

Does an Ethnically Diverse Board Mean Better Stock Performance?

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Calvert has tested the relationship between the ethnic diversity of corporate boards and equity performance using data from 2012-2020. In this article, we share our findings with practical applications for investors:

1. On average, large-cap Australian, Canadian, British and American corporate boards have become more ethnically diverse, with American boards the standouts.
2. We found a significant relationship between the degree of corporate board ethnic diversity relative to country demographics and monthly equity performance.
3. 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
4. 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.”

Introduction

In the last 50 years, the key driver of the global economy shifted from natural resources to human talent, ushering in the era of the “Talent Economy.” Amplified by globalization, this megatrend now impacts all major economies. In fact, nine of the 10 largest companies in the MSCI All Country World Index as of 12/31/2020, would be considered talent- versus resources-based.¹ In the U.S. alone, the percentage of innovative and service-oriented jobs that require substantial independent judgment and decision-making has doubled from 1960-2010.¹

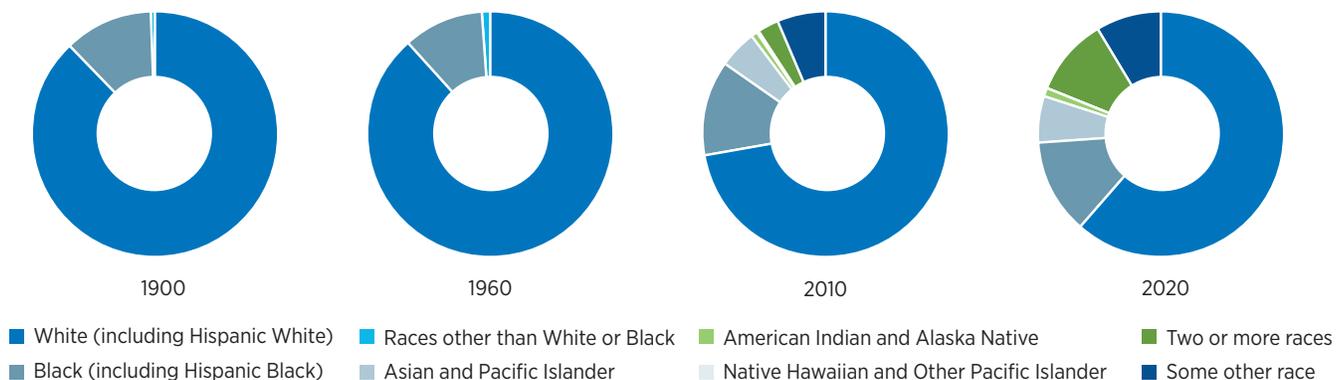
In recent years, the ethnic demographics of countries whose economies are influenced by globalization have become more diverse (Exhibit 1). As the populations of traditional minority groups have grown, the socioeconomic variance and the cultural diversity among different ethnic groups has become more apparent. Looking at educational attainment, for example, we see that the percentage of Americans with bachelor’s and/or

advanced degrees has increased across all ethnic groups from 1997-2017 (Exhibit 2). Increases for those who self-identify as American Indian or Alaska Native, Black or Hispanic have been more dramatic than for those who self-identify as White. In total, the talent pool with advanced education has become much more diverse, yet people who self-identify as other than White are still underrepresented across all workforce levels.

We believe this gap is narrowing because companies increasingly recognize the benefits of having diverse teams. For example, we see evidence of the significant relationship between diversity indicators and work performance in a 2019 study into the effects of gender and ethnic diversity on employee performance at a higher education institution in South Africa.² Today, many companies are actively promoting more diverse and inclusive cultures to attract and retain talent and enhance intellectual capital and innovation, ultimately driving long-term value creation.

Exhibit 1

Percentage of U.S. Population by Race: 1900–2020



Source: United States Census Bureau.

Exhibit 2

Educational Attainment of Adults Ages 25 and Older by Race and Ethnicity: 1997 and 2017.

	Bachelor's Degree			Advanced Degree			Bachelor's Degree or Advanced Degree		
	1997	2017	Increase	1997	2017	Increase	1997	2017	Increase
All racial and ethnic groups	16.0%	21.3%	33.1%	7.8%	12.9%	65.4%	23.8%	34.2%	43.7%
White	17.5%	23.7%	35.4%	8.6%	14.3%	66.3%	26.1%	38.0%	45.6%
American Indian or Alaska Native	7.8%	13.4%	71.8%	4.4%	7.1%	61.4%	12.2%	20.5%	68.0%
Asian	27.5%	30.7%	11.6%	15.2%	24.7%	62.5%	42.7%	55.4%	29.7%
Black	9.5%	15.3%	61.1%	3.8%	8.9%	134.2%	13.3%	24.2%	82.0%
Hispanic	7.4%	12.2%	64.9%	2.9%	5.1%	75.9%	10.3%	17.3%	68.0%
Native Hawaiian or other Pacific Islander	N/A	18.5%	N/A	N/A	6.7%	N/A	N/A	25.2%	N/A
More than one race	N/A	20.9%	N/A	N/A	11.7%	N/A	N/A	32.6%	N/A

Source: U.S. Census Bureau, Current Population Survey, 1997 and 2017. Notes: In 1997, the only racial demographic categories reported were: Hispanic; White; Black; American Indian, Eskimo, or Aleut; and Asian or Pacific Islander.

¹Martin, R. “The Rise (and Likely Fall) of the Talent Economy.” Harvard Business Review. October 2014.

²Zhuwao, S., Ngirande, H., Ndlovu, W., & Setati, S.T. (2019). “Gender diversity, ethnic diversity and employee performance in a South African higher education institution.” SA Journal of Human Resource Management/SA Tydskrif vir Menslikehulpbronbestuur, 17(0), a1061. <https://doi.org/10.4102/sajhrm.v17i0.1061>.

From the Workplace to the Boardroom

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. However, most of the focus has been on *gender* diversity. Studies on the relationship between the ethnic diversity of corporate boards and company performance are fairly limited.

A study³ examining Fortune 500 companies' performance from 1998–2002 found that ethnic diversity among board directors had a positive impact through audit, executive compensation and director nominations. Yet another study⁴ found that the relationship between board ethnicity and the financial performance of S&P 500 companies from 1998–2002 was not significant. It should be noted, however, that there were some methodological shortcomings. For instance, the study only identified Black and Hispanic directors as minorities. Furthermore, the sample set was not ideal; of the 641 firms in the S&P 500 over that five-year period, the ethnicity indicator was only available for 314 firms.

In 2015, McKinsey⁵ changed industry perception about ethnic diversity at companies. They looked at 2014 board composition data of 366 public Canadian, Latin American, British 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. These results have been widely cited in shareholder proposals as reason for companies to improve disclosure on the ethnic diversity at all levels. However, because McKinsey's sample size was small and its testing period was short, there have been calls to examine the relationship more deeply between financial performance and ethnic diversity.

Calvert's Study — A Differentiated Look at Ethnic Diversity

Our research aims to explore recent trends in ethnic diversity at corporate boards as well as its relationship with 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.

We focused on Australian, Canadian, British and American companies in the MSCI All Country World Index from December 2012 to December 2020. This sample included 845 large-cap (as of 12/31/2020) companies, including 65 Australian, 83 Canadian, 87 British and 610 American firms. We used MSCI's Gross Returns database for monthly equity performance.

We obtained data from Institutional Shareholder Services Inc. (ISS) that classifies board directors by ethnic group. ISS gathers information from corporate filings and its own outreach. Where definitive information was not disclosed, ISS classified directors largely along standards put forth by the U.S. Office of Management and Budget's Directive 15, carefully assessing race and ethnicity through a variety of publicly available sources.⁶

To ensure reliability and consistency, we calculated the percentage of directors with available ethnic characteristics information for each company and excluded companies where this information was available for fewer than 50% of directors. After cleaning the data, our sample was reduced to 80,913 monthly observations. The data coverage of our focus group was 96.06% as of 12/31/2020, with an average of 93.23% data coverage across the entire testing period.

The Benefits of a Multi-Categorical Metric

Many studies on ethnic diversity rely on a binary metric: number of minority directors or number of people of color within a group. However, as we've seen, many traditionally minority groups represent increasingly larger percentages of the overall population — though they continue to be underrepresented in the workplace. Data suggests that while "White alone non-Hispanic" represented the most prevalent racial or ethnic group in the U.S. in 2020 (at 57.8%), this is a nontrivial decrease from 63.7% in 2010.⁷ A simplified White and non-White dichotomy ignores the diversity among people of color. For our study, we therefore chose a multi-categorical metric.

Each of the countries in our focus group applies a different framework to classify its population by race, ethnic origin, ancestry or cultural group. Based on the latest framework used for each country's national census, we proposed a framework of seven ethnic groups (Exhibit 3) to differentiate among people of color and compare across countries.⁸

³Carter, D. A., D'Souza, F. P., Simkins, B. J., & Simpson, W. G. (2008). "The diversity of corporate board committees and financial performance." Oklahoma State University. Working Paper.

⁴Carter, D. A., D'Souza, F. P., Simkins, B. J., & Simpson, W. G. (2010). "The gender and ethnic diversity of US boards and board committees and firm financial performance." *Corporate Governance: An International Review*, 18(5), 396-414.

⁵Hunt, V., Layton, D., & Prince, S. (2015). *Diversity Matters*. McKinsey & Company. February 2, 2015.

⁶Institutional Shareholder Services (ISS). September 15, 2020. "Classification Standards Largely Mirror OMB-15 for U.S. Government Administrative Reporting and Statistical Activities." Retrieved March 10, 2021.

⁷United States Census Bureau. "The Chance That Two People Chosen at Random Are of Different Race or Ethnicity Groups Has Increased Since 2010." August 12, 2021.

⁸The Indigenous Peoples group overlaps with Oceanian ethnic group for Australia. There is not an equivalent Indigenous Peoples group for the United Kingdom.

Exhibit 3

Research Framework for Evaluating Ethnic Diversity

	U.S.	U.K.	Canada	Australia
Indigenous Peoples (if applicable)	✓		✓	✓
Asian (incl. South Asian)	✓	✓	✓	✓
Black/African	✓	✓	✓	✓
Hispanic/Latinx	✓	✓	✓	✓
Middle Eastern	✓	✓	✓	✓
Oceanian	✓	✓	✓	
White/Caucasian	✓	✓	✓	✓

Based on this framework, we compiled a list of ethnic diversity factors (Appendix A) to test the relationship between a company board's ethnic diversity and its company's monthly equity performance. Of these factors, we believe ethnic fractionalization is the most meaningful because it allows for important distinctions to be made among people of color.⁹ Ethnic fractionalization evaluates the likelihood that two people chosen at random are from different ethnic groups. The index ranges from 0-1, with 0 meaning all people are members of the same group and 1 meaning each individual belongs to a separate group.

Looking at Ethnic Diversity Across Countries

As measured by average board ethnic fractionalization, corporate boards have become more diverse over time. On average, American companies have the most ethnically diverse boards, and they saw the greatest increase in diversity. This may be because America has the most diverse underlying demographics. However, this relationship was not consistent across countries (Exhibits 4, 5 and 6). Indeed, British demographics are much less diverse than Canadian demographics, but British corporate boards of large-cap companies are generally more diverse than their Canadian counterparts. Clearly, there is more work to be done.

Ethnic Composition of a Company's Board Matters

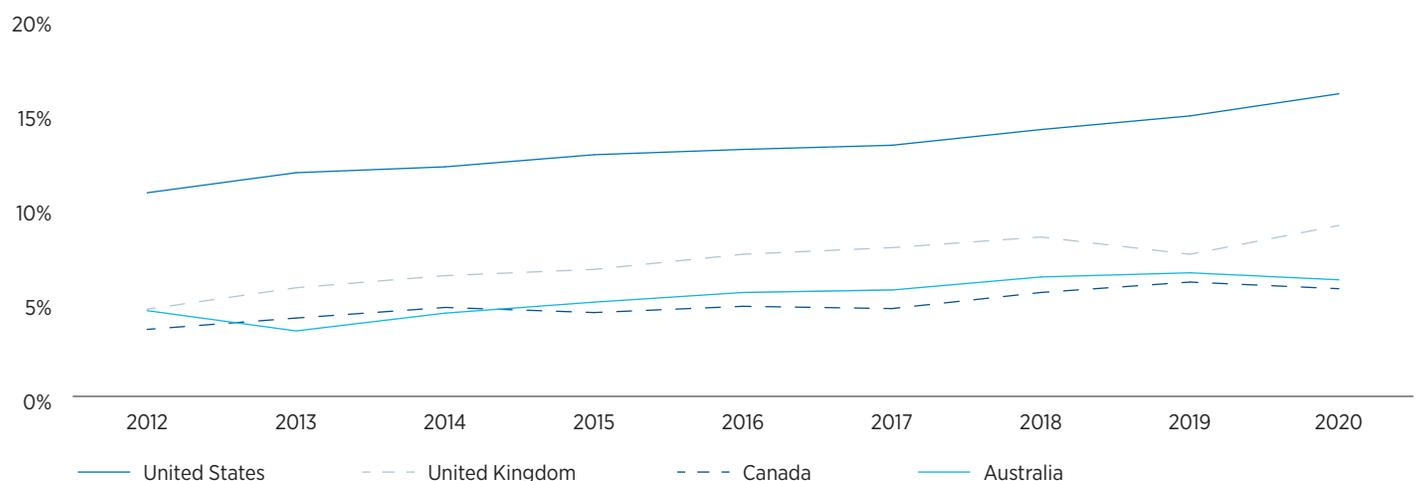
Exhibit 4

2020 Country-Level Ethnic Fractionalization Based on Ethnic Diversity Research Framework and National Census Data for Each Country's Demographic

Australia	Canada	United Kingdom	United States
0.164	0.432	0.204	0.578

Exhibit 5

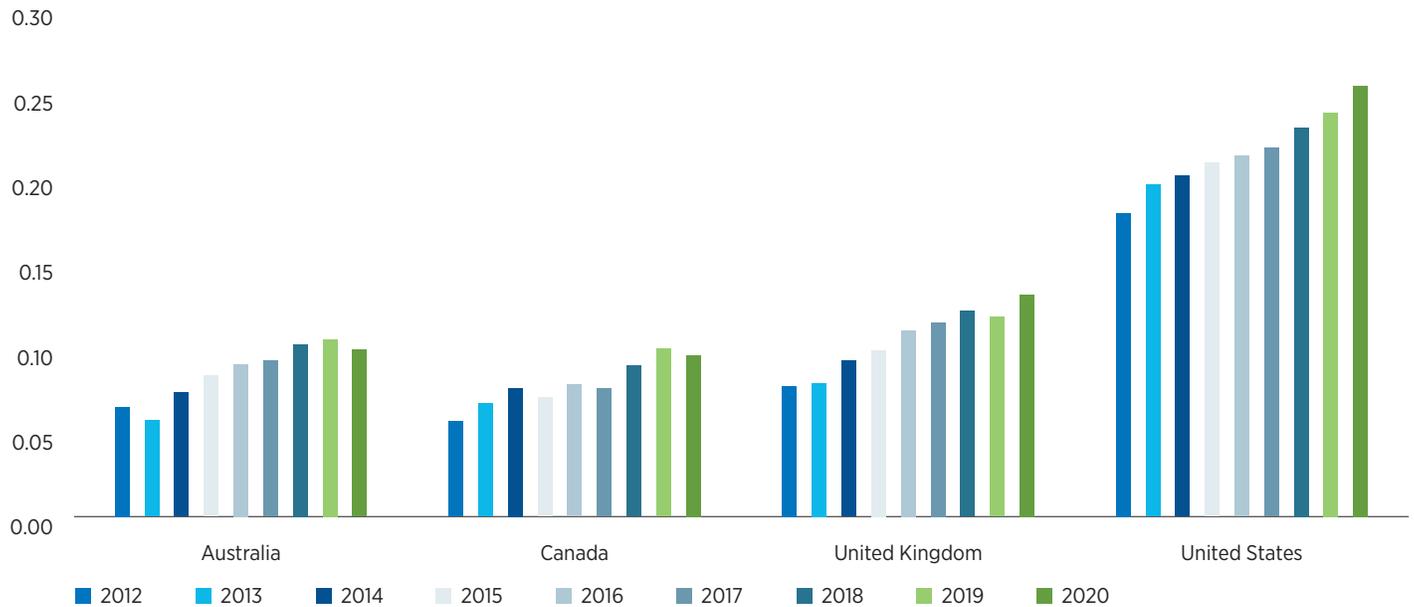
Average Percentage People of Color on Corporate Boards by Country: 2012-2020



⁹ Drazanova L. 2020 "Introducing the Historical Index of Ethnic Fractionalization (HIEF) Dataset: Accounting for Longitudinal Changes in Ethnic Diversity." Journal of Open Humanities Data, 6: 6.

Exhibit 6

Average Board Ethnic Fractionalization by Country for Companies in Australia, Canada, the U.K. and the U.S. from 2012-2020



Having established historical and country-level trends, we grouped and ranked companies by quintile for each factor and analyzed their relationships with respective equity returns. Exhibit 7 reports the results of return streams and rank correlation with and without consideration for the demographics of the country where the company is based. 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

Exhibit 7

Rank Correlation Estimates of Board Ethnic Diversity Factors and Monthly Equity Performance for Companies in Australia, Canada, the U.K. and the U.S. from 12/31/2012-12/31/2020.

Factors	Return Diff	Quintile 1 Return	Quintile 2 Return	Quintile 3 Return	Quintile 4 Return	Quintile 5 Return	Information Coefficients (IC)	IC T-Stat
Number of people of color on corporate boards	0.55	5.57	5.24	4.58	5.19	5.02	0.00	(-0.06)
Percentage of people of color on corporate boards	1.22	6.24	5.16	4.57	5.13	5.02	-0.01	(-0.38)
Percentage of people of color on corporate boards relative to the country demographic	3.12	6.82	5.32	4.74	4.17	3.70	0.13***	(3.84)
Number of ethnic groups on corporate boards	-0.13	4.89	4.91	#N/A	5.02	#N/A	-0.01	(-0.19)
Number of ethnic groups on the corporate boards relative to the country demographic	1.65	5.73	6.81	4.93	#N/A	4.08	0.06*	(1.77)
Ethnic fractionalization of corporate boards	0.19	5.21	4.66	4.91	5.02	#N/A	-0.01	(-0.38)
Ethnic fractionalization of the corporate boards relative to the country demographic	2.71	6.41	5.55	4.49	4.45	3.69	0.12***	(3.36)

Notes: There were 80,913 company-month observations obtained for a set of companies ranging from 838-899 during the testing period. Probability values are based on a t-statistic, which is a type of inferential statistic used to determine if there is a significant difference between the means of two groups, for a two-tailed test of significance, which means that the critical area of a distribution tests whether a sample is greater or less than a range of values. The numbers in the second column from right are the information coefficients and the values in parentheses are the associated t-stat. The first number in each cell is the information coefficient and the value in parentheses is the associated t-value.

***indicates $p < .01$, **indicates $p < .05$ and *indicates $p < .10$. The p-value represents the probability of obtaining results at least as extreme as the observed results of a statistical hypothesis test, assuming that the null hypothesis is correct. A smaller p-value means that there is stronger evidence in favor of the alternative hypothesis.

Taking a closer look at the relative impact of board ethnic diversity factors among companies in the same local market (Exhibit 8), we found significant financial materiality for American companies. For example, there was a performance return spread of 1.49% between companies with the greatest number of people of color on corporate boards (quintile 1) and those with the least (quintile 5). More specifically, “number of people of color” and “number of ethnic groups” were the most meaningful drivers of the relationship with equity performance. We, therefore, concluded that board ethnic diversity factors are good indicators for stock picking in the U.S. large-cap equity market.

We found less significant financial materiality for ethnic diversity among groups of Australian, Canadian or British companies. While we know these countries are less diverse than America and that their boards are relatively less diverse (see Exhibits 4 and 5), other factors may be at play. Perhaps results stem from the fact that the American economy is relatively more reliant on talent and innovation, which will provide equal opportunities for individuals of diverse backgrounds to progress through the corporate

sector, while a large portion of the Australian and Canadian economies remain natural resources-based. Nonetheless, comparing the results with and without controlling country, we noticed that the difference in board ethnic diversity across the four countries was a clear performance differentiator. Thus, we believe investors can benefit from tilting toward the board ethnic diversity factors across all four developed markets.

Conclusion

As investors, we recognize the value of diversity, equality and inclusion as a driver of performance over the long term. We, therefore, encourage companies to address these issues within the workplace. The stock performance penalty for those who don't persist can materially erode shareholder value. Through rigorous corporate engagement aimed at improving corporate behaviors on diversity, equality and inclusion, we can encourage a change in corporate behavior that can lead to a more sustainable and equitable world. We are committed to monitoring the trends of board ethnic diversity and hope to shed further light on its linkage to equity performance.

Exhibit 8

Country-Neutral Rank Correlation Estimates of Board Ethnic Diversity Factors and Monthly Equity Performance for Companies in the U.S. from 12/31/2012-12/31/2020.

Factors	Return Diff	Quintile 1 Return	Quintile 2 Return	Quintile 3 Return	Quintile 4 Return	Quintile 5 Return	IC	IC T-Stat
Number of people of color on corporate boards	1.49	5.14	4.82	4.13	4.46	3.64	0.08*	1.95
Percentage of people of color on corporate boards	1.76	5.40	4.75	4.16	4.38	3.64	0.07	1.60
Number of ethnic groups on corporate boards	1.17	4.82	4.19	#N/A	3.64	#N/A	0.07*	1.70
Ethnic fractionalization of corporate boards	1.05	4.69	4.32	4.25	3.64	#N/A	0.07	1.61

Notes: Probability values are based on a t-statistic for a two-tailed test of significance. The first number in each cell is the information coefficient and the value in the second column is the associated t-value.

***indicates $p < .01$, **indicates $p < .05$ and *indicates $p < .10$.

Appendix A. Factor Definition

Financial Performance

Annualized Gross Rate of Return	The security's total rate of return on an investment before the deduction of any fees, commissions or expenses.
ROE	Point-in-time Return on Total Equity as of most recent fiscal year.
ROA	Point-in-time Return on Assets as of most recent fiscal year.
ROIC	Point-in-time Return on Invested Capital as of most recent fiscal year.
Book-to-Price	Point-in-time Book-to-Price as of most recent fiscal year.
Free Cash Flow Yield	Point-in-time Free Cash Flow Yield as of most recent fiscal year.

Ethnic Diversity

Number of people of color on corporate board	Total number of directors that are not identified as White among the firm's corporate board.
Percentage of people of color on corporate board	Percentage of directors that are not identified as White among the firm's corporate board.
Difference of percentage of people of color on corporate board relative to the country demographic	Subtract percentage of people of color among the country's demographic from percentage of people of color among the firm's corporate board.
Number of ethnic groups on corporate board	Total number of ethnic groups among the firm's corporate board.
Difference of ethnic group on the corporate board relative to the country demographic	Subtract total number of ethnic groups among the country's demographic from total number of ethnic groups among the firm's corporate board.
Ethnic fractionalization of corporate board	The likelihood that two people on corporate board chosen at random are from different ethnic groups.
Difference of ethnic fractionalization of the corporate board relative to the country demographic	The degree of ethnic fractionalization of corporate board exceeds the degree of ethnic fractionalization of the country's demographic.

Fundamental Variables

Entity-level market cap	The company's total market capitalization denominated in USD of all listed equity securities.
Board size	Total number of directors on firm's corporate board.
Country	The company's country classification identified by MSCI.
Sector	The company's sector classification identified by GICS.

Appendix B

Australia

Factors	Return Diff	Quintile 1 Return	Quintile 2 Return	Quintile 3 Return	Quintile 4 Return	Quintile 5 Return	IC	IC T-Stat
Number of people of color on corporate boards	3.73	10.86	8.05	6.91	7.23	7.13	0.01	0.00
Percentage of people of color on corporate boards	4.07	11.19	6.04	7.40	6.54	7.13	0.01	0.00
Number of ethnic groups on corporate boards	0.96	8.09	7.20	#N/A	7.13	#N/A	0.01	-0.01
Ethnic fractionalization of corporate boards	0.98	8.10	7.31	7.10	7.13	#N/A	0.01	0.00

Canada

Factors	Return Diff	Quintile 1 Return	Quintile 2 Return	Quintile 3 Return	Quintile 4 Return	Quintile 5 Return	IC	IC T-Stat
Number of people of color on corporate boards	0.57	5.67	3.00	4.95	6.27	5.11	-0.03	-0.32
Percentage of people of color on corporate boards	1.29	6.39	3.34	4.00	6.12	5.11	-0.04	-0.33
Number of ethnic groups on corporate boards	-1.54	3.57	5.03	#N/A	5.11	#N/A	-0.03	-0.26
Ethnic fractionalization of corporate boards	-0.97	4.13	3.67	6.14	5.11	#N/A	-0.04	-0.34

U.K.

Factors	Return Diff	Quintile 1 Return	Quintile 2 Return	Quintile 3 Return	Quintile 4 Return	Quintile 5 Return	IC	IC T-Stat
Number of people of color on corporate boards	-0.58	6.22	12.65	7.15	7.23	6.80	0.02	0.22
Percentage of people of color on corporate boards	-0.92	5.88	12.24	6.76	8.41	6.80	0.02	0.17
Number of ethnic groups on corporate boards	-2.64	6.83	9.47	#N/A	6.80	#N/A	0.02	0.23
Ethnic fractionalization of corporate boards	5.54	12.22	6.68	7.96	6.80	#N/A	0.02	0.18

Important Additional Information and Disclosures

Source of all data: Calvert Research and Management, as of July 15, 2021, unless otherwise specified.

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