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Responsible Investing

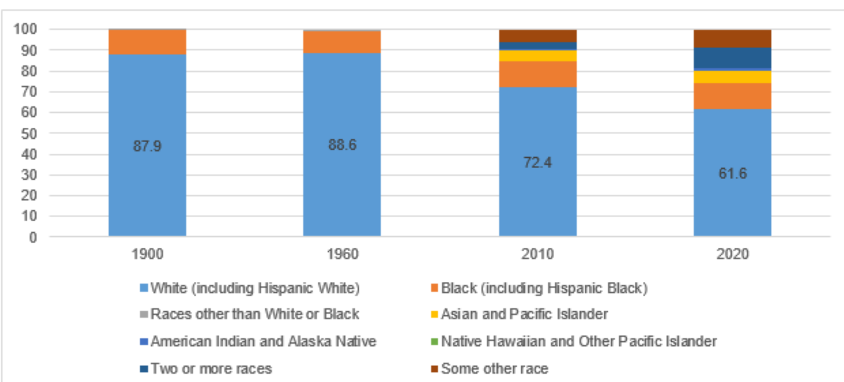
Does an Ethnically Diverse Board Mean Better Stock Performance?

By: Yijia Chen, CFA | November 17, 2021

Washington - Over the last 50 years, we have seen the key driver of the global economy shift from natural resources to human talent, ushering in the era of the "Talent Economy." This megatrend now impacts all major economies as companies place greater focus on intellectual capital and a diverse workforce as material, competitive factors for business success.

Not surprisingly, the ethnic diversity of developed-market countries most affected by globalization has increased — most visibly in the United States (Exhibit 1). As the populations of traditionally marginalized and underrepresented groups have grown, the socioeconomic differences and cultural diversity among different ethnic groups have become more visible. Today, many companies are actively promoting more diverse and inclusive cultures to attract and retain talent and drive innovation. They recognize the importance of intellectual capital in creating long-term value in terms of profitability, brand and market competitiveness.

Exhibit 1. Percentage of U.S. Population by Race: 1900-2020



Source: United States Census Bureau.

Does the fact that more diverse teams drive better results for companies extend to the teams that oversee companies — their corporate boards? Academics and private industry have recently focused great attention on the relationship between board diversity and company performance — establishing a firm link between the two. However, most of the research focus has been on gender diversity. Studies on the relationship between the ethnic diversity of corporate boards and company performance are fairly limited.

One often cited study was conducted by McKinsey in 2015.[1] Here, McKinsey looked at the 2014 board composition data of 366 public Canadian, Latin American, UK and American companies and found that those in the top quartile for racial and ethnic diversity were 35% more likely to have returns above their national industry medians than less-diverse peers, based on earnings before interest and tax data from 2010-2013. While groundbreaking, the study's sample size was small, and its test period was short. There have been calls to examine the relationship more deeply between financial performance and the ethnic diversity.

An Expanded Research Framework

Focused on four developed-market countries in the MSCI All Country World Index - Australia, Canada, the United Kingdom (UK) and the United States - our research aims to explore recent trends in ethnic diversity at corporate boards as well as its relationship to equity performance. Building on existing research, we used a larger data set, looked back further and took a more nuanced approach to evaluating ethnic diversity. Our sample focused on the period from December 2012 to December 2020, and included 845 large-cap companies (as of 12/31/2020): 65 Australian, 83 Canadian, 87 UK and 610 American firms.

Notably, our research introduces a new, multicategorical framework for assessing ethnic diversity. Based on the latest data from each country's national census, we set up a framework of seven ethnic groups to differentiate among underrepresented groups and compare across countries - a metric we refer to as "ethnic fractionalization."

Our key takeaways are:

- On average, large-cap Australian, Canadian, UK and American corporate boards have become more ethnically diverse, with American boards being the standouts.
- We found a significant relationship between the degree of corporate board ethnic diversity relative to country demographics and monthly equity performance.
- Our research suggests that using ethnic diversity factors can improve U.S. large-cap equity stock selection. There may be additional benefit in tilting toward more ethnically diverse companies across all four developed markets.
- We believe "ethnic fractionalization," which measures the likelihood that two randomly chosen people have different ethnicities, is more nuanced than a binary metric, such as "White versus non-White."

Ethnic Composition of a Company's Board Matters

We found no evidence of a significant relationship between the monthly equity returns and absolute levels of board ethnic diversity factors. However, we did find a significant link between monthly equity returns and the level of board ethnic diversity factors relative to the company's home country demographics. In particular, two factors showed statistically significant positive correlation with monthly equity returns and meaningful differences in return between top and bottom quintiles:

1. Percentage of people of color on corporate board relative to the country demographic.
2. Ethnic fractionalization of the corporate board relative to the country demographic.

Bottom line: As investors, we recognize the value of diversity, equality and inclusion as a driver of performance over the long term. Through rigorous corporate engagement aimed at improving corporate behaviors on diversity, equity and inclusion, we can encourage a change in corporate behavior that can lead to a more sustainable and equitable world and stronger long term performance.

To read the full report, click here.

1. Hunt, V., Layton, D., & Prince, S. (2015). Diversity Matters. McKinsey & Company. February 2, 2015.

Yijia Chen, CFA
ESG Quantitative Research Analyst
Calvert Research and Management

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