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RESEARCH NOTE

How Does Diversity Deliver Results?

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Research Note

As investors encourage asset managers and firms to boost management teams' diversity, it feels like the right thing to do. But does it also deliver better results? NASDAQ asked the SEC in early December for permission to adopt a new listing requirement, obligating its 3,249 listed companies to have at least one woman and one person who self-identifies as an underrepresented minority on their boards within the next two years. The connections between diverse management and profits are sometimes difficult to demonstrate, but an increasing body of research is making the link more recognizable.

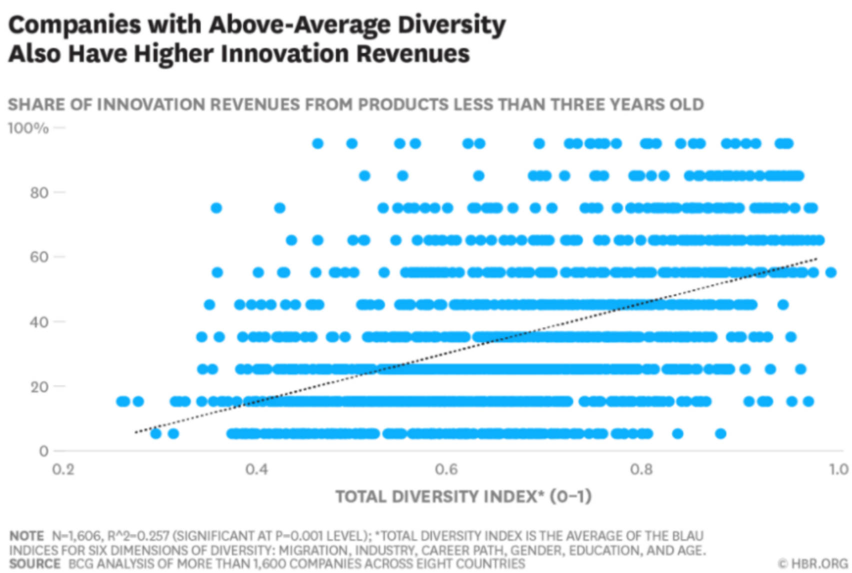
Organizations with diverse management teams report better overall financial performance, according to an extensive survey of 1,700 firms across eight countries conducted by the Boston Consulting Group (BCG).

- EBIT margins for the more diverse companies were 10% higher than for those companies with below-average diversity on their management teams.
- Management teams with above-average diversity reported earning nearly half their revenue from innovative products and services—nearly 20% more than companies with below-average diversity on their management teams.
- BCG's large sample extended across a variety of industries, countries and sizes and observed factors such as age, gender, career path, education, industry background and nationality.
- Companies with above-average scores in these factors also showed a significant correlation with greater innovation. In other words, nearly half the revenue of companies with more diverse leadership came from transformative products and services launched in the past three years.

The connection between diversity and innovation also appears in a study by the Harvard Business Review, which with partnered with the Technical University of Munich and BCG. It found:

- Companies with above-average total diversity across their workforce had both 19% higher innovation revenues and 9% higher EBIT margins, on average. Innovation in this case is measured in terms of new lines of revenue within the past year.
- The study looked at around 1,600 firms in eight different countries, and the results were staggering.
- The most-diverse enterprises were also the most innovative, as measured by the freshness of their revenue mix within the last year.

- The six dimensions of diversity measured (migration, industry, career path, gender, education, and age) had statistically significant correlations with innovation, both individually and collectively, although industry, nation of origin, and gender had slightly larger effects. The study found innovation revenues could increase by 1% by enriching the diversity of the management team, 1.5% with respect to national origin, 2% with respect to industry origin, 2.5% with respect to gender, and 3% with respect to managers with different career paths. With greater increases on more dimensions, the total uplift potential could therefore be even more significant.



Gender, ethnic and cultural diversity all help improve corporate results, finds a McKinsey study of more than 1,000 firms in 12 countries. The study's results revealed:

- Companies in the top quartile for gender diversity on executive teams were 21% more likely to outperform on profitability and 27% more likely to have superior value creation.
- Companies in the top quartile for ethnic/cultural diversity (LGBTQ+, age/generation, international experience) on executive teams were 33% more likely to have industry-leading profitability.
- The two studies used two measures of financial performance – profitability using average EBIT margins for non-financial companies, and average Return on Equity (ROE) for financial companies over five-year periods starting in 2010. Value creation was measured as average economic profit as a percentage of average revenues over the same five-year periods.
- The highest-performing companies on both profitability and diversity had more women in line roles (typically revenue-generating) than in staff roles on their executive teams.
- Overall, companies in the bottom quartile for both gender and ethnic/cultural diversity were 29% less likely to achieve above-average profitability than were all other companies in the data set.

Firms with a higher percentage of a female workforce experienced 2% higher average relative returns compared to other companies in the same regions, according to a Morgan Stanley study. It also revealed:

- Over a six-year period, companies with more gender diversity enjoyed a one-year return on equity that was 1.1% better than companies with low female representation.
- Explaining the results is always more difficult. This study suggests gender diversity may contribute to better employee engagement and employee satisfaction. Interestingly, there seems to be a statistically significant relationship between diversity practices and employee engagement at work, for *all* employees, not just women.
- The research also suggests companies that simply keep their workforce motivated and engaged are able to retain their employees for longer, which helps reduce costs related to turnover.
- A separate 2016 MSCI study looked at the tipping point of female representation on corporate boards and found that U.S. large-cap companies with at least three women on their boards in 2011 had median increases of 10% in ROE and 37% in EPS by 2016. Those with no women had median decreases of 1% and 8% in ROE and EPS, respectively, over the same period. The study covered 532 representative companies from the MSCI World Index.

Diversity also contributed to the performance of asset managers, according to a Harvard Business Review study that found diverse investment teams delivered more profitable exits:

- Venture capital firms that increased their proportion of female partner hires by 10% saw, on average, a 1.5% spike in overall fund returns each year and had 9.7% more-profitable exits (for context, roughly a third of all VC investments have a profitable exit over a 26-year period).
- Conversely, for investments by partners with shared-school backgrounds, performance was worse. The comparative success rate of their exits was 11.5% lower, on average, than for those by partners from different schools.
- The effect of shared ethnicity was even stronger, reducing an investment's comparative success rate by 26.4% to 32.2%.
- The study examined the records of 42,502 firms from 1990 to 2016 and found that 8% of their employees are female, about 2% Latino, and fewer than 1% of investment team members are Black.

The suggested benefits of diversity in organizations do not just stop at improving margins or talent pools. The National Bureau of Economic Research attributes about 25% of the GDP growth per capita in the U.S. to the greater prevalence of white women and Black Americans of both genders in the workplace.

- The study looks at GDP trends beginning in 1960, when significant barriers prevented white women, Black women, and Black men from entering highly skilled occupations (in fields such as law, medicine, science, academia and management). The research found that gender and racial diversity have increased markedly in such fields over the past 60 years and links that change to improvements in aggregate productivity.
- In short, the authors argue, the United States began making better use of the talent at its disposal and delivered better results.
- The analysis of highly skilled occupations shows a positive relationship between diversity and the value of goods and services produced in the United States.

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