

Evaluating the financial materiality of gender diversity factors

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Executive summary

- Calvert tested the financial materiality of five gender diversity factors: (1) number of female board members, (2) percentage of female board members, (3) number of women in board leadership roles, (4) number of women named executive officers (NEOs) and (5) TruValue's circumstantial score related to diversity and inclusion news/issues over a three-year period.
- In summary, gender diversity factors show strong efficacy in equity returns for both the U.S. and international markets. More specifically, companies' circumstantial score associated with gender and inclusion issues is the major driver for superior financial performance of U.S. large-cap companies, while board-level gender diversity works best for U.S. small-cap companies and non-U.S. markets.
- U.S. large-cap companies with at least four women on the board outperformed the most when compared to those with less than four women on the board. This tipping point is an increase from the 2016 MSCI finding, which used a different methodology, that placed the number at three.
- For the U.S. small cap equity market and non-U.S.¹ equity markets, the current tipping point remains at two women on corporate boards. However, we expect the tipping point for U.S. small cap companies to escalate in the near term, thanks to both regulatory changes in states like California and investor actions through engagement and proxy voting.



Introduction

Numerous studies in recent years link a greater inclusion of women in the workplace with material financial benefits for businesses and capital markets across the globe. More specifically, some argue that a gender-diverse executive team has a stronger impact on company performance than the gender of the CEO;² a diverse executive team may be better able to drive superior performance results,^{3,4,5} and diverse boards help companies improve their risk management.^{6,7,8} To verify those arguments, this paper aims to test the financial materiality of gender diversity factors with three-year backtests. In addition, it checks the tipping point for gender diversity indicators that leads to a material financial benefit, which could help advise the construction of an ESG risk framework.

For gender diversity factors, we examined data from June 1, 2016 to May 31, 2019 (unless otherwise indicated) and used (1) number of female board members, (2) percentage of female board members, (3) number of women in board leadership roles,⁹ (4) number of women named executive officers (NEOs)¹⁰ and (5) TruValue's circumstantial score related to diversity and inclusion news/issues.¹¹ In the TruValue circumstantial score, a company is evaluated based on material news stories related to the SASB materiality map, with higher scores more desirable. All five indicators cover more than 90% of companies in the Russell 1000 Index (R1000) and Russell 2000 Index (R2000). For the MSCI World Index (MSCI World) and MSCI Emerging Markets (MSCI EM) Index, the coverage of (4) is not high enough to be included, but the coverage of the other four indicators is over 90%.

²"The Tipping Point: Women on Boards and Financial Performance," MSCI, December 2016: <https://www.msci.com/documents/10199/fd1f8228-cc07-4789-acee-3f9ed97ee8bb>.

³"Female CEOs on a Glass Cliff? A Look at Gender Diversity and Company Performance," ISS Analytics, 10/26/18: <https://www.issgovernance.com/library/female-ceos-on-a-glass-cliff/>.

⁴"Why Diversity Matters," McKinsey & Company, January 2015: <https://www.mckinsey.com/-/media/mckinsey/business%20functions/organization/our%20insights/why%20diversity%20matters/diversity%20matters.ashx>.

⁵"Delivering through Diversity," McKinsey & Company, January 2018: https://www.mckinsey.com/-/media/mckinsey/business%20functions/organization/our%20insights/delivering%20through%20diversity/delivering-through-diversity_full-report.ashx.

⁶"Gender diversity and corporate performance," Credit Suisse, August 2012: https://www.calstrs.com/sites/main/files/file-attachments/csri_gender_diversity_and_corporate_performance.pdf.

⁷"The CS Gender 3000: Women in Senior Management," Credit Suisse, September 2014: <https://www.credit-suisse.com/media/assets/corporate/docs/about-us/research/publications/the-cs-gender-3000-women-in-senior-management.pdf>.

⁸Credit Suisse Research Institute, "The CS Gender 3000: The Reward for Change," 2016: <https://www.credit-suisse.com/media/assets/corporate/docs/about-us/research/publications/csri-gender-3000.pdf>

⁹Board leadership roles include board chair, key committee chair, senior independent director, nonemployee chair or lead director.

¹⁰Named executive officers (NEOs) includes a company's principal executive officer and the company's next two most highly paid executive officers.

¹¹TruValue Insight Score – Diversity and Inclusion factor includes both positive and negative controversies of the companies.



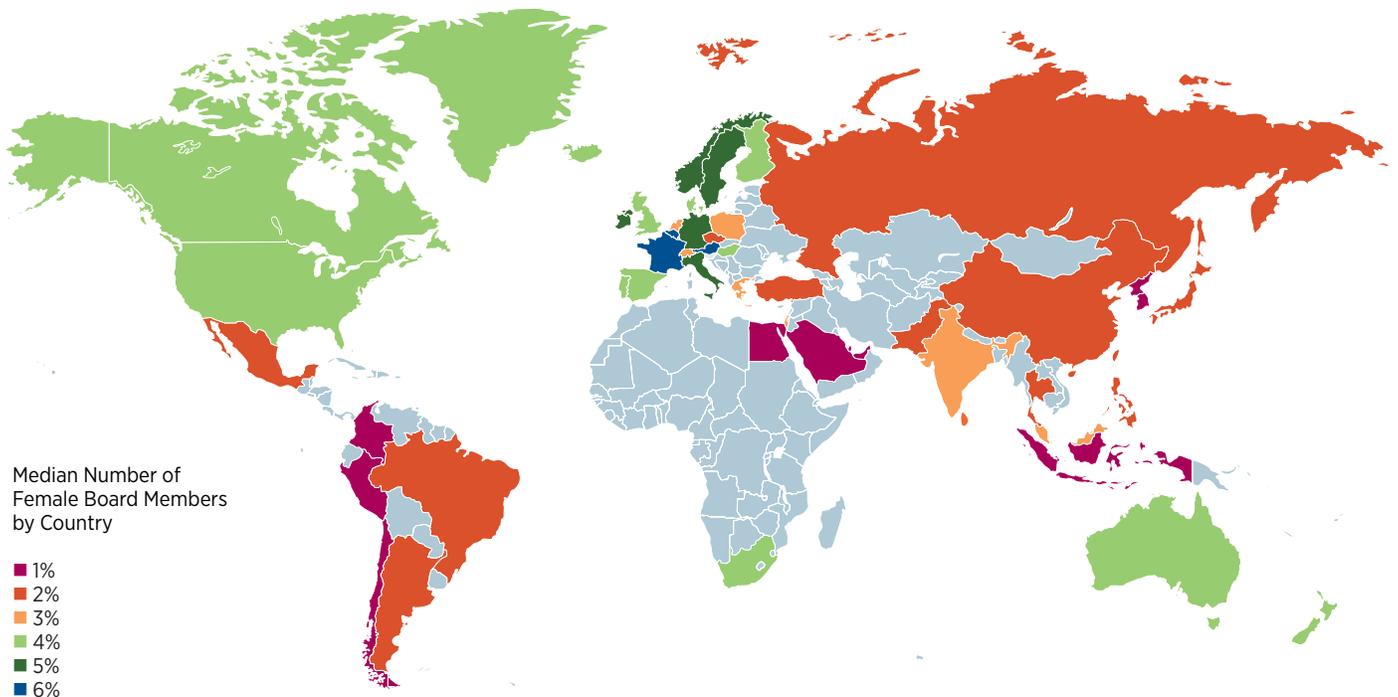
Gender diversity by country, sector and size

Gender diversity factors differ around the world. Exhibit A displays the median number of female board members among the countries included in the MSCI AC World Index. The impact of increasing government regulations and investor actions play a critical role in increasing the number of women on corporate boards. As part of the European Commission's Strategic engagement for gender equality,¹² some jurisdictions set mandatory requirements or quantitative targets on female board representation, which has exerted a direct

positive influence in recent years. France, which ranks highest by both the number and percentage of female board members, introduced a legislative quota in 2011 requiring companies to meet a 40% standard for each gender at the board level by January 2017. In the United States, larger investors have also taken stronger policy stands on board diversity through the formal proxy-voting policies, which helped improve female board representation among U.S. public companies since 2016.

Exhibit A

Median number of female board members for MSCI AC World Index companies by country (2019)



¹²Europe Commission, 2018 Report on equality between women and men in the EU: https://ec.europa.eu/newsroom/just/document.cfm?doc_id=50074.



In a cluster analysis, companies are classified and divided based on a set of measured variables so that similar items are grouped together. We conducted a cluster analysis (Exhibit B) in which we examined companies based on a combination of market cap and board member composition. Each color represents one of these buckets. As a result of this analysis, we determined that within the United States, the difference in gender diversity is largely based on a company's size.

The cluster analysis separated companies into five buckets based on market cap and board composition:

- The red dots mostly consists of the U.S. mega- and large-cap companies, with 10- to 15-person boards and two to five female board members.

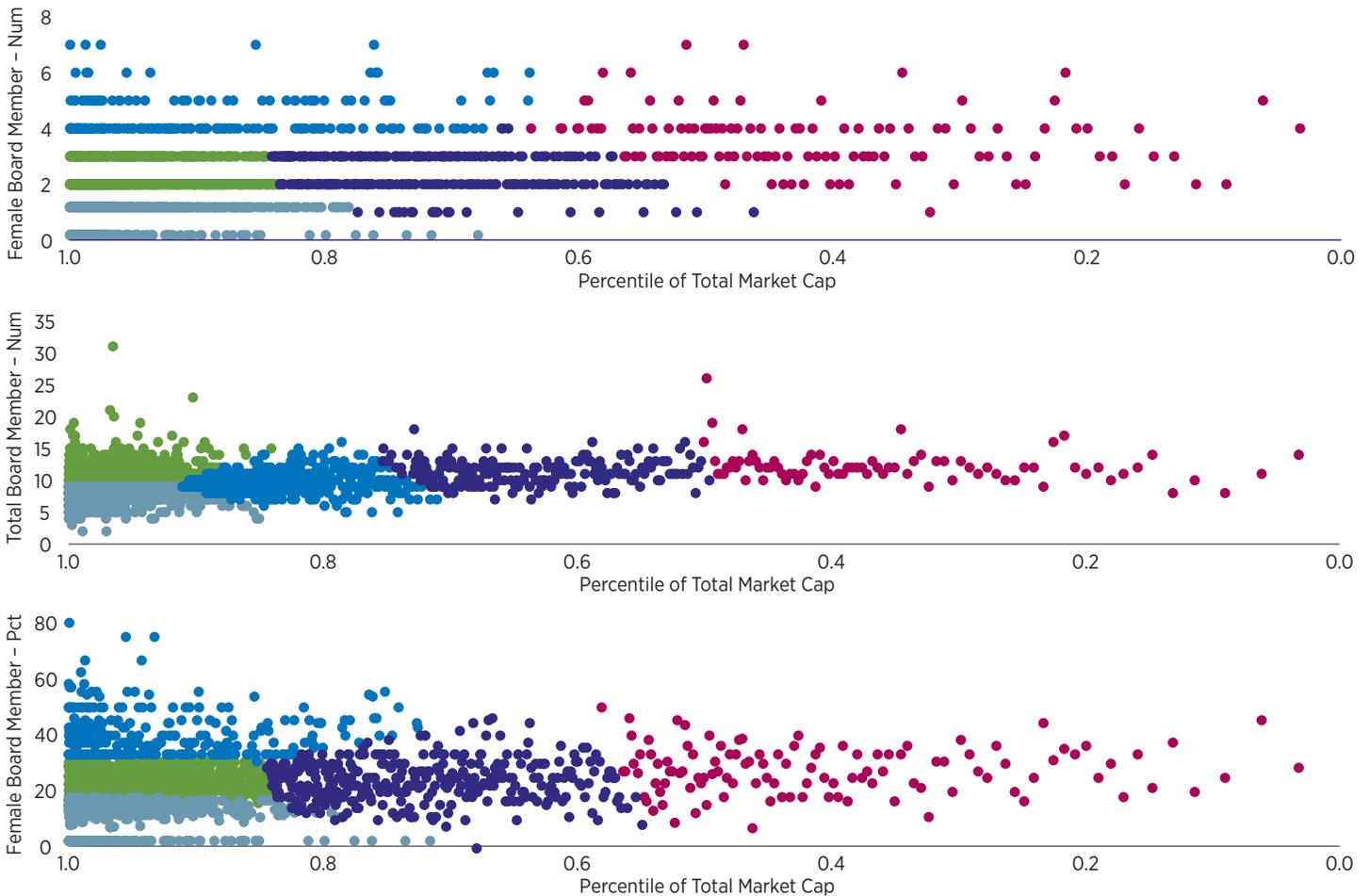
All companies in this group have at least one woman on their corporate boards, but most of them are maintaining only an acceptable level of female representation with an average of 28%.

- The purple dots largely consist of large- and midcap companies. These usually have an 11-person board with two to three women and average 24% female representation.
- The blue, green and gray dots represent mainly small-cap companies that have a smaller average board size and a relatively larger variation in female board representation. Some have as much as 80% female representation, but this group also contains most of the U.S. companies without any women on their boards at all.

Exhibit B

Cluster analysis of female board representation¹⁴ for R3000 companies by size (2019)

A stock's percentile of total market cap is the sum of all stocks' market cap that are larger or equal to the individual stock divided by the sum of all stocks' market caps in the index.



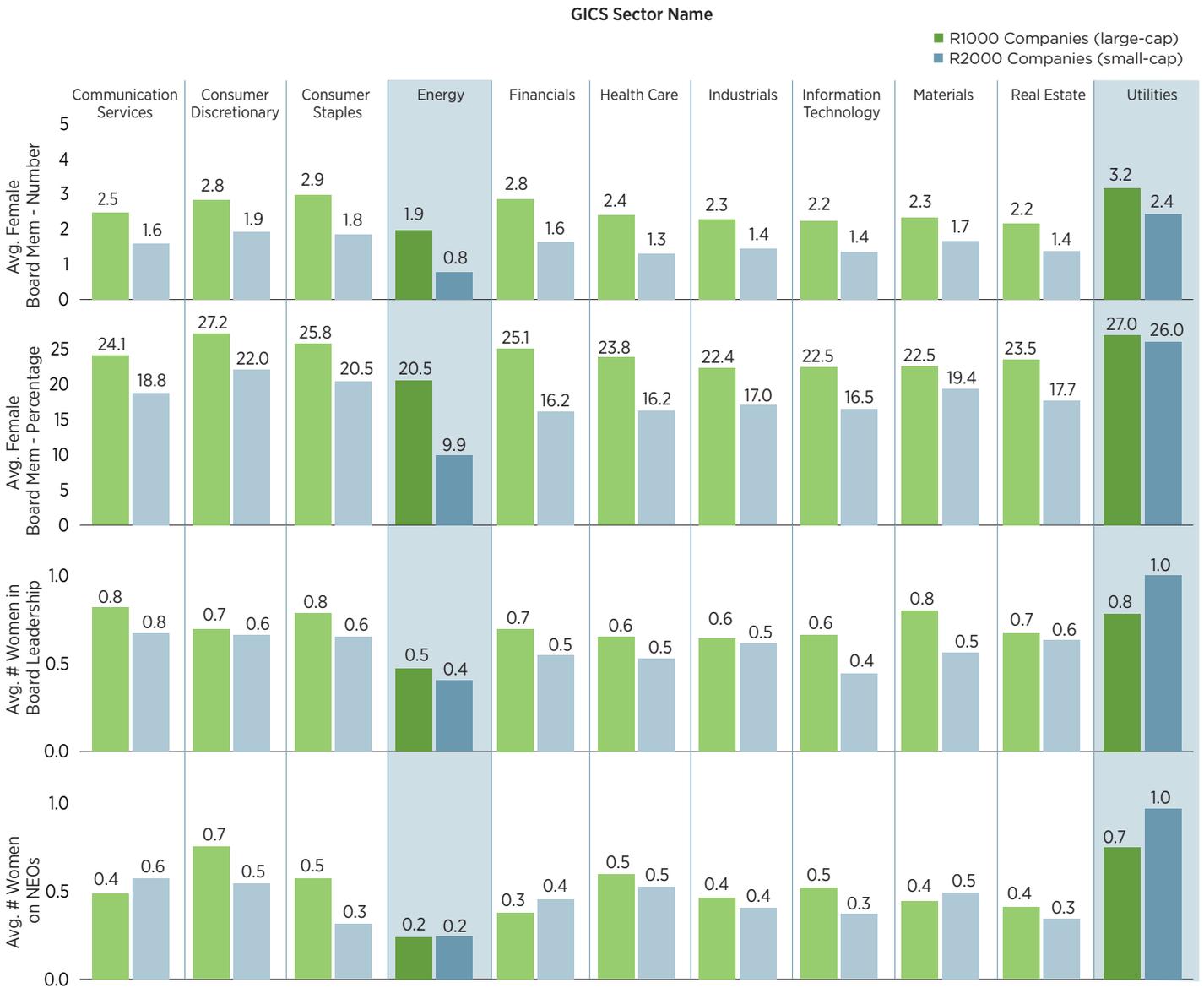
Cluster analysis partitions dots in the view into clusters, where the dots within each cluster are more similar to one another than they are to dots in other clusters. The clusters are distinguished by color. We used Lloyd's algorithm with squared Euclidean distances to compute the k-means clustering in Tableau 10. For a given number of clusters k, the algorithm partitions the data into k clusters. Each cluster has a center (centroid) that is the mean value of all the points in that cluster. K-means locates centers through an iterative procedure that minimizes distances between individual points in a cluster and the cluster center. To find more about cluster analysis, see: <https://boraberan.wordpress.com/2016/07/19/understanding-clustering-in-tableau-10/>.¹³Data from Factset People database. Backtest data was retrieved on 7/2/2019 with the time period of 6/1/16 to 5/31/19. ¹⁴Data from Factset People database. Backtest data was retrieved on 7/2/2019 with the time period of 6/1/16 to 5/31/19.



Exhibit C

Gender diversity factors¹⁵ for U.S. companies by sector (2019)

The chart shows the average number of each indicator for large-cap companies and small-cap companies in each sector.



Looking at the gender diversity indicators by sector in Exhibit C, the difference between large-cap and small-cap companies is relatively small and consistent across sectors. The two exceptions are energy and utilities. The energy sector is the laggard among all sectors, with the lowest female representation on corporate boards as well as the fewest number of women in leadership roles at the board and executive levels. On the other side, utilities is the leading sector, which has been successful in getting more women on corporate boards and in leadership roles.

Across all sectors, although the overall female representation on corporate boards seems to be acceptable, the average number of women in board leadership roles and women on NEOs is less than one, which implies that most companies do not put any women in the three-to-five most important roles of the company. While women’s voices are starting to be heard on corporate boards, their opinions are not as influential in leadership teams.

¹⁵Data from Factset People database. Backtest data was retrieved on 7/2/2019 with the time period of 6/1/16 to 5/31/19.



Which gender diversity indicator better drives the equity performance?

Alpha testing is a common tool to backtest the efficacy of factors in terms of their return performance. Information coefficient (IC) and information coefficient T-Stat (IC T-Stat)¹⁷ are two of the metrics used to evaluate the factor efficacy – a higher IC or IC T-Stat of one testing factor means that a higher factor value drove the equity performance in the backtest period. Based on the conclusions drawn in the previous section about gender diversity indicators by country, size and sector, to isolate the efficacy of quantitative factors, the research controlled sector factor for R1000 companies; size and sector factors for R2000 companies; and country, sector and size factors for non-U.S. universes. The frequency of calculating factors and return performance was monthly. Because point-in-time data for indicators (1), (2), (3) and (4) below were not available to us, the corresponding results in Exhibit D could include look-ahead bias by assuming companies have the same level of gender diversity in the past three years.

As Exhibit D lists, both the number and percentage of female board representation show strong performance among the general developed markets and emerging markets, regardless of country difference.

The number of female board members overall works better than the percentage. However, using only one of the indicators could introduce bias due to the large variations in board sizes, especially for small companies (shown in Exhibit B). Thus, looking at the two indicators together when determining the board gender diversity is important and provides information that is more complete. In comparison to U.S. large-cap companies, small-cap companies have much stronger efficacy on female board representation, which could be persistent in the near future given the gender gap between large-cap and small-cap companies.

TruValue's circumstantial score (measuring both positive and negative news) related to diversity and inclusion issues is a strong factor driving equity performance, especially for global large-cap companies. The indicator includes diversity issues broader than pure gender-related ones, showing that other diversity issues (such as ethnicity diversity and nationality diversity) may also contribute to the strong efficacy. Another highlight for U.S. large-cap companies is that female representation in executive leadership roles (i.e., the number of women on NEOs) is as important as the board-level indicators. It indicates the next steps would be getting more women in the leadership roles to obtain superior company performance for large companies.

Exhibit D

IC and IC T-Stat of gender diversity metrics and financial factors¹⁶ (2016-2019)

The fundamental metrics included in this chart are proved to be material by empirical studies and, thus, they can serve as benchmarks when looking at the IC T-Stat of gender diversity metrics.¹⁷ The IC and IC T-Stat number of Women on NEOs are not available for MSCI EM Index companies due to the low data coverage.

Factor	R1000 (large-cap)		R2000 (small-cap)		MSCI World		MSCI EM	
	IC	IC T-Stat	IC	IC T-Stat	IC	IC T-Stat	IC	IC T-Stat
(1) Female Board Member – Number (2019)	0.009	0.269	0.024	1.066	0.014	0.583	0.022	0.677
(2) Female Board Member – Percentage (2019)	0.007	0.225	0.022	0.952	0.015	0.596	0.019	0.576
(3) # Women in Board Leadership (2019)	0.000	-0.005	-0.006	-0.217	0.001	0.029	0.003	0.053
(4) # Women on NEOs (2019)	0.009	0.261	0.004	0.165	0.005	0.134	#N/A	#N/A
(5) TruValue D&I Insight Score (2016-2019)	0.031	0.967	0.000	0.013	0.014	0.554	0.017	0.539
ROE	0.035	1.070	0.046	2.030	0.034	1.200	0.024	0.670
ROA	0.038	1.189	0.047	2.096	0.030	1.095	-0.001	-0.019
ROIC	0.039	1.232	0.045	1.955	0.036	1.280	0.018	0.499
Net Debt to Assets (LVRB)	0.034	1.071	0.008	0.373	0.020	0.717	0.011	0.263
Free Cash Flow per Dollar	0.027	0.842	0.053	2.341	0.036	1.166	0.058	1.470
Economic Value Added per Dollar	0.039	1.260	0.083	3.749	0.049	1.703	0.061	1.633
Entity-Level Market Cap	0.022	0.714	0.037	1.674	0.015	0.589	0.014	0.410

¹⁶Data from Factset People database. Backtest data was retrieved on 7/2/2019 with the time period of 6/1/16 to 5/31/19.

¹⁷The Information Coefficient T Statistic is the coefficient divided by its standard error (an estimate of the standard deviation of the coefficient). If a coefficient is large compared to its standard error, then it is probably different from zero.



Diversity and inclusion issues emerge

As noted in "Evaluating the Glass Ceiling: Understanding and unlocking the value in gender equity," which we published in June 2019, investors have taken greater actions on gender diversity in proxy voting since 2016, especially for companies in the Russell 3000 Index with no women on the board. According to ISS Analytics,¹⁸ there has been a clear shift in votes against the election of chairs of board nominating committees since 2016. Such votes generally signify that the candidates recommended by the board do not reflect sufficient diversity. Meanwhile, larger investors have taken stronger policy stands to seek action on board diversity through their formal proxy-voting policies.

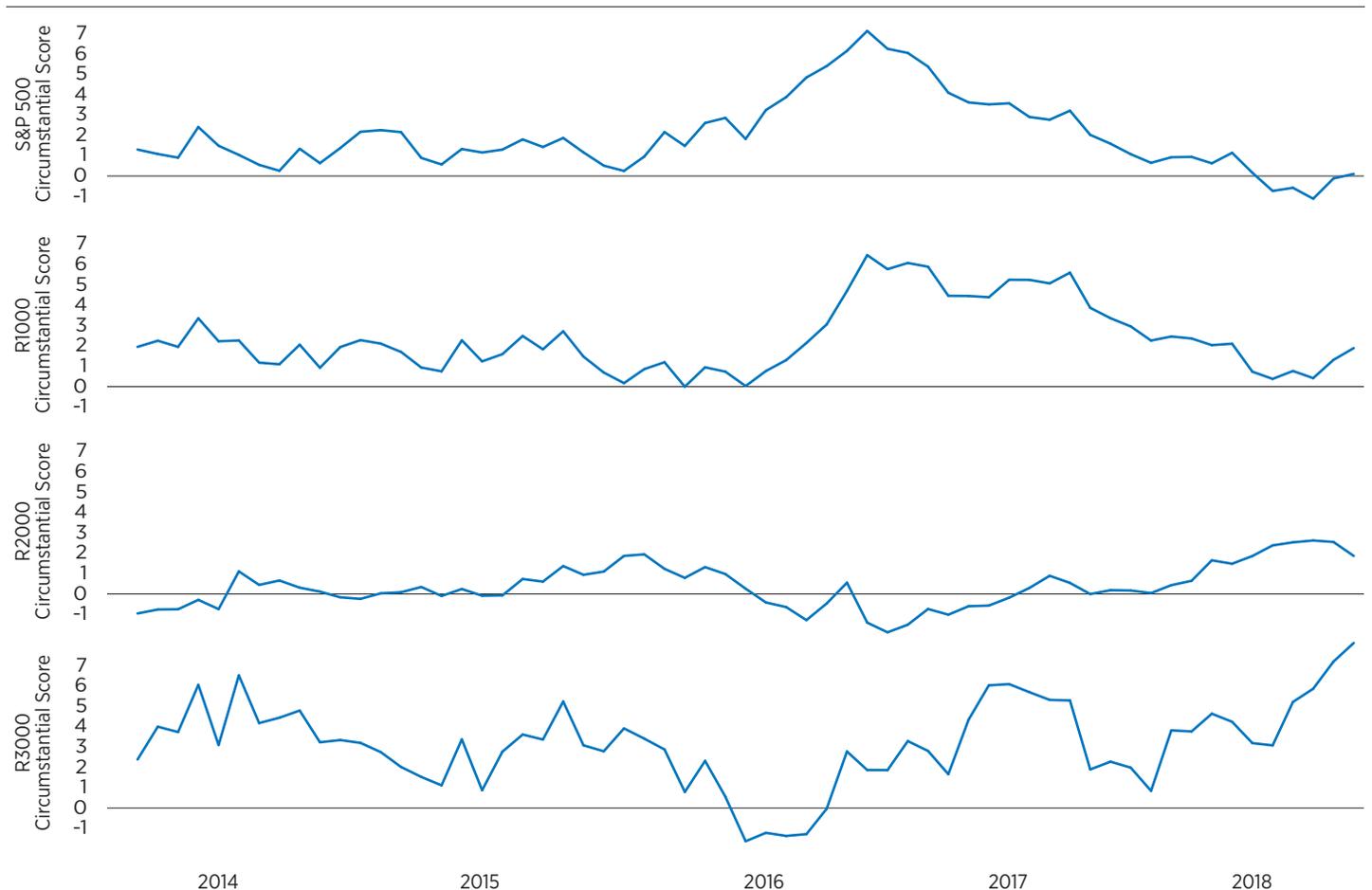
When examining the factor efficacy of circumstantial score related to diversity and inclusion issues, we witnessed the same pattern in a 6-year horizon. Overall, the circumstantial score related to diversity and inclusion issues has been a strong indicator to drive returns of the U.S. equity market in the

observation period (2013-2019). Exhibit E demonstrates a soaring trend since 2016 for R3000 companies. For large-cap companies, the efficacy has become positive since 2013, rose in early 2016, peaked in less than one year and returned to zero in two years. This suggests the changes on diversity and inclusion transformed in a relatively short period for large-cap companies and, thus, the efficacy disappeared quickly.

However, the changes among small-cap companies have happened much slower and are still happening today. The efficacy for small-cap companies started to rise in the middle of 2016, peaked after almost two years and remains positive as of today. As we see from Exhibit B, with more variations in the board size as well as greater female representation on corporate boards, many small-cap companies are still lagging their peers on board gender diversity. If they bridge this gap, it could lead to a consistently positive alpha over a longer period.

Exhibit E

IC T-Stats of TruValue's circumstantial score¹⁹ related to diversity and inclusion issues (LTM²⁰)



¹⁸Institutional Shareholder Services (ISS) Analytics, Governance Insights, 10/5/2018.

¹⁹Data from TruValue Labs, 7/2/2019

²⁰LTM refers to last 12 months. Chart covers period from July 1, 2013 to March 1, 2019.



The tipping point of female representation on corporate boards

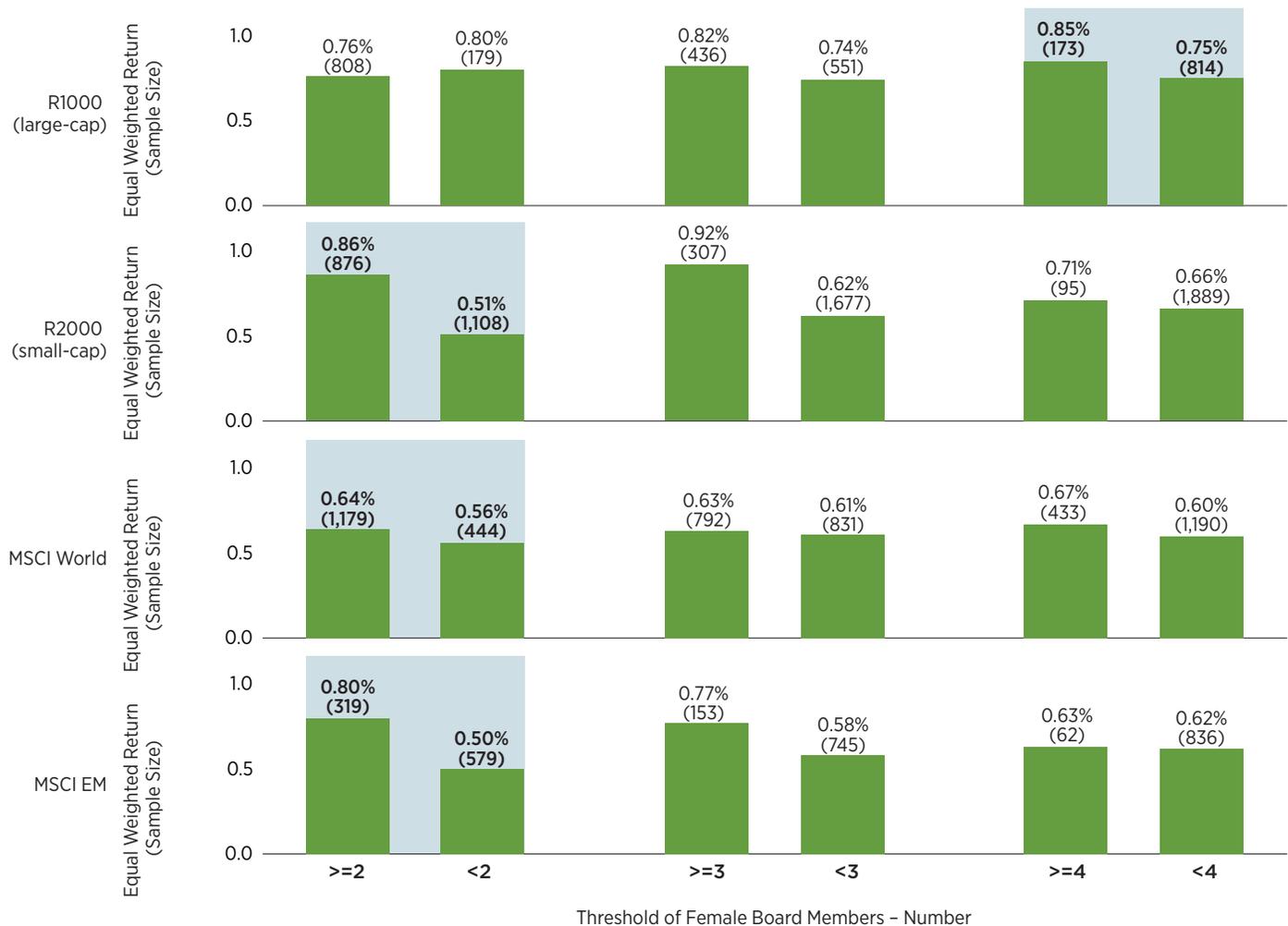
The tipping point of female representation on corporate boards 2016 MSCI study²¹ found that U.S. large-cap companies²² with at least three women on their boards in 2011 had median increases of 10% in ROE and 37% in EPS by 2016, while those with no women had median decreases of 1% and 8% in ROE and EPS over the same period. With the efficacy of board-level gender diversity verified for both the U.S. and non-U.S. markets, the next question is whether we can identify a tipping point for each market from the portfolio construction perspective. We found that for

the Russell 1000 index, the return difference between 3 or fewer female board members and four or greater women on the board is 10bps (=0.85%-0.75%), which is larger than the return difference of the other two groups. The sample size of both buckets are large enough to make sure the returns are not driven by one or two outliers. Therefore, we conclude that the tipping point is now four female board members for U.S. large cap companies (see the shaded boxes in Exhibit F). The tipping point we identified for U.S. large-cap companies is at least four women on the

Exhibit F

Equal-weighted equity returns of companies that are above or below the gender diversity²³ thresholds (2016-2019)

Sample size numbers are in the parentheses. This chart only shows binary buckets with a large enough sample size. The buckets in the shaded areas are the tipping points identified by the return difference between the binary buckets.



²¹"The Tipping Point: Women on Boards and Financial Performance," MSCI, December 2016: <https://www.msci.com/documents/10199/fd1f8228-cc07-4789-acee-3f9ed97ee8bb>.

²²MSCI included U.S. companies that were constituents of the MSCI World Index for the entire July 1, 2011-June 30, 2016 period. The number of U.S. companies it included in that research is 532, which has the characteristics similar to the group of U.S. large-cap companies.

²³Data from Factset People database. Backtest data was retrieved on 7/2/2019 with the time period of 6/1/16 to 5/31/19.



board, which means companies with at least four women on the board outperformed most compared to those with less than four women on the board. This tipping point moved up by one compared to the 2016 MSCI finding.

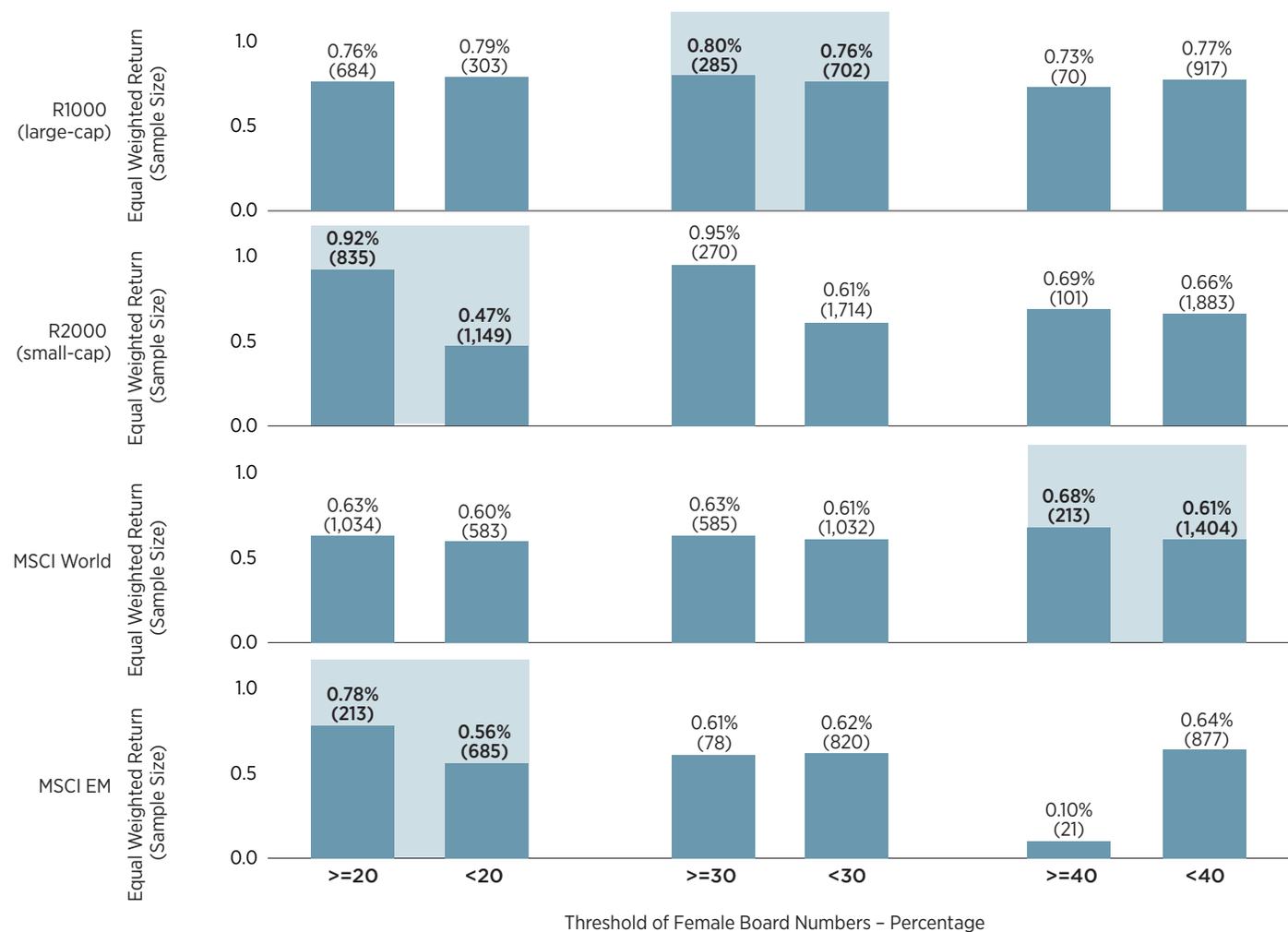
Regarding the broad U.S. equity market and non-U.S. equity markets, the current tipping point remains at two women on corporate boards, using the data from the past three years. The tipping point for U.S. small cap is expected to escalate in the near term, thanks in part to a new California law²⁴ that requires public companies in the state to have least one women

on their boards by the end of 2019. The minimum requirement will go up to three female members if the board size is larger than six by the end of 2021.

Furthermore, for the MSCI developed-market index, the return differences in buckets for at least two women on boards (0.08) and at least four women on boards (0.07) are very close, which may be due to the large difference in board gender diversity by country. It also suggests that investing in the subset of companies with at least four women on boards still gives investors material financial benefits. However, it is very likely that a portfolio with an asset-level constraint

Exhibit G

Equal-weighted equity returns of companies that are above or below the gender diversity²³ thresholds (2016-2019)



²⁴“New California Law Mandates Female Representation on Boards of Directors by December 2019” The National Law Review, April 2019: <https://www.natlawreview.com/article/new-california-law-mandates-female-representation-boards-directors-december-2019>.



of at least four women on boards would end up being very concentrated (given the number of companies that meet the criteria) and less diversified with some country biases.

The gap of board-level gender diversity between developed markets and emerging markets is huge – two-thirds of the companies in developed markets have more than 20% of women on corporate boards, while less than one-third of emerging-market companies reach that. The tipping points of the percentage of female board members overall followed the same pattern as the number of female board members: 30% U.S. large-cap companies; 20% for U.S. small-cap companies and emerging markets; while the percentage for the developed-market index is an exception: The group with at least 40% women on the board performs best, led by European companies.

Conclusions

In summary, gender diversity factors show strong efficacy in equity returns for both the U.S. and international markets. More specifically, companies' circumstantial score associated with gender and inclusion issues is the major driver for superior financial performance of U.S. large-cap companies, while board-level gender diversity works best for U.S. small-cap companies and non-U.S. markets.

The efficacy has risen significantly since 2016. The board-level gender diversity changes among U.S. large-cap companies have happened, while the small-cap companies are still improving their female board representation. Investors can help small-cap companies close the gender gap through engagement and proxy voting, as well as benefit from the rising alpha of gender diversity factors.

Regarding the tipping point of female board representation, U.S. large-cap companies with at least four women on corporate boards outperform most. For U.S. small-cap companies and non-U.S. companies, the tipping point is at least two women on corporate boards. The gap of board-level gender diversity between developed markets and emerging markets is huge. Given the regulatory changes and investor actions that are emerging in the United States, the tipping points are likely to escalate in the near future.

Index Definitions

Morgan Stanley Capital International (MSCI) Emerging Markets Index	An unmanaged index of emerging markets common stocks
Morgan Stanley Capital International (MSCI) World Index	An unmanaged index of equity securities in the developed markets
Russell 1000 Index	An unmanaged index of 1,000 U.S. large cap stocks
Russell 2000 Index	An unmanaged index of 2,000 U.S. small cap stocks
Russell 3000 Index	An unmanaged index of the 3,000 largest U.S.-traded stocks



Important additional information and disclosures

Source of all data: Calvert, as of 6/30/19, unless otherwise specified.

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