09.30.2018

**Summary: LP (Asset owner) round-table, PRI & EQUALS, United Nations**


**To**
EQUALS PRI Roundtable Participants

**From**

Gitanjali Swamy and Ursula Wynhoven, EQUALS.org

Bettina Reinboth and Nabylah Abo Dehman, unpri.org

**CC**
EQUALS Team
PRI Team


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Summary

## True Cost of Predatory & Discriminatory Behavior in Tech Investing (Diversity & Inclusion)

On September 14, the Leadership Coalition of EQUALS ((the Global Partnership for Gender Equality in the Digital Age) and the United Nations Principles for Responsible Investment (PRI) hosted an Asset Owner/Limited Partner(LP) led breakfast discussion on understanding the business case for diversity and inclusion in tech investing. This effort is motivated by statistics on the low investment in women in tech (Women-founders receive just 2% of VC investment today, of which 77% is in technology) and recent revelations on persistent discriminatory and predatory behavior towards women in the industry.

This interactive investor roundtable shed light on the true cost and benefit of diversity and inclusion practice, using recent research from both academia (Berkeley, GMU, Harvard) and industry (BCG) to discuss how the findings show a quantitative demonstrated correlation between good diversity and inclusion practice and investment performance.

### Outcomes

The event concluded with the following action steps:

- The Asset Owner Community requests more events and forums such as this EQUALS-PRI roundtable. The primary purpose of such events is to help LPs (asset owners) know that they are not alone in trying to solve this set of challenges, to enable LPs (asset owners) to share best practice and to take action as a group. There is a strong need for role models and room to build better capacity in handling diversity and inclusion issues (including establishing demands from Asset Owners/LPs to managers/GPs)

- The Asset Owner Community shared experiences show that there is no single silver bullet and LPs (asset owners) have to try a variety of simultaneous efforts ranging from legal protections to special vehicles and most importantly action to change harmful social norms.

- The multiple research, survey and analysis presented around diversity and inclusion (including predatory and non-inclusive behavior) support the benefits of embracing diversity and inclusion. The LP community also requested that we continue to articulate and market these insights. The LP community re-iterated the need for continued discussion and documentation of success stories so as to create a common resource for the industry to draw on.

- The most effective ways to initiate a discussion on diversity with investees includes a discussion around the practical business case for it and a re-iteration of the institutional values around it. Uniformly, Asset Owners/LPs have found the approach of leading with values and the business case to lead to a receptive audience among the Managers/GPs. We have to have a clear rationale, i.e. institutional values require us to invest in ways that support institutional beliefs and commitment, we want the best returns, and we are missing a large proportion of competence, when we leave out some of the best people (because of gender and/or other irrelevant factors) and don't have some of the best performing companies

- Finally, given the lack of a current community of practice to rely on in these matters, the round-tables should aim to create a guidance on a set of recommendations for industry members that list 3 types of action steps:
  - Step 1: Baseline must haves
  - Step 2: Good practice forward
  - Step 3: Best in class solutions

### Challenges

The first challenge discussed by the round-table was around measuring and operationalizing diversity. It is challenging to determine how to measure diversity. Diversity must be an organization-wide issue and not only about the number of women on the board or in senior leadership. In general, total transparency on these matters is critical for proper measurement. But while the lack of transparency is a big issue for LPs, it is also an uncomfortable one for managers/GPs. LPs are seeing increased transparency, which is also leading to many more uncomfortable conversations. In gaining more transparency and early identification of pertinent risks related to diversity, some best practices include: expanding due diligence to cover these issues, allocating budget and staff time, and use of relevant tools and external support as needed. But it is consistently hard to push back against outliers – e.g. Sequoia has been very successful to date without having any diversity, the business model for Tiger management was built on very homogenous and non-diverse cliques.

It can be very difficult to retroactively bolt on diversity, especially when the particular business model hinges on homogeneity. It has been particularly hard to make the diversity argument to exceptionally performing outliers that have limited motivation to change and are the firms that LPs most wish to invest in. This perpetuates the myth that diversity does not pay.

Other areas of challenges identified lay in how to encourage deployment of capital to women. It is often said that there is a big pipeline problem in deploying capital to women, because LPs don't see as much diversity in the pipeline. They would like to see more women-led business in their portfolio, but it unclear if this is due to restrictive criteria that is tailored to a particular demographic or whether there is indeed a shortage of women entrepreneurs. Put differently, is it due to an over-engineered financial product or a is it due to a poor entrepreneur pipeline? LPs are starting to see steps forward in access to capital in emerging markets; e.g. China has the largest number of women entrepreneur unicorns.

Laps also noted challenges with having a universal framework for diversity "hygiene" factors. While we must bring in diversity in every due diligence meeting, it continues to be an effort to sustain that practice. It was noted that sometimes it isn't just that managers/GPs lack women, it was that managers/GPs were also very homogenous in background; e.g. they only come from firms such as BCG, McKinsey, Goldman and had gone to the same schools such as Stanford, Wharton, Harvard.

**Data & Analysis**

The meeting was unanimous in arguing that a strong data driven basis was emerging in understanding Cost & Value for diversity and inclusion. But the statistics were concerning, with women constituting only 6% of VC investment professionals. Research from Berkeley, GMU and Harvard also validated LP intuition on the negative impact of predatory behavior in private capital: there was a strong negative correlation between investment performance and predatory behavior in private capital. But Asset Owners/LPs were unsure on the shift from data to action, being unable to quantify the exact moment to catalyze change and motivate tangible action. LPs argued that women getting access to equivalent funding as male counterparts (looking for investment capital to fund business) doesn't solve the systematic issue. LPs are wondering whether having female founders approach female-only funds silos the situation further.

In the context of public markets, the data showed a conclusive pattern between gender inclusive government policies and superior equity performance. Using data from University of Gothenberg, Leitner et al ran a regression analysis between democracy indicators and equity performance. There was a strong positive correlation between the number of female legislators in parliament and equity returns. Women's rights and participation have improved over the previous 5-10 years in 17 emerging countries, while women's rights stayed relatively constant in developed nations. Thus, a better analysis related improvement in gender rights to equity performance. The results showed that countries with improved women's political empowerment had equity markets which outperformed the MSCI EM index over the 18½ years from 2000 through 2018 by about 3.5 percent per annum using a 5 year look back rule. In 2018 alone the women's rights indicator improved the downside by almost 10 percent.

In the context of private markets, the data showed a high negative correlation between predatory practices and poor investment results. Research by Smith, Auerswald, Swamy used a predatory behavior index (PBI) incorporating multiple types of bad predatory behavior. The coefficient was -0.31 for TVPI v.PBI, resulting in a 45% lower performance on TVPI for firms with predatory behavior. DVPI and IRR have similar correlations. The above result makes intuitive sense – Losing the benefit of the capabilities of 50% of the human race and abusing the workforce will lead to suboptimal results.

Finally, BCG data on organizations showed that Diversity results in better decision making, more innovation and higher resilience. BCG had partnered with Mass Challenge and found that start-ups founded by women receive less in investment, but generate more revenue. The experiments controlled for education of co-founders/founders and quality of investment idea. In summary, experimental data from Mass challenge shows that women entrepreneurs are just better bets – greater capital efficiency, greater percentage of high growth businesses. Of note, when women become 30% of an organization or group, the nature of the organization changes and ensuring diversity or inclusion become less of an organizational battle.

**Marketing & Awareness**

The round-table uniformly agreed that the aforementioned gender diversity and inclusion data and analysis must be marketed in the industry. In particular, the following suggestions were made (1) Create repositories of data and best practices for industry collaboration (2) Market positive impacts of diversity (3) Create greater industry transparency on predatory behavior.

Typically, when a discussion on diversity is initiated, many CEOs ask why diversity matters and tangible proof is required that diversity results in more innovative products/services, adaptability as well as agility of functions. The start-up community is particularly challenging on pay gap and equality.

**Solutions for Diversity**

The group agreed that there was no silver bullet for ensuring diversity and inclusion. Instead they suggested a hierarchy and portfolio of intervention actions**.** Given that there is hard data on performance which reinforces the business case, it would be desirable to have an industry set of recommendations such as Baseline hygiene must haves, Good steps forward and Best in class solutions.

The biggest challenge lies in creating a community of practice from different LPs. Given the past reticence on the part of LPs to address this, few best practices have yet emerged in how to effectively legislate for diverse and inclusive investments. The first step in this is leading with a discussion on institutional values in diversity & inclusion, this should be followed by creation of virtuous diversity cycles in the ecosystem that result from re-enforcement of successful practices.  Investing practice must run true to institutional values.

Specific efforts in training and encouragement of women are also needed. In addition to training and education of women themselves, efforts must be made to ensure the same in the broader industry to increase its awareness of the issues and best practices.

Recognition in the form of "awards" are important both for particular women and effective diversity programs. Women must also be trained to negotiate and claim value more effectively because women are shown to consistently ask for less. It can be a vicious cycle; often asking for less leads to failure from under-resourcing and under-capitalization. On the positive side, women appear to have stronger coaching networks. The creation of nomination committees that focus on identifying and nominating high potential candidates to boards, companies, coalitions are necessary. An effort must be made to ensure diversity in decision making roles, which in turn leads to a positive cycle in other areas.

One of the nuances that has been overlooked is explaining to large investors how having a view on gender indicators, would de-facto capture many other indicators. E.g. Since women tend to be more committed to public benefit, solutions that incorporate their perspective also tend to be more oriented to public and social good. We may get better impact on issues like climate change simply by engaging more women in the decision making. Investors should also focus on pushing corporations to move talent to value creation in the organization. This is different from the current inordinate emphasis on hierarchical organizational movement. Instead, it consists of moving both women and men into the areas where they add more to value creation. It may require changes to how rewards are distributed within an organization, focusing on value creation rather than one's position in the hierarchy to decide that.

**Practitioner's Advice: What Works Well**

There were many individual practical and experience-based suggestions that emerged from the discussion. Firstly, it was important to highlight what had worked in practice in diversity and inclusion efforts. It was demonstrable that Quant portfolios based on gender participation selection perform better. In the domain of active management strategies, increased diversity in management (critical 30%) has been shown to consistently give better returns. Furthermore, increasing women on boards has been shown to gives better governance resulting in better boards.

Conversations on diversity and inclusion with investees, must be approached in a strategic and diplomatic manner. It has been found to be most effective to first have a discussion on institutional values with your investments. It is important to explain the overall commitment to institutional values; diversity and inclusion being one such important value.

Deeper and better diligence is a best practice. It is surprising how few LPs are willing to spend $1500 to commission a private investigator's report before placing millions of dollars. During diligence, it is far better to wait to make investment until the investors are satisfied that the right organizational processes are in place to ensure that positive organizational behavior will result and negative behavior will be culled out early. Better and robust diligence always pays off in investment performance.

Legal best practices include instituting side-letters in investments as it relates to diversity and inclusion practices. It is essential to always reserve the right to pull money back if diligence exposes specific issues around predatory practices. Risk best practices also play a role in good diversity and inclusion process. Large public LPs argued that diversity tends to be labelled as a social issue but it's really a risk issue for institutional investors. Therefore, investors should try to quantify exposure from predatory practices and corrective/protective measures to reduce that exposure. The rationale should be communicated to investees. Diversity is somewhat analogous to environmental and climate issues; successful follow on funding was also an issue in climate investments.

More transparency always works well in investment process. While many LPs have not yet successfully implemented legal representations around diversity or specific instances of non-inclusive and predatory behavior, clear communication about transparency of the same during the process, is beneficial. Performance standards work well in creating diversity and inclusion; unfortunately, the industry has not yet established benchmark standards on the same. Today no-one knows what or where the bar is, what is good and what is bad in this domain.

LPs consistently felt that building better capacity for diversity is necessary. Most GPs complain about lack of pipeline and point to it to justify their lack of diversity. But it is unclear whether the lack of diversity is indeed a pipeline capacity issue or a lack of cognizance/awareness of any approach other than self-selection. Many LPs are looking at new types of investment vehicles, potentially multi-stage ones, to address the pipeline issue.

Certain organizations were more uniquely at an advantage in managing diversity and inclusion better. Larger organizations with other financial businesses such as debt, advisory may be able to manage diversity better due to cross benefits between different businesses. This way, the umbrella could offer many different financial products to women entrepreneurs as opposed to reject them if they were not the right fit for a particular form of venture capital. Larger and multi-product organizations could also invest in initiatives for boosting diversity outside fund vehicle to avail of economies in scale in serving all investment areas. Smaller organizations find it hard to manage diversity especially if it is a bolt-on that is retrospectively added on due to outside pressure.

Interestingly, new emerging markets and investment categories showed a greater willingness to embrace diversity. China has the largest number of female unicorns and female leaders. In fact, pushing diversity into end values *a priori* is shown to be far more effective than retrospective change.

The community is well aware that small pools and allocation to diversity are not enough to solve the diversity problem or even reach a steady sustainable state but they felt it was critical to start somewhere. If these small pools could be combined with a focus on more effective human capital management, it gets a strong reception in the corporate world.

**Practitioner's Advice: What Does Not Work Well**

There are many practices that have been demonstrably ineffective and the round-table participants felt it was important to highlight these in the discussion.

The first ineffective practice was creating special set aside pools without a follow-on funding. Industry practitioners observed a huge drop in the number of women after the very early stage. This cliff at the start characterized many efforts in creating set-aside investment pools. But one participant observed that subsequent growth equity women-only fund pools didn't work either because there was not enough pipeline so the pool never got called completely.

Another ineffective practice was attempting to transform very non-diverse firms into diverse firms just by seeking to bring in women without being willing to make further changes. This usually fails because the business model is optimized for the homogeneity of participant networks (e.g. tiger management). Understandably, it was even harder to have this discussion and effect this form of change in exceptional outlier firms. Thus, introducing diversity required the simultaneous creation of a new business model.

Finally, outsourced and small diligence budgets invariably almost result in disaster. Diligence is a critical function that required proper commitment and investment.

In conclusion, the round-table laid the basis for continued constructive dialog, sharing of best practices and organized action towards acknowledging the true cost of predatory and discriminatory behavior and leveraging the true value of diversity and inclusion. EQUALS and PRI will commit to the action steps laid out with a view to hosting a second event and developing a draft guidance document over the next two quarters.