CFP BOARD CENTER FOR FINANCIAL PLANNING

WANT MORE ASSET MANAGER DIVERSITY? REEVALUATE DUE DILIGENCE PROCESSES USING METRICS THAT MATTER

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EXECUTIVE SUMMARY

The current rise in focus on diversity, equity, and inclusion (DEI) across the financial industry has propelled a number of firms and financial institutions to launch their own strategies and policies to increase DEI. However, upon closer inspection, these strategies and policies are almost never created with the direct input of those who will be most impacted. Those who might benefit most are still often excluded from the conversations that determine what these strategies are, and what makes them effective.

> *In order to build effective and sustainable strategies for increasing DEI, companies must ensure that they are considering both quantitative and qualitative metrics that benefit the communities they intend to impact.*

In financial services, these communities are often represented among diverse Asset Managers, owned and operated by women and people of color. After consulting diverse Asset Managers across the investment industry, the author proposes an important shift in focus for financial planning firms that wish to increase DEI in financial services.

Financial planners can meaningfully advance DEI by focusing not only on increasing diversity of their own staffing, but on the systems they use that can increase diverse perspectives throughout the financial services industry. To do this, it is critical that financial planning firms, herein referred to as Asset Allocators, go beyond focusing on their own internal hiring practices to understand their role as gatekeepers that directly impact a) ***who*** is directing investment assets, and b) ***where*** those assets are being directed.

INFLUENCING THE FINANCIAL INDUSTRY

As a Black-owned firm that is majority-operated by women, people of color, and members of the LGBTQ+ community, Adasina has always seen advancing DEI in the industry as an integral part of its work. Given our current moment of racial reckoning in the United States and the history of systemic racism in the financial industry[1], it is imperative that we focus on returning power to those from whom power and resources have historically been taken; "the financial services industry has a responsibility to consider our role in this moment—both our industry's role in how we got here, and how to work towards the equitable and just financial system our country needs."[2]

In order to do this, we not only integrate DEI principles into our investment strategies, but also critically address the systems in financial services that continue to exclude diverse voices and consolidate power. This approach involves working with several key industry stakeholders:

> **Asset owners:** Individuals or institutions with money to invest. These stakeholders are often referred to as "investors" or "clients".
>
> **Asset allocators:** Financial professionals who make investment decisions on behalf of asset owners. These stakeholders are often referred to as "financial advisors", "financial planners", "wealth managers", or "investment consultants".
>
> **Asset managers:** Firms or financial professionals who compile a portfolio (or collection) of investments based on financial or impact goals. These stakeholders are most often referred to as "asset managers", "portfolio managers", or "money managers".

INVESTMENT ROLES

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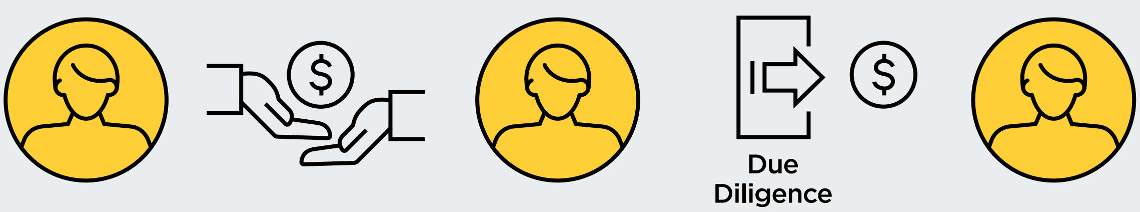

OWNERS

Investor or Client

Individuals or institutions with money to invest

ALLOCATORS

Financial Advisor, Financial Planner, CERTIFIED FINANCIAL PLANNER™ Professional, or Investment Consultant

Financial professionals who make investment decisions on behalf of asset owners

MANAGERS

Asset, Portfolio or Money Manager

Firms or financial professionals who compile a portfolio (or collection) of investments based on financial or impact goals.

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1. Adasina Social Capital, "Race in Finance: Making Black Lives Matter in Financial Services - [Installment 1: Reckoning with Our History](#)," Adasina Social Capital (July 24, 2020).
2. Ibid.

Each of these stakeholders has a critical role in shaping the future of DEI in financial services. However, for the purposes of this article, we will focus on the role of Asset Allocators. We aim to demonstrate how Asset Allocators impact the industry in their role as gatekeepers and the enormous opportunity to advance DEI through updating their Asset Manager selection processes.

Asset Owners hire Asset Allocators to help them make investment decisions and manage a portfolio of investment assets. Asset Allocators select Asset Managers and Asset Managers select specific investments. The Asset Manager directs the investments for the allocation of assets assigned to them. Selecting an Asset Manager can be as simple as purchasing a mutual or exchange-traded fund in a retirement account or as complex as directing assets into a private equity fund. To ensure the selection of qualified Asset Managers, Asset Allocators often engage in a formal evaluation process to screen potential candidates based on a number of criteria. The evaluation process may also assist an Asset Allocator in demonstrating that they have met their fiduciary obligation to the Asset Owner. At the end of this process, however, the vast majority of approved Asset Managers are white- and male-owned firms.

DUE DILIGENCE 2.0 COMMITMENT

In 2020, Adasina partnered with Asset Allocators, Asset Managers, and Asset Owners to target a systemic barrier to diversifying who directs wealth in the financial industry: traditional "due diligence." In this case, due diligence refers to the most common practice used by Asset Allocators for evaluating and selecting Asset Managers on behalf of Asset Owners.

While Asset Owners increasingly tell their Asset Allocators that they want manager diversity along with their financial returns, traditional due-diligence and risk-assessment frameworks in the asset management industry have led to a system in which "white, male asset managers control 98.7% of the investment industry's $69 trillion in assets under management."[3] If there is "no statistical difference in performance between diverse-owned firms and their peers,"[4] then why does this disparity stubbornly persist?

The problem isn't due diligence itself, but rather an outdated approach to the due diligence process that maintains the imbalance of control that already exists. The traditional Asset Manager evaluation process actually exacerbates existing inequities in financial services. If racially diverse Asset Managers are what both Asset Owners and Allocators want, then Asset Allocators must adjust their selection processes to achieve that outcome.

Managers, in particular Black, Indigenous, and People of Color (BIPOC), typically face industry-standard thresholds for assets under management (AUM) and track record requirements that overwhelmingly favor firms that already manage significant assets. Though these standards for due diligence consideration (typically a minimum of $200 million under management and a three-year track record) are a difficult hurdle for any emerging manager, the AUM and track record standards are disproportionately harder for BIPOC Asset Managers to achieve.

As a result of systemic inequities, Asset Managers able to meet these thresholds are likely to have existing wealthy investor networks willing to invest based on relationship alone, and/or have personal or family wealth to draw upon during the initial three-year period. BIPOC people, especially Black and Indigenous people, are underrepresented in financial services[5] and face an enormous wealth gap[6], making them far less likely to have the advantages that enable other Asset Managers to meet these thresholds.

Due diligence processes that require these thresholds to be met, or offer exemptions from these requirements based on relationships (and who gets exemptions from the requirements is a topic worth considering), exacerbate systemic racial inequality in financial services. In order to determine whether DEI strategies are effectively increasing DEI in the field, Asset Allocators should track the outcomes of their due diligence processes and the diversity of the Asset Managers they select for client investments rather than focusing exclusively on diversity hiring metrics within their own firms.

3. Julie Segal, "Asset Managers Owned by Women and Minorities Have to Work 10X as Hard for Assets," Institutional Investor (January 28, 2019).
4. Grid 202 Partners. "A Racial Equity-Centered Approach to Choosing A Financial Advisor." Grid 202 Partners (2020).
5. Edgar Villanueva, "Money as Medicine," Stanford Social Innovation Review (May 21, 2018).
6. Jenna Ross, "The Racial Wealth Gap in America: Asset Types Held by Race," Visual Capitalist (June 12, 2020).

RETHINKING DEI METRICS

Given society's pressing need to reduce systemic racial inequities in education, hiring, compensation, promotion, healthcare, environmental safety, and incarceration rates, among many others, the Asset Owner and Asset Allocator's most impactful potential contribution to reducing these inequities is to allocate more capital to BIPOC Asset Managers and specifically to those managers whose practices support the well-being of communities, entrepreneurs, and stakeholders of color. Furthermore, by not actively allocating to BIPOC Asset Managers, there may be a loss of potential financial returns.[7] Fiduciaries are required to act with prudence, which means "acting with or showing care and thought for the future"[8] and "in the best interests of their clients."[9] Thus, updating due-diligence processes to increase the flow of capital to BIPOC Asset Managers is consistent with the fiduciary responsibility of many Asset Allocators.

BIPOC Asset Managers consistently state that existing financial industry due diligence standards result in institutional assets continuing to be managed by the same firms, which are overwhelmingly white and male.[10] While Asset Allocators may have initial conversations with many BIPOC Asset Managers, these managers are notably missing from institutional portfolios. Often BIPOC Asset Managers are eliminated from the selection pool based on historical industry standards for due diligence that reinforce existing social inequities.

7. Lyons-Padilla, Sarah, et al. "Race Influences Professional Investors' Financial Judgments," Proceedings of the National Academy of Sciences of the United States of America (August 27, 2019).
8. Oxford Dictionary, "Definition of Prudent," Oxford University Press via Lexico.com (October 23, 2020).
9. "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," United States Securities and Exchange Commission (July 12, 2019).
10. David Morris, "Investment management is overwhelmingly dominated by white men—and it's costing you money," Fortune (June 19, 2020).

Forward-thinking Asset Allocators can update their due diligence processes in a number of ways to be more inclusive. The Due Diligence 2.0 Commitment includes nine specific shifts Asset Allocators can make in the due diligence process to remove systemic barriers to BIPOC Asset Managers while maintaining full fiduciary responsibilities. These shifts are easily applied to women Asset Managers as well. An abbreviated version of the nine principles follows. In addition, we later offer sample metrics for evaluating the success of implementing these updated due diligence practices in service of advancing DEI in finance.

1. Consider Track Record Alternatives

For newer strategies or products, instead of insisting on a specific minimum track record for the product, evaluate members of the investment and leadership team based on past experience, investment sourcing capabilities, domain expertise, as well as assess prior track records in related or relevant work.

2. Expand What it Means to "Work Together"

Particularly for private market investments, the management team is often evaluated based on how long they've worked together. However, for BIPOC managers, opportunities to "work together" or "invest together" at existing asset management firms are few and far between. Instead, take into consideration the time individual investment managers have worked together while building the firm and in other organizations as substitutes to evaluate the stability of the partnership.

NINE PRINCIPLES

- **Consider Track Record Alternatives**
- **Expand What it Means to "Work Together"**
- **Reassess Assets Under Management (AUM) as a Risk Metric**
- **Respect BIPOC Time**
- **Contextualize Fees**
- **Include Historically Unrecognized Risks**
- **Be Willing to Go First**
- **Offer Transparency About Remaining Hurdles**
- **Provide Detailed Feedback**

3. Reassess Assets Under Management (AUM) as a Risk Metric

Instead of using AUM as a proxy for the financial stability of a manager, commit to evaluating a) the manager's history of operating effectively with lower than industry-standard budgets, b) growth momentum in AUM, c) AUM growth in previous position(s) at prior firm(s), and d) what happens to the underlying investments in the event of firm insolvency. In many cases, when a manager becomes insolvent, the underlying assets are simply apportioned pro rata to the investors. If this is true for a product you are considering as an allocator, reevaluate the true risk of loss to the investor and whether AUM is an appropriate indicator.

4. Respect BIPOC Time

Reports from BIPOC managers conclude that while they have committed extensive time to due diligence conversations and formulating written responses to questions, very little capital has actually moved to their management. Recognizing that time is the most precious commodity for BIPOC managers, minimize requests for meeting time with managers and, if possible, convene group meetings in which managers can answer questions for multiple Asset Allocators at once. Condense, standardize, and/or support managers in completing due diligence questionnaires.

5. Contextualize Fees

Rather than eliminating BIPOC managers from consideration due to higher fees, compare the services they provide to peer managers (e.g., does the BIPOC manager require more staff or outsourced partnerships to collect data from impacted communities?). Additionally, because higher fees are often correlated with lower assets under management, consider allowing for initial high fees predicated on a manager projection for future fee reductions tied to fundraising success.

6. Include Historically Unrecognized Risks

To the extent you consider market inefficiencies or underpriced risks in your investment philosophy and analysis, consider evaluating the potential risks and costs of BIPOC under-capitalization in your analysis.[11]

7. Be Willing to Go First

Consider being an anchor/seed investor or part of a first close (or in the case of a mutual fund or exchange-traded fund, at/near fund inception) rather than insisting on being in later closes.

8. Offer Transparency About Remaining Hurdles

If after the aforementioned revisions you still have specific minimum thresholds, explicitly state those at the outset when communicating with BIPOC managers. If the manager finds them overly burdensome, they have the opportunity to invest their time in other opportunities.

9. Provide Detailed Feedback

If you choose not to invest with a BIPOC manager who has engaged in your due diligence process, provide clear, specific, and timely feedback regarding the reasons for rejection. This creates a new opportunity for mentorship and professional growth for managers who may have lacked access to these resources in the past.

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11. David Brancaccio, Nova Safo, and Alex Schroeder, "U.S. suffered $16 trillion loss over 20 years due to racism, new Citigroup study finds," Marketplace (September 23, 2020).

In addition, by looking to measure the success of implementing the Due Diligence 2.0 Commitment, Asset Allocators will also find better metrics for assessing the DEI practices of Asset Managers. After integrating the Due Diligence 2.0 Commitment principals into a due diligence process, Asset Allocators can evaluate the remaining Asset Manager pool by a number of relevant criteria, including:

Ownership: Do women and BIPOC staff account for at least 50% of the firm's ownership? Do BIPOC staff account for at least 30% of the firm's ownership?

Leadership: Are at least 50% of the voting members of the investment committee and/or portfolio management team women and BIPOC? Do BIPOC staff account for at least 30% of the firm's management?

Diversity and Inclusion Practices: Do the Asset Managers in your portfolios have hiring policies in place to attract, retain, and train women and BIPOC employees at all levels in the firm?

Historical Record: How many emerging Asset Managers are in your portfolios? Are there any that have a track record less than 1 year? Less than 2 years?

Allocation: What percentage of total assets are allocated to women and BIPOC-owned Asset Managers? What percentage do you intend to reach by 2025? 2030?

There are a number of significant outcomes from reevaluating traditional due diligence processes that contribute to both short-term and long-term benefits. Asset Allocators who want to embrace DEI will only achieve a diverse Asset Manager pool by using updated evaluation processes that do not continue to replicate the status quo of a disproportionately white Asset Manager lineup. By reevaluating with metrics sourced directly from the women and BIPOC Asset Managers, allocators are far more likely to achieve a diverse pool of Asset Managers because their solutions will come from those with the best perspective on the problem.

In the long-term, by approving more diverse Asset Managers, Asset Allocators will begin shifting the previously one-sided distribution of who controls wealth and power within finance. In doing so we can not only shift more capital to women and BIPOC Asset Managers, but make a significant move towards ending the racial wealth gap.[12] By allocating more assets to diverse managers, communities negatively impacted by historic inequities have the opportunity to prosper and build wealth where they have otherwise been excluded.

12. Brent Kessel, Kamila Elliott, and Ako Ndefo-Haven, Two American Financial Plans:The Next 50 Years of the Racial Wealth Gap and What You Can Do About It, www.TheRacialWealthGap.com (2021).

IMPLEMENTATION

How can financial planners and other Asset Allocators begin implementing a new, DEI-focused due diligence process?

Here are a few suggestions:

- **SIGN** the Due Diligence 2.0 Commitment.

- **TELL** BIPOC Asset Managers in your manager evaluation process that you've signed the Due Diligence 2.0 Commitment and ask them for feedback on your process in alignment with the principles.

- **ACCEPT** the Due Diligence 2.0 Questionnaire, a template that integrates the nine practices, in lieu of a proprietary questionnaire, as a "common form" questionnaire that reduces the workload and thereby removes barriers for diverse managers. The questions in this document were submitted by seasoned allocators and reviewed by BIPOC asset managers to remove embedded bias and create a more inclusive, yet equally rigorous, means of evaluating asset management firms, investment products, and strategies.

- **USE** the Due Diligence 2.0 Questionnaire as a guide for updating your current due diligence process to be more equitable and inclusive.

- **ALLOCATE** assets to diverse Asset Managers, once approved for use in portfolios. Add a goal to your standard investment policy of allocating **a specified percentage** to diverse Asset Managers. Many such commitments target 25% of assets allocated to diverse Asset Managers by 2025.

- **SHARE** your experiences and challenges with your larger community within financial services and get ongoing support for doing the work!

Implementing the Due Diligence 2.0 Commitment is possible for Asset Allocators of any size. There are diverse Asset Managers in all sectors and with varying specializations to meet every Asset Allocator's needs. It is up to the Asset Allocator to seek Asset Managers outside of their traditional networks and brand-name asset management firms, such as Emerging Manager Monthly's Diverse Manager Directory.

INVESTMENTS AND BEYOND

Beyond the benefits of increasing DEI in the due diligence process, there are other considerable DEI benefits of allocating to diverse managers. At Adasina, we believe that it is critical that those most impacted by injustice be central to the process of determining the solutions to that injustice. In the case of investments, those most impacted by injustice should be central to determining how to invest to advance social justice.

As a firm founded by a queer, Black woman and staffed primarily by women and people of color, Adasina has remained close to the communities most impacted by issues of racial, gender, economic, and climate justice.

By allocating assets to diverse managers, allocators can also ensure a diversity of perspectives, as well as implementing a DEI strategy that extends into their investments as well.

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