CASE STUDIES

CASE STUDY:

JOHN S. AND JAMES L. KNIGHT FOUNDATION[54]

In 2010, the Knight Foundation President and CEO, Alberto Ibargüen, sat on a panel at the Black Corporate Directors Conference. When a conference attendee asked him point blank how much of the Foundation's assets were invested with diverse firms, he did not know the answer and resolved to find out. Upon returning from the conference, he enlisted the help of the Foundation's CFO, Juan Martinez, and outsourced CIO and investment consultant, Kevin Stephenson of Cambridge Associates, to determine the amount. They discovered that only $7 million (less than .05% of the Foundation's assets) was invested with just one minority private equity manager. Ibargüen and Martinez felt that this result did not reflect the value of diversity, which was a strong tenet of the Foundation, and began a process to increase manager diversity while not adding investment risk or diluting portfolio returns.

The Foundation's commitment to diversity in its investment practices started with an organic conversation driven by staff with support from both the board chair and the investment committee. The plan was developed through regular discussions with the investment committee on their progress. Because there was no intent to change the portfolio's investment risk or return expectations, there was no official vote by the investment committee. The staff had the agency to move this agenda forward. "I wish I could say there is a magic bullet or magic lever that we pull," said Martinez. "The reality is we sat with our investment consultants, and we said this is something we want to do and here are the criteria…. We know they exist, we know they're out there, and we want to be a part of this."[55]

As of May 2016, the Knight Foundation had invested $465 million, or 22% of the total $2.1 billion endowment, with 12 minority/women-owned firms.

Cambridge Associates was an active partner in implementing the agenda. For example, it helped the Foundation develop clear definitions of "minority- and women-owned," the framework decided upon by the Foundation, and how this new instruction would fit into the Foundation's investment plan. The Foundation pursued this approach, believing that the diverse set of voices and unique perspectives brought to the investment process would provide an additive value; this could only be guaranteed if diversity was reflected throughout the firm. "It's not hard to see how many people in a firm are minorities or women," said Martinez. "Firms usually have their entire investment team on their website. It's not a ton of extra research to ask someone to do, and it tells something about a firm's diversity without even having to ask the question."

With support from the investment committee, which annually approves the investment policy, Martinez followed up with Stephenson on multiple occasions to explore how the Foundation could both increase the number of and assets under management by minority- and women-owned firms and be purposeful in integrating this interest into its current investment plan.

For the investment committee, it was important that working with any new diverse managers be non-dilutive in returns and non-additive to risk on both the implementation and execution side, in accordance with the policy for investing with any manager. The investment committee trusted staff and the outsourced CIO to execute the investment policy and asset allocation policy in a way that would maximize returns.

The Foundation has chosen not to adopt a specific mandate or policy concerning investment with diverse management firms. Rather, it holds Cambridge Associates accountable to taking a strong consideration of including minority- and women-owned firms within the portfolio. Cambridge Associates reports to the investment committee quarterly and includes an update on investments with minority- and women-owned firms. In the interim, Martinez works with the consultants to understand what they are doing within the markets, how this reflects the intentions and desires of the investment committee, and any implications this might have on the Foundation.

As of May 2016, the Knight Foundation had invested $465 million, or 22% of the total $2.1 billion endowment, with 12 minority/women-owned firms.

CASE STUDY:

NEW YORK CITY COMPTROLLER'S OFFICE[56]

For over 20 years, the City of New York has been a leader in hiring minority and women managers to invest pension funds. As of May 31, 2016, over $11 billion, or 6% of the portfolio, was invested with minority and/or women managers.

When looking for managers to hire, Scott Evans, Deputy Comptroller for Asset Management/ Chief Investment Officer, says, "When we see homogeneity, we are concerned. When we see diversity, that is definitely a plus." He continues, "Diversity is not merely a social value, it has strong economic value for our investments."

In May 2015, Comptroller Stringer announced that the New York City Pension Funds had taken steps to formally consider diversity as a criterion in manager evaluation and selection, by systematically asking current and prospective money managers about the diversity of their investment professionals as part of the due diligence process (you can read the press release here: *http://comptroller.nyc.gov/newsroom/comptroller-stringer-announces-major-new-diversity-intiative-for-investment-managers/*). General consultants who help choose managers for these funds will also be required to consider the diversity of a manager's investment professionals in the selection process, among all other relevant factors, such as the investment returns a manager has achieved in both up and down markets. A collateral benefit of this process is to potentially create an incentive for augmenting the pipeline of diverse investment professionals and advancing minorities and women to lead firms and possibly open firms of their own. (you can view a copy of the New York City Bureau of Asset Management Diversity Due Diligence Questionnaire – Public Markets[57] here: *http://diverseassetmanagers.org/fiduciaryguide*.)

> The overarching reason for the New York City Comptroller Office's commitment to investing with diverse managers is science. Study after study shows that diverse groups make better decisions.

In addition to requiring firms to report data on the diversity and composition of their board and staff, they also require reporting on compensation. "Understanding compensation allows us to really understand who is at the decision-making table," says Evans. "Going forward, you'll hear us talk not just about the assets invested with minorities and/or women; we'll also have a category called 'Diversity Practitioners.' This will be managers that demonstrate strong diversity in their decision-makers and a commitment to diversity in their policies and practices." (you can see a copy of the Diversity Profile Scorecard here:[58] *http://diverseassetmanagers.org/fiduciaryguide*.)

Comptroller Stringer remarks, "The New York City Pension Funds intend to help set a standard and push the envelope for how pension funds and asset managers alike engage on diversity on a holistic level. As our society and economy become dramatically more diverse, so too must our investors and our investments. The opportunities of tomorrow won't be captured using the business practices of yesterday. Fostering diversity, in the interest of improving long term risk-adjusted returns, is a fiduciary duty, and these funds are poised to prove that."

CASE STUDY:

EXELON CORPORATION[59]

"We all have a fiduciary obligation to achieve the best performance we can, and that's what this program is about. It comes down to whether the institution is committed to diversity. What we have found is that incorporating diversity helps us identify new and innovative ways to drive progress and performance across our business. You can find great talent and a high level of performance among minority managers."
– Doug Brown, CIO, Exelon Corporation

Exelon began its "minority-owned investment manager program" in 2002, starting with $30 million invested. Since then, the program has grown to over $2 billion, or more than 5% of total assets invested with approximately 20 minority-owned investment management firms. Investments range in size from $20 million to $500 million in a variety of asset classes.

In the aftermath of the financial crisis of 2008, the company decided to overhaul its approach to investment management, building a brand new investment team and rethinking the investment strategy of all its trusts. With an investment team of 13 led by CIO Doug Brown, Exelon opted to end investments in funds of funds and steered away from working with consultants, preferring direct manager relationships that the investment team could seek out and foster.

Brown has set up his team so that no one person is specifically responsible for the minority-owned investment manager program. Rather, the entire investment team researches and selects management firms through the lens of the company's commitment to diversity and to following talent in all corners.

"Diversity and inclusion is important to Exelon, both to the board and the staff," Brown says. "It's in the culture that factors into everything that the company does – from how we purchase from suppliers, how we hire, and how we finance the company." Brown believes that in order for institutions to move the needle on a diverse asset manager program, they need good governance. He credits this as one of the reasons Exelon has had such success with its program.

The team decided to grow the program with fewer, more meaningful manager relationships sizeable enough that they would make a difference in the investment program, but even more importantly, make a difference in the minority firms' businesses. The investment team used its networks to get out the word, and minority firms started reaching out to them. They also attended numerous conferences with the Rainbow Push Wall Street Project, the National Association of Investment Companies (NAIC), and the White House, which helped promote their reputation for having a quality program.

Brown reports the program has delivered strong results for the company. "The managers in our program have performed in line with all of our managers. We have a robust program with high standards and a difficult due diligence process. If you are not including minority-owned firms, you could be missing out on opportunities for outstanding investment performance," he says.

CASE STUDY:

STATE OF ILLINOIS[60]

The State of Illinois launched its emerging manager mandate over a decade ago under the leadership of former State Senate President, Emil Jones, Jr. At first, legislation was passed simply requiring the reporting of numbers of emerging managers managing the respective public funds in the state. "Emerging investment manager" was defined as, a qualified investment adviser that managed an investment portfolio of at least $10 million but less than $10 billion and was a "minority-owned business," "female-owned business," or "business of a person with a disability." However, the funds were quite comfortable reporting fairly dismal numbers, as no follow up mechanisms existed to inquire into the low numbers reported.

As a result, a Senate Select Committee on Pensions and Investments was formed, which began requiring funds to report publicly on their emerging manager numbers and respond to questions from the Committee at annual Diversity Hearings. The Committee also began asking funds to set goals for certain asset classes.

THE JOURNEY

According to Kwame Raoul, State Senator and Chair of the Senate Select Committee on Pensions and Investments, funds initially reacted with hesitation, questioning whether focusing intentionally on diversity would be a breach of their fiduciary duty and feeling uncertain of where to find qualified diverse managers. Yet, the Committee countered this reluctance, informing the funds that investing with diverse managers would help fulfill fiduciary obligations and working with the funds to create lists of qualified diverse managers.

Eventually, the State of Illinois passed a legislative mandate. Under state law that came into effect in 2010, it became state policy to encourage trustees of public employee retirement systems, pension funds, and investment boards to use emerging investment managers, increase the racial, ethnic, and gender diversity of its fiduciaries to the greatest extent feasible, and remove any barriers to the full participation in investment opportunities afforded. The law further mandated that funds adopt a policy that sets goals for utilization of emerging managers.

The law also directed funds to adopt what has become known as the "Rooney Rule," whereby any emerging investment manager that meets the criteria established by a board and consultant for a specific search shall receive an invitation to present his or her firm for consideration.

In 2016, the law was amended to require funds to set an aspirational goal of using emerging investment managers for no less than 20% of the total funds under management. It also set an aspirational goal that no less than 20% of investment consultants utilized be minorities, females, and persons with disabilities.

With regard to investment consultants, "funds would tell us that they religiously followed their consultants' advice," says Senator Raoul. "So, during the Diversity Hearings, we began to question the consultants themselves on their commitment to diversity within their companies and their recommendations. Over the past few years, we have seen some positive evolution as a result of asking these questions, both from the standpoint of an increase in the internal diversity of investment consulting firms but also in the diversity of the firms recommended to funds."

"We are proud to be a leader in this type of legislation and oversight," says Senator Raoul. "Already, other states have begun to follow our lead. We hope this trend continues."

> *We are proud to be a leader in this type of legislation and oversight. Already, other states have begun to follow our lead. We hope this trend continues.*

– Kwame Raoul
State Senator and Chair of the Senate Select Committee on Pensions and Investments

Funds' reports and testimony are delivered at annual Diversity Hearings overseen by the Senate Committee on Public Pensions and State Investments chaired by Senator Kwame Raoul. Prior to the hearings, funds respond to a questionnaire regarding their diversity inclusion.

To view the completed Diversity Questionnaire for the State Universities Retirement System of Illinois (SURS), the SURS Diversity Report presented at the hearings in November 2015, and DAMI's testimony at the August 2016 State of Illinois Diversity Hearings, see: http://diverseassetmanagers.org/fiduciaryguide.[61]

ENDNOTES

CASE STUDY: JOHN S. AND JAMES L. KNIGHT FOUNDATION

54. Unless otherwise noted, information in the following section is drawn from: Juan Martinez, Chief Investment Officer of the John S. and James L. Knight Foundation, telephone interview by the author, January 25, 2016.

55. Whyte, "Asset Management's Jackie Robinson Moment."

ENDNOTES

CASE STUDY: NEW YORK CITY COMPTROLLER'S OFFICE

56. Unless otherwise noted, information in the following section is drawn from: Scott Evans, Deputy Comptroller for Asset Management/Chief Investment Officer for the City of New York, in person interview by the author, February 3, 2016.

57. Provided by the Office of the New York City Comptroller.

58. Provided by the Office of the New York City Comptroller.

ENDNOTES

CASE STUDY: EXELON CORPORATION

59. Unless otherwise noted, information in the following section is drawn from: Doug Brown, Chief Investment Officer of Exelon Corporation, telephone interview by the author, January 22, 2016.

ENDNOTES

CASE STUDY: STATE OF ILLINOIS

60. Unless otherwise noted, information in the following section is drawn from: Illinois State Senator Kwame Raoul, telephone interview by the author, December 16, 2015.

61. Provided by Illinois State Senator Kwame Raoul.