Report from Diversity, Equity and Inclusion (DEI) Task Force

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DATE: February 17, 2022

TO: Members, State Board of Investment

FROM: Diversity, Equity and Inclusion (DEI) Task Force

SUBJECT: Report from the DEI Task Force

The following documents were prepared by the DEI Task Force for the Executive Director of the Minnesota State Board of Investment (SBI). They were presented to the Investment Advisory Council (IAC) in order to gather additional comments from other IAC members on the two initial recommendations presented related to:

1. Updated MSBI Investment Beliefs
2. Enhanced DEI data collection

The DEI Task Force was created to identify opportunities and make recommendations to the Executive Director on how to increase diversity, equity and inclusion, in the SBI investment programs. This update is being provided for informational purposes and no action is required by the SBI at this meeting. The Executive Director plans to review these materials and prepare recommendations for the IAC and SBI to consider at future meetings, including potential changes in the structure of the DEI Task Force to ensure continued progress on DEI issues during the upcoming Executive Director leadership transition.

DEI Task Force Members: Susanna Gibbons, Morris Goodwin, Gary Martin, Peggy Ingison, Carol Peterfeso, and Bibi Black

DEI Task Force Staff support: Katie Comstock (Aon) and Nate Blumenshine

The Diversity, Equity and Inclusion (DEI) Task Force for the Minnesota State Board of Investment (MSBI) held its initial meeting on October 11, 2021, and has made significant progress in developing its understanding of the current DEI landscape through its discussions, use of outside speakers, consultant expertise, and external research. While the work of the Task Force continues, we are prepared to make some initial recommendations.

1. **We recommend modifications to the current statement of beliefs to incorporate our evolving understanding of the benefits of diversity, and our obligation as plan fiduciaries. Current research suggests that greater diversity in our decision makers (including staff, asset managers, and consultants) will lead to improved investment results and improved economic outcomes, to the benefit of the Plans, the State of Minnesota, and its taxpayers.**

   Background and relevant research

   In reviewing the obligation of the MSBI and the Investment Advisory Council (IAC), we sought expertise from Reinhart Institutional Investor Services, a law firm with expertise in advising public plans on their fiduciary duties. We did not retain Reinhart as counsel or on an advisory basis, but they provided us with a summary of the current DEI landscape for fiduciaries, based on their expertise in this topic. Key findings from their presentation:

   - Minnesota Statutes (sections 356A.04 and 356A.05) are unique (in Reinhart's experience) in that they establish a three-pronged fiduciary duty. We are required to serve the interests of plan beneficiaries, the taxpayers who help finance the plan, and the State of Minnesota, which established the plan. At times, this may introduce the need to balance the interests of these parties.
   - Prudence imposes a duty of inquiry: we need to inform ourselves about a range of developments impacting the plan, including the importance of DEI; that duty is process-oriented rather than prescriptive since circumstances change.
   - The economic and by implication possible benefits of diversity that need to be considered in making investment decisions have become increasingly clear.
     - "Gompers has found that diversity significantly improves financial performance…"at Venture Capital Firms. Ethnic diversity improved the performance of IPOs and acquisitions by 26.4% to 32.2%.[1]
     - "Closing…racial wealth gaps would boost…the US economy by an additional $2-3 trillion. That's equivalent to 8% to 12% of US GDP" [2]
     - Companies in "…the top quartile for ethnic and racial diversity in management were 35% more likely to have financial returns above their industry mean"[3]
     - Diversity can reduce bias: "diverse teams are more likely to constantly reexamine facts and remain objective."[4]

[1] Harvard Business Review, 2018-07, *The Other Diversity Dividend*
[2] McKinsey & Company Online, America 2021 – The Opportunity to Advance Racial Equity
[3] McKinsey & Company, *Why Diversity Matters,* January 2015
[4] Harvard Business Review, *Why Diverse Teams are Smarter*, November 2016

- The standard of prudent care references peer practices. Investment practices are evolving, and growing number of public plans have concluded that DEI issues are financially material.[5]

We have also reviewed additional independent research, which confirms the information presented by Reinhart.

  - Section 342 of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 established the Office of Minority and Women Inclusion. In its annual report to Congress, the Board of Governors of the Federal Reserve System affirms "that diverse perspectives inspire the best ideas, decisionmaking, and – ultimately – service to the public."
  - "…banks with more female directors faced lower and less-frequent fines for misconduct, savings those institutions $7.84 million a year, on average. The conclusion: Banks with more women on their boards commit less fraud."[6]
  - Finally, for those concerned that we might lose our focus on performance by including more diverse-owned firms, a recent study by the Knight Foundation concludes that there is no evidence to suggest that the Plans would be harmed by adding minority- and women-owned firms.[7]

The support for updating our belief statement to incorporate the importance of Diversity, Equity and Inclusion as an organizing principle is grounded in our fiduciary duty, fact-based, and supported by a significant and growing body of research. **Based on this research, we recommend the Executive Director develop language that reflects the importance of DEI policies and strategies as important tools for increasing a broader more diverse perspective of our teams and incorporating the benefits of DEI on the returns of our portfolios.** We considered a broad range of ideas, and suggest the following.

- It is important to update policy within our existing frameworks, which we believe work well.
- We should incorporate language acknowledging the three-pronged Fiduciary obligation in the State of Minnesota, and the need to balance what may seem to be competing interests.
- We should recognize the enhanced performance benefits from working with diverse teams.
- We should develop an understanding of the economic impact that our investments have on the residents and taxpayers of the State of Minnesota.

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[5] We have reviewed updated policy and belief statements provided by our Consultant, Aon; we have reviewed additional information from LACERA, The Office of the Illinois State Treasurer, CalSTRS, CalPERS, and the State of Connecticut. This information is available in BoardEffect.

[6] Banks with More Women on Their Boards Commit Less Fraud, by Scott Berinato, Harvard Business Review, May-June 2021.

[7] *Diversifying Investments: A Study of Ownership Diversity and Performance in the Asset Management Industry*, Knight Foundation Executive Report, January 2019; Professor Josh Lerner, Harvard University, and Bella Research Group.

We have included sample language as **Attachment A** to this recommendation.

2. **There is a clear need for measurement and metrics with respect to Diversity, Equity, and Inclusion. In order to evaluate the extent to which we achieve the economic benefits of improvements in Diversity, we need to establish our starting point, and monitor progress over time.**

Background and relevant research

The landscape for DEI due diligence efforts has shifted dramatically in the past 12 months. The widespread adoption of DEI policies and procedures has brought increased scrutiny to the asset management business, and with it, the need for additional information about investment manager practices and outcomes. The MSBI DEI task force has reviewed its own due diligence practices, along with updated practices from eVestment, ILPA, and other industry sources, and discussed a range of possibilities around appropriate due diligence procedures[8]. The purpose of adopting such procedures would be threefold. First, we need to establish our starting point for evaluating the success of our efforts as we move forward. Second, we need to compare our starting point with the industry broadly speaking so that we can also measure and monitor our progress relative to the industry. Third, we need to develop a process for monitoring manager investment practices so we can evaluate the economic impact of specific investment decisions.

SBI staff has updated its procedures on gathering DEI data, and had some information to report to the Task Force. The SBI invests in 90 different public markets funds, managed by 72 different firms and has not yet attempted to gather DEI data from these managers. The SBI invests in 283 private markets investment funds, managed by 84 different firms[9]. Of those, 35 managers covering 171 funds, have provided some diversity data. Twenty-Seven managers provided detailed gender diversity information, and 22 managers reported additional information about the racial makeup of staff. The task force discussed the need to balance the depth of information desired with the likelihood of receiving that information. We did not want the length of the questionnaire to be an impediment to receiving any information at all, but we would like to create opportunities to expand the data collected as best practices for due diligence continue to evolve.

We recommend the Executive Director consider the following range of possibilities for the ongoing DEI data collection efforts.

Initial focus:

- Continue with current effort to collect basic demographic information. The standard EEO-1 template provides a useful starting point, and is consistent with the Albourne data request and the Harmony questionnaire. We acknowledge that some of the racial information may not be available for international companies.

[8] Due diligence procedures from ILPA, eVestment, Albourne, Harmony Analytics, Office of the Illinois Treasurer, and Aon are available in BoardEffect

[9] Public and Private Markets manager and funds data as of 12/31/2021

- Organize demographic data by:
  - Firm ownership
  - Decision-making level
  - Compensation

- Develop report on data at the aggregate level so that we can begin to monitor progress on both outcomes and participation level.

Enhanced due diligence:

- Evaluate information on pay equity policies
- Evaluate qualitative information specific policies and practices
- Evaluate quantitative information on investment manager employee pipelines: to what extent does diverse talent rise in terms of responsibility or compensation? (See questions B.6 and B.7 of Albourne questionnaire; this should be modified to solicit information on race as well as gender).
- Develop reporting to highlight the extent to which individual managers show improvement, so that we can determine whether broader trends in the SBI are driven by changes in reporting or changes in practice.

Best Practice due diligence requires continued research and vetting by the task force

- Request quantitative information on investment-level board diversity[10]
- Request information on proxy voting policies
- Request qualitative information on the community implications of investment manager underwriting practices. To what extent does their process consider the disproportionate economic impacts of their investments on various socioeconomic communities?[11]
- Request information on Investment manager business partners, including broker/dealers[12]

We believe it is important for the Executive Director to decide the appropriate starting point for our due diligence procedures based on current resource constraints, as well as the longer-term vision for this process. We have attempted to outline what we believe is the current state of play. However, this is a rapidly evolving area, and we think that longer-term vision will be critical in creating and maintaining a robust due diligence process.

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[10] See *The Missing Element of Private Equity*, in Harvard Law School Forum on Corporate Governance, posted by FCLTGlobal, Sunday August 8, 2021.

[11] See "Measure and Management" section, The Racial Justice in investment cohort, preliminary report; Initiative for Responsible Investment at the Hauser Institute, Kennedy School of Government, Harvard University.

[12] See Illinois State Treasurer supplemental diversity questions

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SBI Investment Beliefs

Please note: sample additions to the belief statement are highlighted in the document below.

In September 2017, and updated in xxx 2022, the State Board of Investment (SBI) adopted a set of Investment Beliefs for managingthe assets of the Combined Funds (those funds utilized to support the defined benefit plans of the State's employees). The primary purpose of these Beliefs is to guide the SBI toward sound investing principles related to investing on behalf of the Combined Funds. In this respect, the Beliefs help provide context forSBI's actions, reflect SBI's investment values, and acknowledge SBI's role in supporting the State's broader retirement systems. When relevant, the SBI also uses these Beliefs as a guide when investing the assets of the other investment programs that it manages, as deemed appropriate.

Under Minnesota law[1], the SBI, Staff, and IAC owe a fiduciary duty to plan beneficiaries; the taxpayers who help to finance the plan; and the state of Minnesota, which established the plan. As fiduciaries, we consider both the return potential and the risk of all of our decisions.

For large, diversified, long-term investors such as the SBI, broad market returns are the primary driver of the returns experienced by the investor. Market returns depend on the long-term health of the economy, which in turn depends on the productivity of social and environmental systems. Given our three-pronged fiduciary obligation, we must consider the impact that our investment decisions have on the health of these systems. We must be active in assessing and balancing any trade-offs that arise.

The SBI is a long-term investor whose primary mission is to maintain the viability of the retirement systems it supports.

When determining an appropriate level of risk that the systems' assets should bear the SBI must reflect the nature of those systems' liabilities and funding policy.

The SBI's strategic allocation policy is the primary determinant of (i) the asset portfolio's long-term investment return and (ii) asset portfolio's risk.

While the SBI can sacrifice some short-term liquidity to pursue a greater long-term return, the investment portfolio's net cash flows and ability to pay benefits on a year-by-year basis are key risk considerations.

Diversification improves the risk-adjusted return profile of the SBI investment portfolio.

Diversification of the SBI investment portfolio takes place across several critical dimensions, such as allocation across global regions and country markets (e.g., U.S. versus Europe, Asia, emerging markets, etc.), allocation among different types of assets (equities, bonds, real estate, etc.), spreading assets across various sectors and industries (e.g., technology, financials, consumer-oriented, etc.), and weighting of different risk factor premiums (e.g., value vs. growth, small companies vs. big companies, carry, illiquidity, etc.). If the correlation (i.e., relationship) among the returns generated by these factors is less than perfect (i.e., less than 1.0), then diversification is beneficial.

There are long-term benefits to SBI managing investment costs.

The equity risk premium is significantly positive over a long-term investment horizon although it can vary over time.

The equity risk premium is also pervasive across several asset classes and its overall exposure should be managed accordingly.

[1] Minnesota Statute 356A01

Private market investments have an illiquidity premium that the SBI can capture.

This risk premium can increase the portfolio's long-term compound return and help diversify the portfolio's risk.

It is extremely challenging for a large institutional investor to add significant value over market-representative benchmarks, particularly in the highly competitive public global equity markets.

Passive management should be utilized when there is low confidence that active management can add value. Active management can have potential to add value where information processing is difficult and challenging, allowing for market inefficiencies that are potentially exploitable.

The SBI benefits significantly when roles and levels of authority are clearly defined and followed.

The role of the members of the State Board of Investment (Board) is to establish investment policies that are in compliance with state statute and guide the ongoing management of the funds. The Board delegates implementation of that policy to the Executive Director/CIO, and exercises oversight with respect to the Executive Director/CIO's implementation activities and the portfolio's active risk level in the context of the portfolio's strategic allocation policy. The Board also ensures adequate resources are available to the SBI staff to perform their work;

The Investment Advisory Council (IAC) key role is advising the Board and Executive Director/CIO on general policy matters and methods to enhance the management of the investment portfolio;

The Executive Director's/CIO's key role is implementing SBI investment policies and setting the portfolio's active risk level in a prudent manner to achieve value-added over policy benchmarks.

Utilizing engagement initiatives to address environmental, social, and governance-related (ESG) issues can lead to positive portfolio and governance outcomes.

In addition to specific engagement strategies the SBI might apply, proxy rights attached to shareholder interests in public companies are also "plan assets" of the SBI and represent a key mechanism for expressing SBI's positions relating to specific ESG issues. By taking a leadership role in promoting responsible corporate governance through the proxy voting process, SBI can contribute significantly to implementing ESG best practices which should, in turn, add long-term value to SBI's investments.

Economic risks introduced by issues of environmental degradation and social inequities need to be assessed.

In order to integrate prudent financial management practices with principles of environmental stewardship, inclusive economic prosperity, and corporate accountability to shareholders and stakeholders alike, appropriate decision-making tools and frameworks are needed. The standard of practice can be expected to evolve over time, and must be actively engaged with monitoring and evaluating the long-term ESG risks embedded in our investment decisions.

Best practices can only be developed by the best people.

Ensuring the opportunity for economic prosperity for all requires supporting fairness in hiring, promotion and retention practices among all SBI service providers, SBI portfolio investment companies, and SBI staff and IAC members. This will require a continual effort to broaden the understanding of the systems within which the SBI operates.