Investment perspectives

Diversity of thought can lead to improved outcomes

Asad Rashid
Senior Investment Research Consultant

One of the core pillars of a well-constructed portfolio is diversification. Whether in terms of the sources of return or the risks of individual assets, diversification aims to mitigate risk and reduce portfolio level volatility, which can improve overall risk-adjusted returns.

One of the lesser known facts is that as researchers, we extend this concept of diversification to investment teams. When we evaluate actively managed funds, one of the metrics we consider is diversity of thought in the investment teams. We assess whether the team are all from similar firms in the industry or have worked together for so long that they could be susceptible to group think, which can result in unchallenged decision-making. We often look for evidence of external hires or junior professionals who can provide some challenge to the investment ideas under consideration and prompt more rigorous debate.

Diversity of thought is closely linked to diversity and inclusion – as evidenced by the case studies discussed in this article, the investment teams with a high success rate are typically those that have smart people who think differently, who have been trained differently, went to different schools, have different knowledge bases and have different genders and ethnic backgrounds. Global economies and supply chains are now so inter-linked that challenges or regulations in one country can have significant effects on the economy of another country. A diverse and well-networked group of professionals is likely to have the best chance of responding to such challenges.

We focus on diversity of thought in teams because individuals with a different background to the existing team can often spot risks or understand local trends that might be missed by others. This typically improves the group's collective accuracy, analytical thinking and innovativeness.

Case Study 1

A 2018 study[1] by Harvard Business Review on venture capital firms (an ideal test subject given the investments and the responsible decision makers are easily identifiable) found that diversity can improve financial performance both at the portfolio company level and on overall fund returns. Investment teams with shared school backgrounds, or shared ethnicity, tended to have a comparative success rate between 11-32% lower than more diverse teams.

The study identified that success was delivered not at the stage of initial investment, but as a result of ongoing involvement of a more diverse team in later strategic decisions and recruitment, and because creative thinking is required to support the growth of young companies.

Case Study 2

In 2016, a Morgan Stanley study[2] on more than 1,600 stocks globally found that gender diversity can lead to a 2% higher return on equity with lower volatility. Digging deeper, Morgan Stanley found that the reasons behind this better risk-adjusted

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[1] https://hbr.org/2018/07/the-other-diversity-dividend
[2] https://www.morganstanley.com/ideas/gender-diversity-investment-framework

return were that companies with a diverse workforce had increased productivity, had better decision-making, greater innovation and higher employee retention and satisfaction. The effects of having a more diverse workforce proved beneficial to these companies.

Case Study 3

McKinsey have conducted several studies on the link between diverse leadership teams and company performance (in 2015, 2018 and 2020).

Their 2020 study[3] (conducted on 1,000 large companies in 2019 before the global pandemic) found that the link between the likelihood of financial outperformance and gender diversity / ethnic diversity has strengthened over time. Companies in the top quartile of McKinsey's dataset for gender and ethnic diversity were more likely to have a higher earnings before interest and taxes ("EBIT") margin than companies in the bottom quartile. The percentage of companies that demonstrate this positive relationship has risen from 15% to 25% on gender diversity and from 35% to 36% on ethnic diversity over 2014 to 2019.

Case Study 4

A 2019 study by RockCreek, the International Finance Corporation and Oliver Wyman[4] found that funds with gender balanced senior investment teams (more than 30% of the opposite gender) have historical investment returns that are 10 to 20% higher than those with a majority of male or female leaders. The underlying portfolio companies in these funds with gender diverse leadership teams outperformed their less diverse counterparts by 25%.

Interestingly, the researchers found that investment teams that skewed heavily toward a particular gender underperformed gender-balanced teams. The key takeaway from the study was that the balance between genders can contribute to outperformance due to the increased diversity of thought and background.

The study also included a survey of more than 500 fund managers and institutional investors. This survey revealed that while 65% of institutional investors surveyed said they consider gender diversity to be important when choosing managers, only 25% of them asked fund managers about the gender diversity of their firms when conducting due diligence.

How can you assess diversity of thought in asset managers?

Diversity should not be seen as a "tick-box" exercise and the results of these case studies show the financial benefits and impact of diversity of thought in both public and private markets. Here are our main takeaways you can consider when assessing diversity within your asset managers:

- Ask for indicators of diversity, such as gender and ethnicity splits of key decision-making teams in the asset management firm. How have these indicators changed over time?
- Can the asset manager supply information to support an assessment of the link between diversity and financial performance?
- Recognising that indicators are just that, can the asset manager provide case studies demonstrating how diversity of thought works in practice in their investment teams? E.g. can they provide evidence of how investment ideas are debated, with examples of challenge? Such case studies are likely to highlight the better decision-making, greater innovation and higher employee satisfaction, which are the leading indicators of diversity of thought.

We believe asking these questions will encourage a greater focus on diversity of thought and help engagement with your managers.

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[3] https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matter

[4] https://www.institutionalinvestor.com/article/b1df7fg0bq3jfv/Want-20-Higher-Returns-Do-This

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