Narrowing the Gap

Why long-term investors and corporate leaders should view addressing economic inequality and improving diversity as critical forms of risk management.

March 2021
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Successful long-term investing requires a comprehensive view of the micro- and macro-level risks that threaten a company’s growth and viability, both at the macro and the micro levels. At Ariel Investments, we believe there is overwhelming evidence that economic inequality—particularly the wealth gap between Black and white Americans—poses a major threat to U.S. corporations at both levels.

The events of 2020 drew heightened attention to the issue of economic inequality across Corporate America and the investor community. Following the protests across the United States sparked by the murder of George Floyd at the hands of Minneapolis police officers, nearly half of the companies in the S&P 500 Index issued public statements denouncing discrimination or pledging a review of policies and practices related to diversity and inclusion.¹

Simply recognizing the problems of racism and inequality, however, is not enough. The private sector can play a leading role in addressing social issues², and investors can help lead the charge. Investors should integrate the risk posed by economic inequality into their investment decision-making and hold portfolio companies accountable for addressing this critical issue. Inaction on these fronts can have financially material effects that undermine corporate value and threaten fund performance.

This paper is designed to help investors understand the urgent need to address economic inequality and provide corporate leadership teams practical steps to drive change within their companies and for society at large. Drawing on Ariel’s work with the Black Corporate Directors Conference, we outline actions relating to people, purchasing, and philanthropy that companies can take to leverage corporate influence.
Quantifying the wealth gap

The wealth gap between Black and white Americans is a longstanding and well-documented issue. Research by Yale’s School of Management Dean Kerwin Charles has found that while the racial wealth gap shrank between 1940 and 1970, it has grown in recent decades and is now as wide as it was in the 1950s. Similarly, Ray Boshara of the Federal Reserve Bank of St. Louis Federal finds that between 1992 and 2016, college-educated whites saw their wealth increase by 96 percent while college-educated Blacks saw theirs fall by 10 percent.

Data from the past decade has shown some signs that perhaps the tide was beginning to turn. By 2013, the median wealth of white families in the US was 10.8 times the median wealth of Black families, the highest such ratio since 1989, according to data from the U.S. Federal Reserve. But by 2019, this ratio had declined to 7.8 times, according to the Federal Reserve’s 2019 Survey of Consumer Finances.

Unfortunately, the pandemic has been reversing this trend and exacerbating others. Black-owned small businesses are closing at nearly twice the rate of small businesses overall. New York Fed researchers Claire Kramer Mills and Jessica Battisto have linked this disparate impact to geographic location and lower rates of coverage from the Paycheck Protection Program, as well as weaker cash positions, weaker bank relationships, and preexisting funding gaps that left little cushion coming into the crisis. According to the US Bureau of Labor Statistics, the Black-white unemployment gap has expanded significantly during the pandemic. As of December 2019, the Black unemployment rate was 3.2 percentage points higher than the white unemployment rate. By December 2020, that gap had expanded to 4 percentage points. This reflects long-standing empirical trends showing that Black individuals are often last to be hired during periods of economic growth and first to be fired during recessions, suggests research by University of Connecticut’s Kenneth A. Couch and University of California at Santa Cruz’s Robert Fairlie.

Corporate leadership reflects the disparity

Nowhere is the lack of diverse representation in Corporate America more visible than in public company board rooms and C-suites. Over the past decade, a significant amount of research has found strong linkages between financial outperformance and high levels of diversity within company leadership and employee bases.

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<td>Percent of Black board directors among the 3,000 largest U.S. companies in 2019</td>
<td>Number of Black Fortune 500 CEOs as of March 2021</td>
<td>Percent of Black executives and senior-level managers at U.S. employers with at least 100 employees in 2018</td>
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Economic inequality: A key business risk—and opportunity

Bolstered by the events of 2020, there is increasing momentum in the investor community to emphasize the management of diversity-related risks and opportunities as a business imperative. Investors, as well as corporate leaders, need to understand that the risks presented by the racial wealth gap affect companies in both systemic and acute ways.

A 2020 Citigroup study by Dana M. Peterson and Catherine L. Mann suggests that the US economy lost $16 trillion over the past 20 years because of discriminatory policies surrounding Black wages, education, housing, and investment. Addressing these issues, Citigroup notes, could yield an additional $5 trillion in GDP over the next five years.14 World Bank lead economist Daniel Lederman and Australian National University’s Markus Brueckner have also linked higher income inequality to reduced GDP.15 Research also demonstrates that rising inequality has damaging effects on social and political cohesion,16 causing social unrest and retrenchment from globalization, according to research by the economist Dambisa Moyo.17

As investors monitor macroeconomic trends across their portfolios, these signals should give them pause. There is strong reason for concern about foregone growth and the destabilizing effects of racial injustice and economic inequity.

In addition to these macroeconomic and societal risks, not addressing economic inequality and not embedding diversity in a company’s culture can pose acute risks at the company level. Companies and investors should not view these issues purely as threats, though. Proactively and thoughtfully addressing these issues can lead to sustainable advantages for companies in multiple ways:

• **Improving financial performance:** The Sustainable Accounting Standards Board identifies 10 industries where issues of employee engagement, diversity, and inclusion are likely to have a material impact on a company’s financial condition or operating performance. This view of materiality may be too narrow. On the basis of our analysis of portfolio companies and engagement with corporate boards, we believe that these issues have a material impact across all industries.

• **Enhancing innovation and problem-solving:** Homogeneity and groupthink undermine creativity and critical thinking. Bringing varied perspectives to the table enhances a group’s ability to make difficult decisions. University of Michigan Professor Scott Page found that diverse backgrounds and perspectives help teams to identify better solutions to complex problems.18

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**The top- and bottom-line case for diversity**

Over the past decade, a significant amount of research found strong linkages between financial outperformance and high levels of diversity within a company’s leadership and employee base.

- **+$1.8 trillion**
  Excess profits generated from 2003 to 2019 by companies with a female CEO19

- **+19%**
  Excess innovation revenue generated by companies with above-average diversity on management teams20

- **+33%**
  Increased likelihood of generating industry-leading profitability by companies with top-quartile diversity on executive teams21
• **Strengthening governance:** Diverse perspectives are a key element of strong governance and oversight. Companies with more women on their boards are less likely to be subject to costly public governance controversies such as bribery, fraud, or shareholder battles, according to a 2015 MSCI study.²²

• **Attracting talent:** In addition to being linked to improved innovation, revenue, and profitability, diverse and inclusive cultures can help companies attract and retain top talent. Deloitte’s Millennial Survey 2018 of millennials and Gen Z individuals finds that they have greater rates of employer loyalty to diverse companies.²³

• **Engendering confidence and trust:** Opting out of the diversity discussion, or participating in a superficial way, also presents a risk to a company’s social license to operate. Customers and other stakeholders take note when a company makes a public commitment to diversity but fails to follow through in its day-to-day operations—investors increasingly are attuned to this as well.

• **Building resilient business models:** Just as companies are taking steps to prepare for the transition to a low-carbon economy, we believe that companies should be incorporating diversity into their strategic planning. According to SASB, business model resilience is an ESG issue that applies to “industries in which evolving environmental and social realities may challenge companies to fundamentally adapt or may put their business models at risk.”²⁴ As risk-aware investors, we know these factors have potential to affect the long-term financial performance of our portfolio companies.

### How companies can address the risk—and be part of the solution

Companies across industries are making commitments to address racial equity and justice. Often, these commitments involve financial contributions to organizations committed to serving communities of color, as well as supporting employees’ efforts to support these types of organizations.

While we applaud these efforts, addressing these systemic issues requires embedding change within the systems that define companies’ strategies, operations, and cultures. But with so many initiatives put into action this year, how should companies refine their efforts to deepen diversity strategies and mitigate the acute and systemic risks presented by the racial wealth gap?

To guide these efforts, we propose using a simple framework to guide these efforts: Three P’s, focusing on measurement of people, purchasing, and philanthropy.
The Three Ps

People

Measuring and reporting on employee and leadership diversity needs to become more nuanced and granular—and corporate leaders must be held accountable for progress towards these goals.

Many companies report information about employee diversity by grouping all women and ethnic/racial minority employees into one multicultural minority group. This reporting often puts all levels of employees—from entry-level workers to senior executives—into one pool. As a result, these data paint a two-dimensional picture of the company’s commitment to diversity, making it difficult for investors to make informed assessments.

By disaggregating the data, companies can identify gaps and create targeted recruitment and retention strategies while also providing more useful information for investors. A disaggregated approach reveals when diverse representation is concentrated in lower-wage, entry-level, or administrative roles versus mid-level or management-track positions. This type of reporting is increasingly common at the board level, but we recommend that companies extend it to the C-suite, senior management, and all other levels of the organization.

Creating a pipeline of diverse talent is essential to improving minority representation at the highest levels of corporations. Indra Nooyi, who served as PepsiCo’s CFO before becoming the company’s CEO, and Ken Frazier, who served as Merck & Co.’s general counsel before eventually becoming CEO, are just two examples of minority executives who gradually rose to lead some of America’s most respected companies.

But what practical steps can companies take to build a strong pipeline? Setting granular and measurable targets is a great starting point. For example, an Ariel portfolio company in the financial services sector made commitments to set specific public goals and time frames for female, Black, and Latinx representation at the vice president level by 2025.

Since 2003, the National Football League has required the inclusion and interview of at least one minority candidate for any head-coaching opening. The so-called Rooney Rule has since expanded to include general manager positions. While the Rooney Rule presents a partial solution to the challenge, companies should expand it to include more than one minority candidate. Research demonstrates that including only one minority in a slate of candidates elicits implicit bias. Having more than one minority in a candidate pool is the best way to guarantee all individuals a fair opportunity.

Action Items

• Tie executive pay to diversity metrics
• Set clear hiring goals
• Measure workforce diversity data at all levels and set targets
• Break out diversity metrics by racial and ethnic groups
• Adopt the Rooney Rule—and expand it to require that more than one diverse candidate be interviewed for open senior positions and/or board seats
• Measure employee participation in 401k plans and address racial disparities

“For everything else in corporate America, we get measured and paid if we make it happen—and don’t get paid or lose our job if we don’t. The only area where that isn’t true is diversity. It’s the only area you can work on and not show meaningful progress but keep your job.”

Melody Hobson, Ariel Investments Co-CEO and President
Purchasing

Partnering with minority businesses across services is a powerful way for companies to access different sources of expertise while bolstering businesses that can fuel growth in minority communities.

While most the majority of Fortune 500 companies set supplier diversity goals, very few of these supplier diversity programs extend to professional services, financial services, and technology. In fact, many supplier diversity program “success stories” focus on lower-margin areas of spend such as construction, catering, or janitorial services. When vendor diversity efforts exclude the high-margin, high-growth parts of the economy, this reinforces implicit bias that minority-owned professional firms cannot perform certain services at a high level.

Building vendor or business diversity programs, particularly in professional services industries, is a powerful opportunity for companies to embed diversity more deeply into their business practices. More than one-third of the portfolio companies in Ariel’s flagship strategies have supplier diversity programs. This year, two of them embraced the term “business diversity,” reflecting the importance of going beyond traditional procurement categories to work with diverse firms across all areas of spend, including professional services, financial services, and technology. As one chief diversity officer recently told us: “We have to stop thinking about diversity and inclusion as an HR silo…Embedding equity, access, and opportunity into all aspects of our business, including purchasing, is a no-brainer.”

Company purchasing programs can also encourage diversity when partnering with nonminority-owned professional-services firms. Companies can push for diverse partners and teams to service their relationships. For example, Intel implemented a rule in 2021 stating it will only hire U.S. law firms with above average diversity, meaning their U.S equity partnerships are composed of at least 21 percent women and 10 percent underrepresented minorities. These policies put pressure on law firms, consulting firms, money managers, and others to recruit, retain, and promote diverse talent to the leadership ranks of a firm.

Action Items

- Measure all spending by specific category, including professional services
- Replace the term “supplier diversity” with “business diversity”
- Measure the diversity of executives on your vendor and professional services relationships and require firms to make measurable progress
- Recognize that minority-owned businesses need access to customers in addition to access to capital

“Supplier diversity allows us to make an even greater contribution to the long-term economic stability of our communities. Our commitment will directly benefit underrepresented businesses, and in turn, those businesses will elevate the people and areas where they are located by creating sustainable jobs and tax revenue.”
Tim Dismond, Chief Diversity Officer of CBRE Group, an Ariel Investments portfolio company

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Philanthropy

Philanthropic contributions to civil rights organizations and other groups that target minority communities ultimately serve to uplift the corporation’s employee and customer bases.

In the wake of George Floyd’s murder, many companies made significant contributions to civil rights groups and organizations committed to fighting racism. These contributions bolster companies’ relationships with their communities and provide much-needed support for these groups’ missions.

While we applaud these donations, we believe that they are just a first step in addressing the risks associated with inequality and the racial wealth gap. When a company makes a philanthropic contribution, we suggest a multi-year commitment. This ensures that those organizations in receipt of critical funds can build long-term budgets and focus on implementing sustainable actions for addressing some of society’s most intractable challenges.

“Philanthropy is commendable, but it must not cause the philanthropist to overlook the circumstances of economic injustice which make philanthropy necessary.”

Rev. Dr. Martin Luther King Jr.

Action Items

- Measure corporate philanthropy to ensure that civil rights organizations and other organizations serving communities of color benefit, in addition to supporting arts and cultural institutions
- Commit to using corporate philanthropy to build long-standing, multi-year relationships with organizations
- Encourage executives to employ the Three Ps on the civic and non-profit boards on which they serve

Turning influence into impact

The pandemic has brought into focus the long-standing and critically important disparities between Black and white communities in the US. The wealth gap has grown, and health outcomes have worsened. All members of society should examine whether they contribute to the problem or are part of the solution.

At Ariel Investments, we believe that these disparities present risks not only to economic stability and investment portfolios, but to the communities in which we operate, market our services, and hire our employees. Addressing all of these issues is squarely within our mandate of stewarding our clients’ capital and acting as responsible corporate citizens.

These issues are unquestionably complex, and the solutions are not always easy to conceive or execute. But that does not lessen the responsibility and urgency for action. We believe that corporations can use their positions as employers, customers, and philanthropists to address the material risk that the racial wealth gap poses to the US economy. It is time for investors and corporations to turn their influence into impact.
About the Authors

John T. Oxtoby  
Senior Vice President, Director of Environmental, Social, and Governance (ESG) Investing

John leads Ariel’s efforts to integrate environmental, social, and governance research into our investment process. In collaboration with Ariel’s domestic research analysts, he works with portfolio companies to adopt and strengthen environmental, social, and governance practices in order to create long-term shareholder value. Prior to joining Ariel, John worked in the White House with Senior Advisor Valerie Jarrett and Chairman of the Council of Economic Advisers Austan Goolsbee, on public-private partnerships, including the CEO-led President’s Jobs Council. John is an FSA Credential holder, which is administered by the Sustainability Accounting Standards Board (SASB). He graduated with a BA in economics from Harvard College and earned an MBA from Harvard Business School.

Leah Yablonka  
ESG Research Analyst

Leah works closely with Ariel’s domestic research analysts to analyze the ESG risks and opportunities in current and prospective investments. In addition, Leah leads the tracking and reporting of Ariel’s ESG research and engagement activities for both internal and external stakeholders. Prior to joining Ariel in 2019, she was a management consultant at PwC. Leah is an FSA Credential holder, which is administered by the Sustainability Accounting Standards Board (SASB). She graduated cum laude from the University of Maryland with a BS in Environmental Science and Policy and a Minor in Sustainability Studies, and received a Master of Environmental Management with a focus in ESG and climate finance from the Yale School of Forestry and Environmental Studies.
Appendix

3 https://academic.oup.com/qje/article-article/133/1/1459/4830121?redirectedFrom=fulltext
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Slow and steady wins the race.