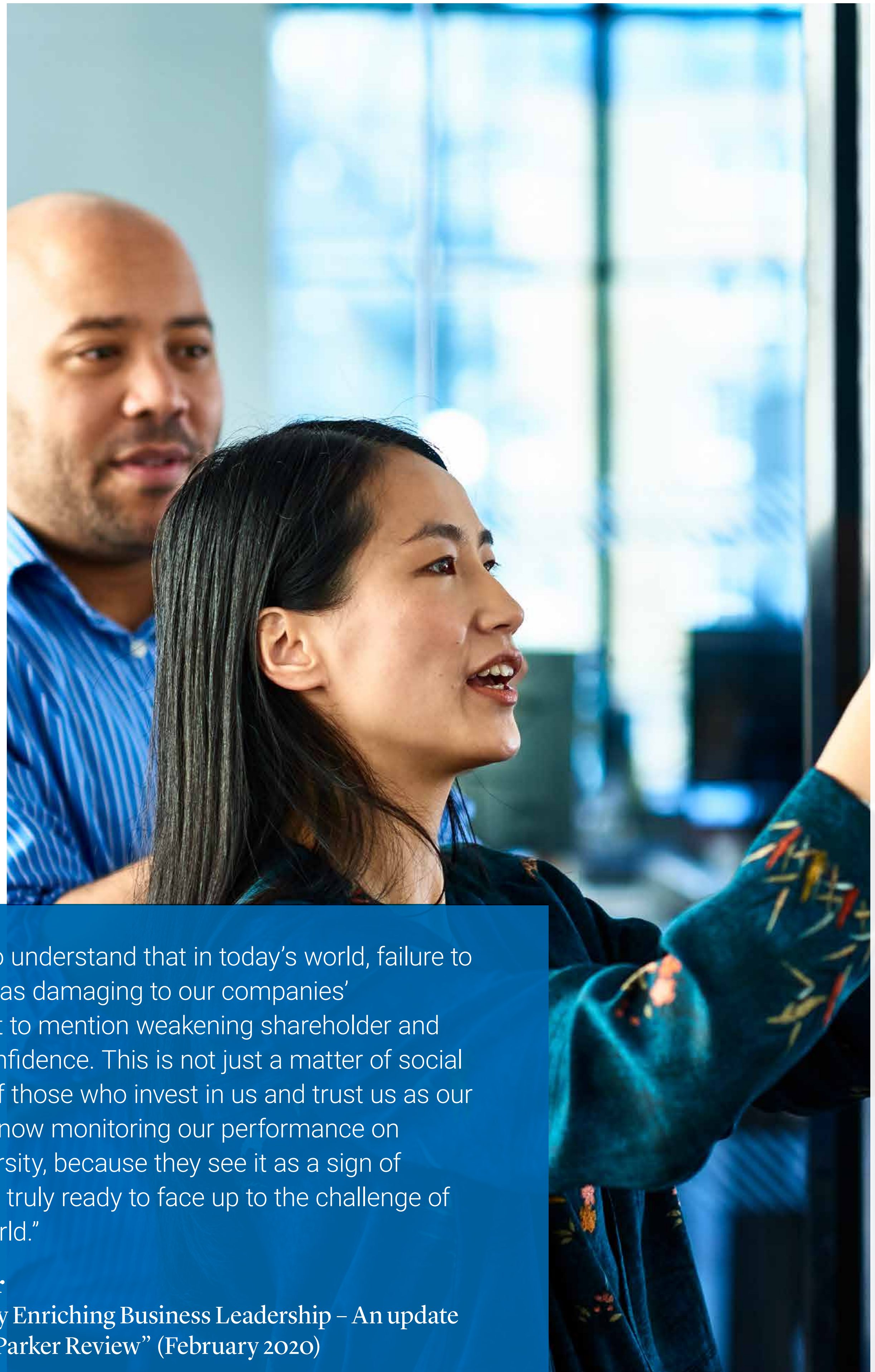
2. Credit Suisse Research Institute, "The CS Gender 3000 in 2019: The changing face of companies" (2019); INVolve, "The Value of Diversity" (2018)
3. LGIM 2019 Active Ownership Report

The difficult conversation on race

As the updated report from the Parker Review discusses, "There is a clear discomfort related to discussing race and ethnicity in the workplace – there is no avoiding it. This is particularly true where we as a society have been told not to notice the colour of a person's skin and that race/ethnicity should not matter."

The reality of this issue is that, as a society and as businesses, there is general nervousness when talking about race and listening to experiences from colleagues. Companies, leaders and boards must learn to be comfortable talking about the way in which race and ethnicity informs a person's experience and perspective.

To ensure impact, businesses at the very least need to create public statements and internal and external communications on the importance of ethnicity and race, much like they have done for gender. Lack of measurable action may be interpreted as a sign that the organisation doesn't care. This communication should come from the top, from the CEO, which provides permission for their organisation to start taking additional action: talking about race and pushing for tangible and measurable actions.



"But we need to understand that in today's world, failure to act can be just as damaging to our companies' reputations, not to mention weakening shareholder and stakeholder confidence. This is not just a matter of social justice. Many of those who invest in us and trust us as our customers are now monitoring our performance on leadership diversity, because they see it as a sign of whether we are truly ready to face up to the challenge of the modern world."

Sir John Parker
"Ethnic Diversity Enriching Business Leadership – An update report from the Parker Review" (February 2020)

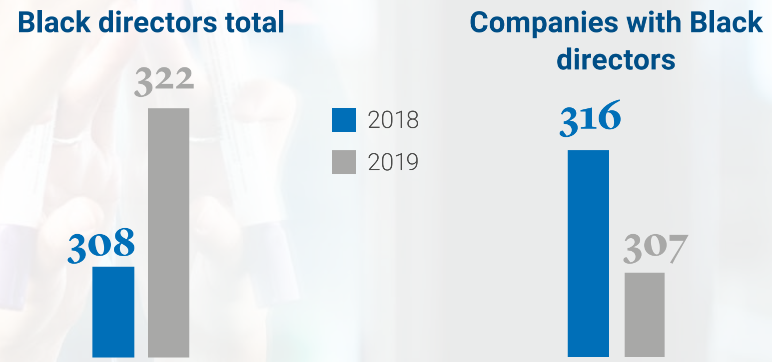
Data are now becoming more available on ethnic diversity at board level. For example, 36% of companies in the FTSE 100 and 8% of the S&P 500 have all-Caucasian board.[4]

Number of FTSE 100 companies with ethnicity on the board

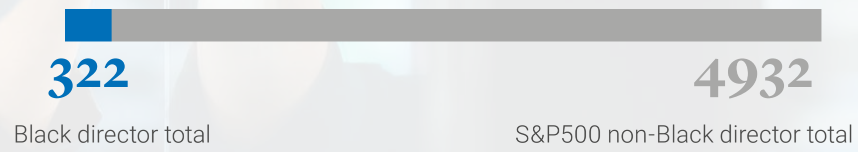
Number of S&P 500 companies with ethnicity on the board

Source: Institutional Shareholder Services (ISS), data as at 1 September 2020

Black representation on S&P 500 boards



Black director total vs S&P 500 non-Black director total



Source: "2019 BE Registry of Corporate Directors." Black Enterprise Lists, Nov. 2019; Russell Reynolds analysis

There are similar shortcomings in corporate policies. A report by the UK's Financial Reporting Council earlier this year found that over half of FTSE 250 companies (52%) fail to mention ethnicity in their board diversity policy, and just 2% of the index's constituents set measurable ethnicity targets.

Industry collaborations and diversity initiatives such as the 30% Club in the UK and the 30% Coalition in the US have now broadened their ambitions to include ethnicity alongside gender, demonstrating how quickly this issue has become embedded in market expectations.

4. Institutional Shareholder Services (ISS)

What do we do now?

We acknowledge that we have not advocated strongly enough on racial diversity to date. We therefore intend to expand our diversity strategy and corporate engagement – **including through strengthened proxy voting policies and a focused outreach campaign regarding diverse board member representation** – over the coming months and expect many other investors to formulate new policies in this area.

It is incumbent on companies to improve the ethnic diversity within their organisations – and on us as investors to demand more transparent disclosure on ethnic diversity, require explicit policies on ethnic diversity and inclusion, and hold companies accountable for these policies.

A large part of this work will be in collaboration with companies as well as other stakeholders and policymakers. For example, the UK's Financial Reporting Council expects much improved reporting by companies under the new UK Corporate Governance Code which promotes diversity in appointments and succession plans, including ethnic diversity. We support this fully.

We are also members of both the 30% Coalition in the US and the Human Capital Management Coalition (see sidebar), which both have explicit metrics about ethnic diversity across the composition of the workforce at investee companies. Additionally, we responded to the 2020 Parker Review on ethnic diversity on UK boards, which recommended that each FTSE 100 company should have at least one director of colour by 2021 and by 2024 for the FTSE 250, and we participated in a consultation on the ethnic pay gap by the UK government.

The Human Capital Management Coalition (HCMC) was established in 2013 as a cooperative effort among 28 institutional investors representing over $4 trillion in assets under management to further elevate human capital management as a key contributor to the creation of long-term value. One of the key asks from the HCMC is the mandatory disclosure of comparable workforce data by companies.

The HCMC's July 2017 petition for rulemaking to the SEC related to the modernisation of reporting, and underscores the need for four key metrics to be uniformly disclosed by all companies. Those metrics are: (i) workforce composition, (ii) turnover and stability measures, (iii) total cost of the workforce, and (iv) diversity by seniority.

The March 2019 letter from HCMC in support of the IAC recommendation can be read here, and the HCMC's response to the SEC's rulemaking release regarding the modernisation of Regulation S-K can be read here.

Taking action: engagement and voting

In addition to these multi-lateral initiatives, we use our own voting weight and influence to advance ethnic diversity.

Our proxy voting policy currently calls for boards to be cognisant of ethnic diversity when selecting new directors. We focus on the board, as this is where accountability for the issue belongs, and where we can have most influence as we are able to elect board members annually. By focusing on it at board level, a company is signalling that this issue sits at the top and is a full company aspiration.

In 2019, there were roughly 30 shareholder resolutions in the US that related to corporate diversity and we supported 24 of those resolutions. These included:

Company name	Meeting date	Proposal text	ISS recommendation	Vote instruction
Adobe Inc.	11 April 2019	Report on gender pay gap	For	For
Skechers USA., Inc.	23 May 2019	Report on plans to increase board diversity	For	For
Facebook, Inc.	30 May 2019	Disclose board diversity and qualifications matrix	Against	For
The TJX Companies, Inc.	04 June 2019	Report on gender, race or ethnicity pay equity	Against	For
Alphabet Inc.	19 June 2019	Report on gender pay gap	For	For

However, we do not currently have a stated target or representation threshold for ethnic diversity on boards like we do for gender. This is because there are no consistent, transparent data on this subject and ethnicity is harder to quantify than gender.

We also recognise that companies need to build a relationship of trust with their employees, so that such data can be captured, explaining how it can be used to improve the business and that they are safe to discuss their perspectives.

To date, we have refrained from imposing voting sanctions on companies with boards that lack ethnic diversity.

However, the time has come to change this. We have initiated **a new engagement campaign** that specifically engages FTSE 100 and S&P 500 companies that do not have ethnically diverse directors on the board. A letter to each of them will set out the importance of capturing and reporting this data, as well as our voting intention. **Starting in 2022, we will vote against the chair of their nomination committee or the chair of their board if they fail to meet our expectations on ethnic diversity.**

ESG Integration

As well as more direct engagement by LGIM's Investment Stewardship team, our investment teams are also looking to elevate the importance of ethnic diversity in their portfolio construction.

A company's discrimination policy is currently one input into LGIM's ESG score for companies. Attracting and supporting a diverse and inclusive workplace is critical to creating a working culture with diversity of thought to support decision making. A strong policy against discrimination is a key element to achieving this objective.

We are planning to expand this to factor in ethnic diversity more specifically, as we already do for gender diversity.

Further steps

Equally, we appreciate that we can and should do more to help companies achieve ethnic diversity rather than simply making demands. As long-term investors and responsible stewards of capital, we will work with companies to help them improve their practices. We can provide a great starting place for their systemic change:

- Disclosure of ethnic representation at board level, at executive level, at management level (as defined by the company), and throughout the full workforce.
- Disclosure of the ethnic pay gap.
- Aspirational goals for ethnic diversity and pay equality, and strategies for reaching them with regular updates towards these goals.
- Participation in the 'race at work' charter or other relevant industry initiatives.
- Disclosure of an anti-discrimination policy, including specificity on the process for investigating and sanctioning discriminatory or harassing behaviour.
- Inclusive hiring policies, such as the 'Rooney rule' which has been adopted in the US, requiring a minimum number of ethnic-minority candidates to be interviewed for every job opening.
- For US companies to disclose EEO1 data on the workforce.
- A focus on inclusive culture to harness the value of a diverse workforce.

However, this should not be seen as a checklist of requests, but rather viewed as some emerging best practices to help businesses integrate ethnic diversity as a strategic imperative throughout the organisation's practices and disclosures.

Conclusion

The public reaction to recent tragedies of institutional and structural racism makes clear that society is increasingly unwilling to tolerate discrimination or corporate platitudes on race. This is why we are determined to accelerate and amplify our engagement on ethnic diversity. We have already had an impact on corporate gender diversity – although there is still much to be done there too – and we believe the framework for action we have set out in this document will help us effect similar positive change on ethnic diversity.

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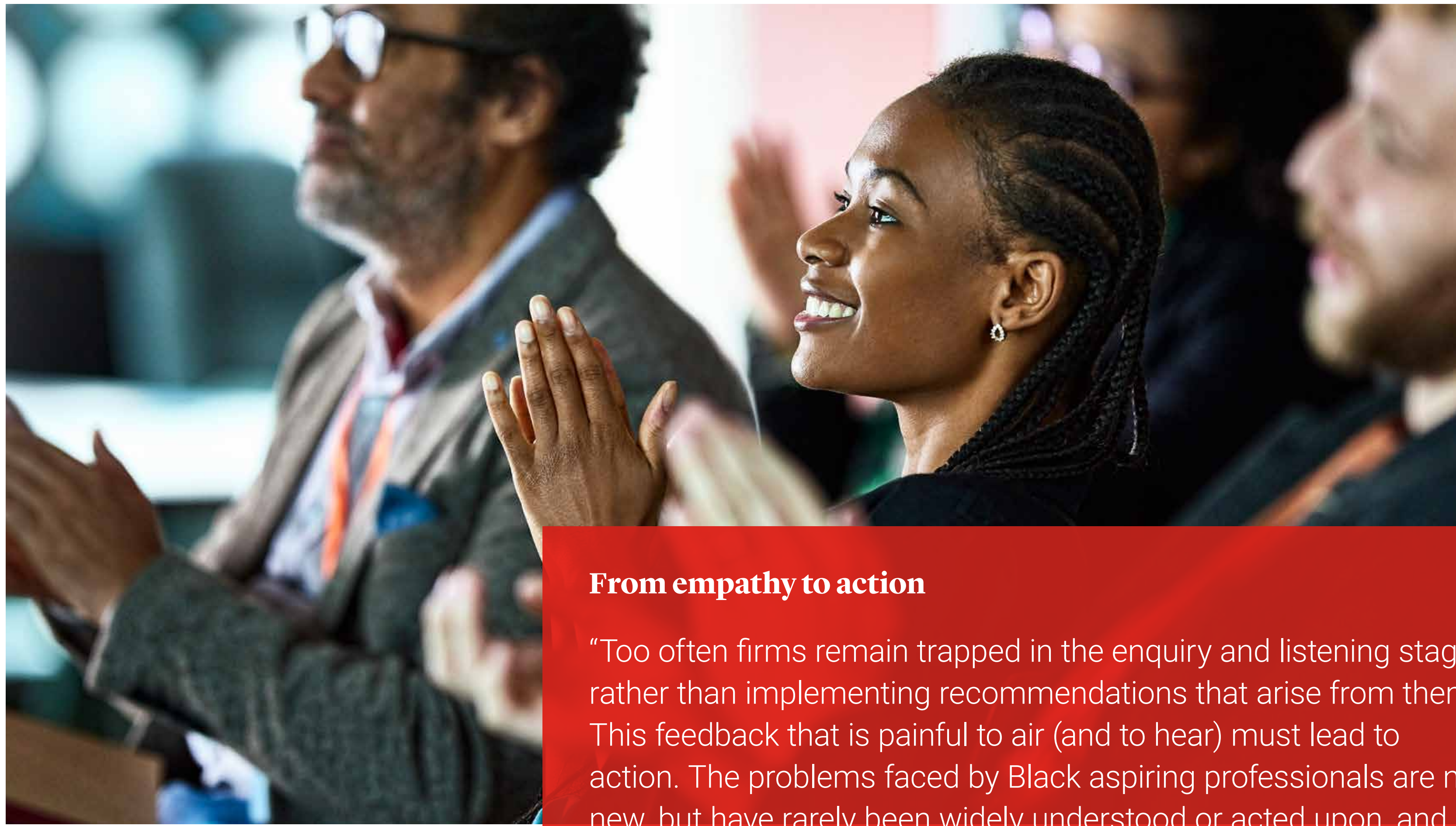

From empathy to action

"Too often firms remain trapped in the enquiry and listening stage rather than implementing recommendations that arise from them. This feedback that is painful to air (and to hear) must lead to action. The problems faced by Black aspiring professionals are not new, but have rarely been widely understood or acted upon, and right now we have an opportunity to change that.

We know that in many industries, creating a diverse workforce has been challenging. To change that and genuinely embed diversity, I believe we need to build a more inclusive corporate culture. That begins by understanding the lived experience of employees and candidates; considering all ethnic minorities in aggregate risks ignoring the very different experiences of each community and individual.

Corporations must also showcase role models from different backgrounds to attract a more diverse candidate pool, and can support earlier interventions in communities that have historically been under-represented in business and management such as through helping teach softer skills like networking.

Justin Onuekwusi
Head of Retail Multi-Asset Funds at Legal & General Investment Management

Contact us

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The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

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