



the power of
change

The what, why and how of creating a
diverse private markets portfolio



welcome to brighter

Introduction and methodology

Challenging assumptions, creating opportunities, investing for change



Appetite for embracing and promoting diversity, equity and inclusion (DEI) within institutional investors' portfolios is increasing, coinciding with a push into private markets. We've explored what we believe to be the best ways to combine these aims within an investment strategy.

This paper draws on various studies probing DEI in private markets — from both our own research and third-party sources. We also assessed diversity efforts more broadly to gain a holistic understanding of their impact on an organization. Our research included evaluating the private markets DEI programs of various asset managers and reviewing conversations with investors on their emerging manager programs to assess how they create, implement and oversee specific approaches.

For now, at least, there is no consensus on a precise definition of DEI in investment practice. Even when descriptions seem aligned among investment organizations, the respective thresholds for achieving diversity may not be. To create a common frame of reference in this paper, we use the labels “DEI managers” and “diverse managers” to refer to fund managers that are at least majority-owned by women and/or minorities.¹

Change brings opportunity. We have the power to make this change happen.

¹ “Minorities” refers to African Americans, Hispanics, Asians, Native Americans, LGBTQ+, disabled people and US military veterans. LGBTQ+ is defined as lesbian, gay, bisexual, transgender, queer and/or questioning, and self-identifying members of the community who are not included in the LGBTQ acronym.

The why: The case for DEI

There are several motivating factors behind investors' recent push to develop DEI allocation programs. These include broad ESG-related goals, fiduciary or regulatory duties, and perhaps increasingly, a recognition that institutional investors — who control much of the industry's capital — must act to address systemic imbalances. These investors have driven relatively rapid action on climate change and other environmental issues. Collaborative support could also lead to swift, positive change on DEI.

And although the impact of DEI on private markets fund performance is still uncertain, research indicates that diversity typically results in improved corporate performance. A 2015 McKinsey study showed public companies in the top quartile for gender diversity are 15% more likely to have financial returns above their respective national industry medians — and for ethnic diversity, that percentage increases to 35%.²

Although not causation, this correlation suggests firms committing to diversity may be more successful. To apply this conclusion to private markets fund managers, more diverse proponents could outperform benchmark medians. This should encourage investors to consider implementing DEI manager programs to help satisfy ESG-related goals without necessarily compromising returns.

Because of the small number of diverse private markets managers available, determining the full impact of investing with them remains challenging. Yet growing empirical evidence suggests they have the potential to outperform their benchmarks.^{3,4} As the DEI manager universe develops, the impact of diversity on fund performance will likely become more apparent.

² Hunt V, Layton D and Prince S. "Why Diversity Matters," McKinsey & Company, January 2015.

³ Bella Private Markets. *2018 Diverse Asset Management Enhanced Performance Analysis*, January 2019.

⁴ NAIC. *Examining the Returns*, 2019.



Potential for improved performance

There are compelling reasons that DEI private markets managers might outperform benchmarks. Operating in different networks may enable their investment teams to access exclusive opportunities and deal flow. Growing research also suggests diverse teams make better decisions,^{5,6,7} are less likely to be influenced by unconscious biases and may benefit from differing perspectives. Additionally, diversity of opinion can improve how managers source and identify talent within their own teams and portfolio companies.

Moreover, diversity within a team could impact how managers allocate capital. The deal flow generated by a diverse team may encompass opportunities in communities or industries historically underserved by private capital. These could include businesses

run by diverse entrepreneurs or those that have diverse teams themselves. To the extent that this diversity leads to better decision-making, this suggests an increased potential for alpha generation, as enhanced decision-making may generate greater innovation and better performance.

Recent analysis by the Carlyle Group (“Carlyle”) supports this notion. This analysis showed that the average earnings growth of Carlyle portfolio companies with two or more diverse board members was nearly 12% greater per year than its average portfolio company over the past three years. Companies with diverse boards generated earnings growth five times greater on average than their less diverse peers, with each diverse board member associated with a 5% increase in annualized earnings growth.⁸

⁵ Woolley AW, Chabris CF et al. “Evidence for a Collective Intelligence Factor in the Performance of Human Groups,” *Science*, Volume 330 (2010), pp. 686–688, available at <http://www.chabris.com/Woolley2010a.pdf>.

⁶ Kaplan S and VanderBrug J. “The Rise of Gender Capitalism,” *Stanford Social Innovation Review*, Fall Issue (2014), available at https://ssir.org/articles/entry/the_rise_of_gender_capitalism#.

⁷ Phillips KW, Liljenquist KA and Neale MA. “Better Decisions Through Diversity,” 2010, available at https://insight.kellogg.northwestern.edu/article/better_decisions_through_diversity.

⁸ Thomas JM and Starr M. “From Impact Investing to Investing for Impact,” The Carlyle Group, February 2020.

The what: Definitions of DEI in investments

For investors to create and deploy robust DEI investment programs in private markets, they need a clear, consistent and quantifiable definition of DEI in investment practices. This definition should be specific about DEI principles and how they relate to the entire manager universe to avoid confusion among firms that may look similar. For example, although emerging managers are often led by professionals who would be considered diverse, they may not qualify under specific DEI criteria. To be clear, “emerging managers” in private markets refers to managers that have only recently begun to manage institutional capital.

It’s also important to allow the definition to evolve over time to stay relevant and provide the investor with needed guidance.

We believe investors should focus on criteria that have real influence and significance within a DEI program, and we’ve outlined some of these below.

Fund manager ownership: Clarifying the level of ownership by a recognized minority group can be useful when applying and evaluating a DEI program since this can vary significantly within private markets. Some programs specify a threshold: minimum ownership of around 25%. Others state that a “significant” proportion needs to be owned by those identifying as belonging to a minority group.

Investment committee composition: With responsibility for final approval of investment decisions — and potentially investment policy governance — assessing diversity levels within this central committee is also meaningful. Further, it can help identify and avoid situations where the company’s owners — who may tick the DEI boxes — aren’t truly driving the manager’s direction and growth.

Investment team composition: The composition of a firm’s investment team is another meaningful criterion when evaluating DEI. Not only do its members have a direct impact on investments, but these teams are regularly reshuffled, allowing investors to gauge whether change is actively taking place.

Thresholds: The higher the threshold on DEI requirements, the smaller the potential investment universe. However, aiming for a majority on any of the above criteria shows investors’ commitment to changing the industry landscape. That said, having some flexibility on thresholds by implementing an “at-least” element would enable investors to



capture fund managers that are moving in the right direction and open up a slightly larger universe.

For example, implementing an *at least* 50% threshold would capture fund managers with a 50:50 ratio of a minority group to a nonminority group. Although this is not a *majority* of minorities, most would agree it is still significant and worth consideration. To avoid the potential for compromise on a DEI program while also increasing the investment universe, investors could implement thresholds on a range of measures, including those outlined above, and consider all managers that meet at least one of them.

Alignment: Fair and aligned compensation between minority groups and those that have traditionally held investment roles is another useful metric for investors in their DEI programs. To qualify for an allocation, all professionals at the fund manager should be appropriately aligned, incentivized and compensated across each related cohort.

The how: Putting theory into practice

How to allocate

A DEI program should fit within an investor's overall risk appetite. If a DEI investment program is part of a broader private markets portfolio, indicating what underlying private markets asset classes the investor intends to target can be helpful. This determination can include either hard allocation targets, which indicate strategy intention and expectation, or soft allocation targets, which allow flexibility for adapting to changing market environments and opportunity sets.

However, investors need to be aware that the total capital committed to DEI managers may be limited at the start of a program. But this can be revised over time as the investment universe — and returns — develop. To facilitate deployment, consider screening DEI private markets managers alongside traditional peers. Doing so may also reduce the risk of selecting a firm for diversity's sake.

How to implement

The size and sophistication of an institutional investor will likely determine much of its implementation strategy. Time, resources and expertise all play a part in researching, identifying and evaluating diverse managers that may ultimately operate in a foreign jurisdiction.

But investors have options — from pure-advisory models, allowing investors with the capacity and expertise to identify diverse managers themselves, to fully delegated solutions that use specialist teams to source, research and gain access to a range of new managers. Such solutions can also implement the portfolio allocation, including full due diligence tasks. Program structures may offer ongoing monitoring and reporting. They can also provide feedback if a manager isn't selected or is terminated from a mandate, retaining an open dialogue in case of future interest.

Due diligence

Although we believe all managers should meet the same standard for investment, there are several notable due diligence areas specific to DEI manager selection. We discuss some of these below.

Track record: Because some diverse managers may not have long track records, it's essential to find ways to mitigate performance risk. Representative track records compiled from senior professionals' prior experience or typical asset class or peer group benchmarks should provide guidance.

Experience: We value prior experience working for an institutional fund manager and as a team. This experience is especially significant if the manager is raising its first fund. In such instances, it is often useful to evaluate whether senior leadership relationships have been stress-tested and whether senior management has experience building out teams. Talking to the team's advisors and mentors may also be helpful.

Alignment: There needs to be alignment between the fund, its managers and the overall organization. Probing financial incentives is important, but cultural evaluations can help. For a DEI program, it's useful to assess the alignment of financial incentives across all professionals on an investment team and the organization more broadly. Examine the decision-making influence of minority groups to ensure alignment, and make sure HR policies promote meritocratic DEI hiring, particularly within the investment team.

Operational due diligence: Due to its size and lifespan, a DEI manager's compliance or reporting functions may be less robust than those of its larger, more established peers. Senior professionals may be responsible for managing many different business functions, which could distract them

from investment activity. Employing a third party to oversee and monitor these functions can help mitigate risks. Thoughtful outsourcing to relevant third parties can be assessed during due diligence.

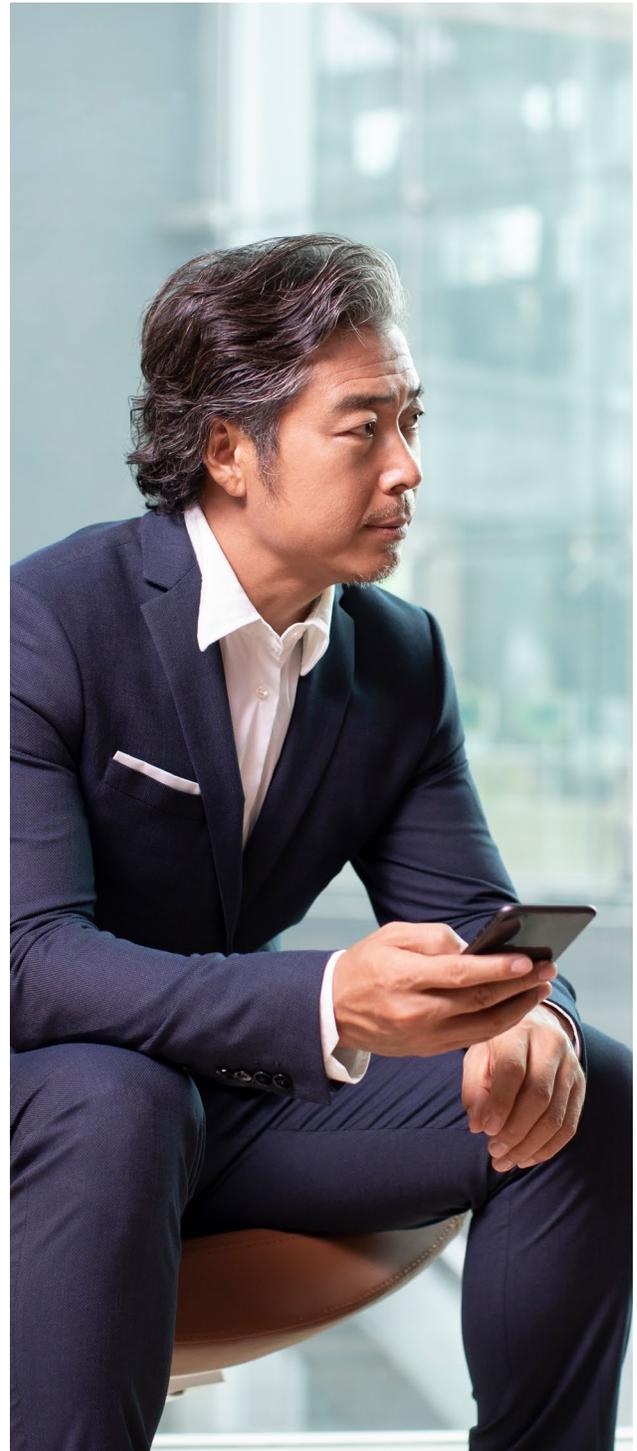
Ongoing tasks: Overall, investors need to create their own frameworks for monitoring and evaluating their DEI programs and ensuring they're meeting relevant objectives and investment targets. Key performance indicators can be useful and should encourage data collection on diversity and a range of other important metrics. This will help create a better picture for measuring the broader industry on DEI.

Measuring up and making a difference

Senior leadership support of an institutional investor's DEI program in private markets will likely be essential for achieving buy-in across the organization. Further buy-in may be achieved by tying goals to attainment and performance. Ensuring leadership understands the potential for attractive returns from DEI managers and is directly nurturing the next generation of talent is a good first step.

Visibility and leadership backing should help in reaching program objectives. Firm oversight of the program is crucial to ensure best practices and investment targets are being met. For credibility in the wider market, this oversight should come from a team with experience, gravitas and its own diversity. Proper documentation of the program and processes should be developed and periodically updated, and the program should fit within an investor's overall portfolio objectives.

An investor's actions should also reflect its DEI investment program. Merit-based diverse hiring and retention policies and training on biases and inequality are practices any investor can implement to increase the breadth of its staff.



Conclusion:

Making DEI work in private markets

There is much to consider when creating, launching and owning a DEI program in private markets, but evidence shows a growing number of institutional investors are eager to enter this market. With clearly defined strategies, rigorous and disciplined approaches to allocation, and sustained support through implementation, we believe these programs are well-placed for the future.

Investors don't have to make this journey alone. Advisors with the resources and expertise in this specialist field can offer guidance and support on strategy, implementation and monitoring.

As momentum for improving DEI builds within the investment industry, the potential for collaboration on best practices and discovering new investment opportunities continues to grow. We hope and expect this momentum will create a broader, more inclusive industry that targets — and meets — investment objectives.

Be the change. Invest to make it happen.

For further information, please contact your local Mercer consultant and visit <https://www.mercer.ca/en/what-we-do/wealth-and-investments/investment-solutions.html>.

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