DIVERSE PERSPECTIVES

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Some U.S.-based public pension funds and their consultants are ensuring they are doing business with more minority- and women-owned asset managers and brokerage firms, and as a result, the funds are seeing increased innovation. Although there are no requirements that public pension systems in Texas work with minority- and women-owned firms, there are some key practices institutional investors can use to diversify their knowledge base.

by Allen Jones, TEXPERS Communications Manager

Last year, Chicago-based Northern Trust Asset Management expanded its use of minority-owned brokerage firms. The firm is an Associate Advisor member of the Texas Association of Public Employee Retirement Systems and works with several state and local funds in Texas. Northern Trust "set a target to execute 10 percent of all equity security trading commissions with minority brokers for approximately 120 common and collective investment trusts it manages," according to a March 27, 2018 news release North Trust provided TEXPERS to explain its diversity program.

"We have had a formal minority brokerage policy and selection process in place since 2007, and our CEO Action for Diversity and Inclusion program started years before that in 1989," says Bob Parise, practice lead for Public Funds and Taft-Hartley within the firm's institutional group.

The firm's CEO Action for Diversity and Inclusion program is the largest CEO-driven business commitment to advancing diversity and inclusion in the workplace. Northern Trust already directs one-third more trading volume to minority brokers than its peers, according to a 2016 third-party study commissioned by the firm.

"For more than a decade, as part of our overall commitment to diversity, we have been developing relationships with minority-owned firms that provide brokerage services and leveraging their capabilities across a number of portfolios," Parise says. "As we have seen their practices develop over the course of time, it has been our intention to explore ways to expand these relationships within the minority brokerage community."

Northern Trust implements its diversity program in other aspects of the financial industry. In October, the firm announced its selection of five firms owned by minorities, women, veterans or people with disabilities that offer equity research that advise Northern Trust's investment decisions.

Economist William Michael Cunningham has been collecting financial and social data through his firm, Creative Investment Research, since 1989. He tracks minority-owned financial firms and often speaks about the importance of investing in minority and undeserved communities. He says that although there are fewer minority-owned financial firms operating in the U.S., there are more opportunities due to diversity programs implemented by institutional investors and their consultants such as Northern Trust.

Cunningham says there is a barbell effect, where investors split their investment portfolio between startup companies – many being women- and minority-owned – on one end and mature companies on the other. The goal is to balance the weight and risk on both ends.

"At the same time, focus on the minority firm sector has become institutionalized, with firms like Exelon and Apple establishing ground breaking efforts," he says. "The problem is there are fewer and fewer firms to take advantage of these programs."

Workplace Diversity

Cunningham says the need for greater gender and racial makeup within the U.S. workforce continues to be acknowledged by major corporations. He points to several studies that demonstrate the benefits private companies and public-sector institutions can gain when striving to bring more minorities and women into their fold.

It is well established that racially diverse companies financially outperform industry norms by at least 35 percent and companies in the top quartile for gender diversity are 15 percent more likely to have financial returns above their national industry peers, according to a 2015 report by McKinsey and Company. Diversity is seen as necessary within the financial services industry, too. Asset management firms and brokerages are recognizing the importance of recruiting and retaining minorities and women in crucial positions to improve business and meet the needs of their diverse customer bases. However, workplace diversity within the financial services industry is not occurring at great rates, according to Feb. 27 report of the U.S. Government Accountability Office.

The GAO has been tracking the representation of minorities and women in the financial services industry for the U.S. Congress. Representation increased only slightly for minorities and remained unchanged for women between 2007 and 2015, according to a November 2017 GAO report, which tracked changes in management-level diversity and diversity practices in the financial services. The GAO reported a similar trend at the senior-level management of these firms. During the time frame, women represented about 29 percent of senior-level managers and representation of minorities in senior management increased by less than 1 percentage point for each racial or ethnic group tracked.

In the 2017 report, the GAO noted that minority- and women-owned asset managers face challenges when contending for investment management opportunities with institutional investors, such as retirement plans. Among the them, pension systems and their consultants often contract with larger asset managers that have brand recognition. And, small firms were often unable to meet minimum requirements set by institutional investors such as size of assets under management and experience.

Diversity, according to the GAO, lends itself to increased innovation and better results. In 2017, the GAO identified four key practices public pension funds can use to increase opportunities for minority- and women-owned asset managers:

1. Leadership must have a commitment to increasing opportunities for minority- and women-owned asset managers.
2. Leaders should review investment polices and practices to remove barriers that limit the participation of smaller, newer firms.
3. Institutional investors should conduct outreach to inform minority- and women-owned asset managers about investment opportunities and selection processes.
4. Funds should clearly outline priorities and expectations about inclusive practices to investment staff and consultants and ensure those expectations are met.

Texas Statutes

Although there are no state statutes relating to minority- and women-owned financial firms applicable to all pension funds in Texas, there are emerging manager requirements applicable to the Employees Retirement System of Texas and Teacher Retirement System of Texas. The programs generally focus on newer firms entering the industry, which may overlap with minority- and women-owned firms.

ERS statute mentions emerging managers in Government Code Sec. 815.301(g), stating that "the board of trustees shall make a good faith effort to award contracts to or acquire services from qualified emerging fund managers." Government Code Sec. 815.301(h) defines

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emerging fund manager as "a private professional investment manager that manages assets of not more than $2 billion." ERS's Emerging Manager Program is described in the ERS Investment Policy.

TRS statute mentions external investment managers in Government Code Sec. 825.301 but does not specifically mention emerging or minority-owned brokers. However, TRS's investment policy describes its program and states that emerging managers may include women- and minority-owned organizations but may not, since that's not explicitly how it is defined it in its IPS.

Anumeh Kumar, executive director of the Texas Pension Review Board, the state's public retirement system oversight agency, says general contracting requirements might apply to investment management services, which she believes directly address minority ownership.

Industry Examples

Cunningham says Texas-based funds, especially smaller retirement systems, do not have to wait for a state mandate to institute diversity rules to work with women- and minority-owned financial institutions. He suggests looking at what bigger funds in the U.S. are doing to find ways to establish a local "win-win situation" by using minority- and women-owned firms.

He says the Chicago Teachers' Pension Fund is at the forefront of public retirement systems in the U.S. that provide minority-owned firms opportunities. The state of Illinois has regulations requiring pension funds to diversify investment managers and work with minority- and women-owned brokerages.

"The Chicago Teachers' Pension Fund has history, a long experience with minority firms, along with a strong set of Chicago-based institutions," he says. "You have Ariel Capital, Loop Capital and several others that form an impressive ecosystem of minority firms. Chicago also used to have more black banks than anyone else, a legacy of single branch banking and a group of hard-working black folks from the South."

Minority-, women- and persons with disabilities-owned firms have opportunities to provide goods and services, including asset management and brokerage services, to the approximately $10 billion Chicago Teachers' Pension Fund.

The fund began investing in women- and minority-owned firms during the early 1990s. According to the fund's 2018 Annual Diversity and Inclusion Report, on June 30 that year, the fund invested $4.5 billion, or 42 percent, of total fund assets with firms owned by minorities, women and disabled persons. Since 1994, that percentage has increased from 6.7 percent.

Angela Miller-May, chief investment officer of the Chicago Teachers' Pension Fund, says a section of Illinois' pension code outlines diversity requirements that the Chicago teachers' fund has implemented. The fund's investment manager diversity and brokerage utilization rules spell out per asset class the minimum standards and goals that must be met in providing opportunities for emerging and other firms owned by minority, women, and persons with disabilities, also known as MWDBE firms.

"The fund is committed to providing opportunities for emerging and other minority-, women- and persons-with-disabilities-owned investment manager and brokerage firms," Miller-May says. "The CTPF board of trustees adopted the Investment Manager Diversity Policy to set goals for increasing the fund's utilization of MWDBE investment management firms. Policy also sets forth goals for increasing the utilization of the fund's approved MWDBE brokerage firms."

According to the fund's Investment Manager Diversity Rule, 20 percent of total assets must be invested with MWDBE investment managers. Of the fund's active assets, 25 percent are to be invested with MWDBE investment managers. That rule is further broken down between asset classes – 30 percent equity assets, 15 percent fixed income assets, and 10 percent alternative assets.

As for the fund's Brokerage Utilization Rule, investment managers must work with fund-approved brokers. The rule also establishes minimum commission requirements each calendar year.

Parise of Northern Trust is familiar with the Chicago Teachers' Pension Fund. The firm works with the fund, he says. Because of Northern Trust's own diversity program, its approach is the same when working with the Chicago fund or any other fund in various states. He says small funds in Texas should examine the diversity programs their consultants utilize to make sure management and trading activities are focused on meeting portfolio investment objectives.

Expert Advice

Gilbert Garcia is a managing partner at Garcia Hamilton & Associates LP in Houston. It is the largest Hispanic-owned financial firm in the U.S. Garcia says his firm works with many minority-owned money management and brokerage firms, such as Cabrera Capital, Luke Capital Management, CastleOak Securities, and The Williams Capital Group, and Academy Investment Management. Many of the firms are owned by minorities, women, veterans, and persons with disabilities.

"We manage about $13.2 billion and do about 70 percent trades with those class of brokers," he says.

Garcia says pension funds serve a diverse group of people and they want to see their funds do business with people that look like them. He provides some tips small pension funds can utilize to diversify their investment managers and the brokers they work with:

1. To insure your consultant casts a broad net when hiring managers, consider the "Garcia Rule," which is policy at Houston metro and the Illinois State Treasurer. It requires their consultants to bring one diverse firm for consideration to the finals in every manager search. The consultant opens their process to new, good performing diverse managers. The trustees might find an incredible manager. And the minority-owned firm gets great exposure. The real question is "why wouldn't everybody adopt it."

2. Eliminate conflicts by making your consultant disclose the amount if they (or any affiliated companies) receive revenue or economic benefit from any manager brought before the board. This should include fees for education seminars, product placement studies, systems licensing, speaking engagement or any other form of benefit paid by the manager. If they won't disclose this information, then assume the worst.

3. Diversity is a strength that leads to better decision making. And, the work force/beneficiaries are becoming increasingly more diverse. It is proper to ask your consultants and managers their diversity stats. What is their diversity in partners, consultants, portfolio managers, research analysts, etc. and what steps are they doing to be good citizens in their communities?

4. Likewise, make sure your managers are achieving best execution. One good sign is if their brokerage activity is across many firms. Ask the ownership diversity of the brokers they utilize. Again, best execution may come from the largest brokers, but it might also come from smaller boutique brokers like some of the minority-owned brokers.