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United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

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RANKING MEMBER

June 20, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: June 25, 2019, "Diverse Asset Managers: Challenges, Solutions and Opportunities for Inclusion."

The Subcommittee on Diversity and Inclusion will hold a hearing entitled, "Diverse Asset Managers: Challenges, Solutions and Opportunities for Inclusion," at 10:00 a.m. on Tuesday, June 25, 2019, in room 2128 of the Rayburn House Office Building. The witnesses for this one-panel hearing are:

- **Juan Martinez**, Vice President/Chief Financial Officer and Treasurer, Knight Foundation
- **John Rogers**, Chairman, CEO & Chief Investment Officer, Ariel Investments
- **Brenda Chia**, Founding Board Member & Co-Chair, Association of Asian American Investment Managers (AAAIM)
- **Angela Miller-May**, Chief Investment Officer, Chicago Teachers' Pension Fund
- **Meredith Jones,** Investment researcher and Author

Purpose

This hearing will explore the challenges minority- and women-owned (MWO) firms face trying to compete in the asset management industry, and will discuss legislation to increase the use of diverse asset managers by institutional investors.

Background

Asset managers manage funds on behalf of institutional investors. Institutional investors, such as pension funds, endowments and foundations, can be public or private entities that pool funds on behalf of others and invest the funds in securities and other investment assets. Generally, institutional investors rely on their investment boards of directors or trustees, investment committees or other investment staff as well as investment consultants to decide how their funds are managed and by whom. The investment boards of directors or trustees may also include a Chief Investment Officer (CIO) as the executive responsible for the fund's investment portfolios and oversight of the investment team. Investment consultants may also be used to source, vet and provide recommendations on asset managers qualified to manage funds.[1]

Underrepresentation of MWO Firms Asset Management

Although MWO firms account for approximately 8.6% of all asset management firms, recent reports show that they only manage 1.1% of all assets under management or $785 billion out of $71.4 trillion, and are underrepresented as managers in every asset class.[2] In its 2017 report, GAO identified 186 MWO firms in the asset management industry, but concluded that use of MWO managers for federal assets remains low.[3] They found that four of the ten federal pension plans they reviewed used no MWO firms to manage their funds.[4] Of the pension funds GAO reviewed that were using MWO firms, those MWO firms were managing less than 1% of pension fund assets.[5]

In April 2019, the House Financial Services Committee sent a letter to the Federal Thrift Retirement Investment Board (FTRIB), which manages the Thrift Savings Plan, requesting an update on its diversity policies and the number of MWO firms used to manage the Thrift Savings Plan.[6] According to GAO's 2017 report, FTRIB said it had not implemented GAO's recommended diversity practices and did not have plans to do so.[7] Although FTRIB rightly asserted that it has a fiduciary responsibility to limit making guarantees about any mutual fund offerings, the Committee letter asserted that GAO's recommendation did not require FTRIB to provide such guarantees of any MWO mutual fund offering specifically. Instead, GAO's recommendation advised the implementation of key diversity practices to help broaden FTRIB's selection and consideration of qualified MWO firms. In response to the Committee's letter, FTRIB said it continues to not use any MWO firms and have not implemented any new diversity policies.[8]

Barriers and Biases Blocking MWO Firms from Being Selected to Manage Investments

Despite evidence that MWO firms perform as well as (and sometimes outperform) their industry counterparts, they are not consistently selected to manage institutional assets. Several reports discussed below have found the reasons for this are unconscious bias against MWO firms and a lack of intentionality by institutional investors to identify and assign management opportunities to qualified MWO firms.

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[1] GAO, *FINANCIAL SERVICES INDUSTRY: Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority- and Women-Owned Asset Managers*, GAO-17-726 (September 2017).
[2] Josh Lerner, Ann Leamon, Meagan Madden, and Jake Ledbetter, *Diverse Asset Management Project Firm Assessment*, Bella Research Group (May 2017).
[3] GAO-17-726.
[4] Ibid.
[5] Ibid.
[6] House Committee on Financial Services, *Letter to the Federal Retirement Thrift Investment Board* (April 10, 2019).
[7]GAO-17-726.
[8] Federal Retirement Thrift Investment Board, *Letter to Committee on Financial Services* (April 2019).

<u>Biases Against MWO Firms</u>

According to a report by the National Association of Investment Companies (NAIC), investors may believe that increasing asset allocations to MWO asset managers means creating social programs that sacrifice returns, as well as labeling MWO firms as "riskier," "unqualified," or "without a track record."[9] NAIC also found that investors believe it takes too much effort to properly vet MWO firms. Further, investment staff are unwilling to risk their careers by selecting a diverse asset manager about whom they have a preconceived notion may perform poorly.[10] Bella Research Group similarly reported that false assumptions harm opportunities for MWO firms, who in fact, often have top-quartile returns. Bella's research concluded that compared to peers who manage similar asset classes, 25% of women-owned and 28% of minority-owned asset management firms fall in the top quartile on average for fund performance.[11]

Internal processes for selecting asset managers may also be biased against MWO firms. According to GAO, the minimum size requirements for assets under management—which ranged from $1 to $60 billion for the federal pension plans they surveyed in 2017—could potentially exclude smaller MWO firms.[12] GAO also found that investment funds did not consistently provide public notice or solicit diverse asset managers. For example, only two out of the eight federal pension fund entities GAO interviewed issued public requests for proposals when new asset management opportunities arose. Other pension funds told GAO that they used "other avenues such as internal investment staff or consultants to identify potential asset managers".[13]

<u>Limited Number of Diverse Investment Consultants</u>

Investment consultants are the de facto gatekeepers to the relationships between institutional investors and asset managers; a gateway of opportunities to manage trillions of dollars in assets. According to a Greenwich Associates report, 86% of institutional investor relationships were intermediated by investment consultants in the U.S. in 2015.[14] However, Greenwich also found that only a fraction of MWO firms receive an invitation to visit the investment consultant's office for a meeting, let alone win the business of an institutional investor.[15] In 2017, GAO similarly found that all eight of the ten pension plans they reviewed used investment consultants to some extent in their asset manager search process, with some more reliant on them than others.[16]

Given the reliance upon and influence of investment consultants' advice, a lack of gender, racial and ethnic diversity among investment consulting firm staff could further diminish the creation of investment opportunities for MWO firms. For example, a 2016 service employees

[9] Gregory B. Fairchild, *The Limited Partner Perspective: The Opportunity in Diverse Emerging Managers*, National Association of Investment Companies (2015).
[10] Ibid.
[11] *Diverse Asset Management Project Firm Assessment*, 2017.
[12] Ibid.
[13] Ibid.
[14] Christopher Dunn et. al., *Best Practices in Formal Meetings with Investment Consultants,* Greenwich Associates (Mar 2016).
[15] Ibid.
[16] GAO-17-726.

report found that African American and Latino employees each represent only 4% of investment consulting firm management staff in the United States, respectively.[17] According to a 2018 Investment Consultant Survey, investment consulting firms also do not have policies in place to intentionally consider female or minority candidates for new hires. They reported that only 27% of the firms they interviewed had a Rooney Rule—a policy to consider a minimum number of candidates reflective of gender and racial diversity—for hiring new staff.[18] The survey concluded that many of the firms that did not have a Rooney Rule for hiring also did not have one for diverse asset manager searches.[19]

Proposals to Increase Participation of MWO Asset Management Firms

- ***Intentional Outreach to MWO firms***: Outreach to and building networks among diverse communities can be a way to develop a strong pipeline of diverse asset managers.[20] In 2017, GAO recommended that pension funds should reach out to MWO asset managers about investment opportunities, meet with industry affinity groups and trade associations and invite diverse managers to present their investment capabilities.[21]

- ***Considering at least one MWO firm in every asset allocation or search (Rooney Rule)***: Some investment consulting firms and fund investment committees have initiated the practice of considering at least one MWO firm in every asset class and allocation opportunity. For example, the National Education Association requires its investment consulting firm to use the Rooney Rule to select asset managers for all clients—unless they specifically request otherwise.[22]

- ***Leadership commitment to and accountability for diversity:*** Research shows that institutional investors who make diversity a priority from the top achieve greater diversity results. For example, the Knight Foundation leadership requires their investment consultants to report quarterly on asset allocations managed by MWO firms. As a result, 36% of Knight's endowment ($830 million) is managed by with firms that are substantially- or majority-owned by women or minorities.[23] In 2009, Illinois state lawmakers passed a law encouraging the trustees of public pension funds to use emerging asset managers for managing their investments.[24] Chicago Teachers' Pension Fund invested $4.5 billion, more than 41.9 percent of total fund assets, with MWO and disabled-owned firms in fiscal year 2018. Their Board of Trustees president said that took steps to

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[17] Talia L. Schank, *Casting a Wider Net: Increasing opportunities for minority and women owned asset managers in institutional investments*, Service Employees International Union (2016).
[18] Diverse Asset Managers Initiative, *Annual Investment Consultant Survey* (2018).
[19] Ibid.
[20] Diverse Asset Management Initiative, *Fiduciary Guide to Investing with Diverse Asset Managers and Firms* (April 2017).
[21] GAO-17-726.
[22] Mary Ellen Flannery, *How NEA is Working to Diversify Wall Street*, NEA Today (June 21, 2018).
[23] Knight Foundation, *Financial Information*, available at https://knightfoundation.org/about/financial-info/.
[24] Public Act 96-006, see http://ilga.gov/legislation/publicacts/96/PDF/096-0006.pdf.

exceed Illinois' measures and affirmatively increased the participation of MWO managers by 525% since they started tracking in the early 1990's.[25]

Legislative Proposal to Require the Consideration of MWO Asset Management Funds

The draft bill would require:

1. The Board of Governors of the Federal Reserve System to consider at least one diverse asset manager when contracting out for asset management services, report on the extent to which they use diverse asset managers, and keep track of all diverse asset management firms in the United States; and
2. Companies that register and are registered with the Securities and Exchange Commission (SEC) to consider at least one diverse asset manager when contracting out for asset management services, report to the SEC on the extent to which they use diverse asset managers.

[25] *Chicago Teachers' Pension Fund Remains Leader among Pension Funds in Minority, Women and Disabled-Owned Business Enterprise Efforts*, The Chicago Teachers' Pension Fund (Oct. 17, 2018).