Hedge Fund Law Report
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Employment

Why Equal Representation Within Fund Managers Is Essential (Part One of Four)

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Women, African-Americans and Latinos are proportionately underrepresented in the financial services sector in ownership and management positions, as well as in rank-and-file employment. Few hedge fund managers currently have formal structures in place to correct underrepresentation, and research shows that organizations often perceive themselves as more diverse than they actually are. In conjunction with an open-minded work climate, however, diversity can lead to a number of benefits, including stronger performance; fewer errors; increased creativity and cooperation; and greater empathy.

This article, the first in a four-part series, discusses the lack of diversity within the financial services and alternative investment management industries and explains why fund managers should focus on increasing diversity. The second article will analyze diversity training; performance ratings and hiring tests; grievance procedures; and specific actions managers can take to promote diversity and inclusion. The third article will explore implicit biases, their harms and whether they can be reduced in both the short and long term. The fourth article will evaluate methods for constraining decision making and examine the role that legal and compliance leaders can take to promote diversity and reduce implicit biases.

See "HFLR Program Looks at Recent Developments and Trends in Employment Law Relevant to Fund Managers" (Jul. 26, 2018).

A Lack of Diversity Within the Industry

Statistics Show Low Diversity

The Bureau of Labor Statistics, in its annualized Current Population Survey for the year 2017, published data on the percentage of employed persons by industry, sex and race.[1] Data from that survey has been extracted into Table 1, which shows the composition of the U.S. labor force as a whole and of North American Industry Classification (NAICS) 523 (which encompasses securities, commodities, funds, trusts and other financial investments), as well as the percentage differences between the two.[2]

Table 1

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	Women	Whites	Blacks or African Americans	Asians	Hispanics or Latinos[3]
U.S. Labor Force	46.9%	78.4%	12.1%	6.2%	16.9%
NAICS 523	37.7%	83.2%	5%	9.2%	7.8%
Percentage Difference	-19.6%	+6.1%	-58.7%	+48.4%	-53.9%

A 2017 Preqin special report, entitled "Women in Alternative Assets," found that female employees make up only 18.6% of hedge fund employees.[4] The survey also found that demographically proportionate representation decreases with seniority.

Table 2, below, summarizes the survey's findings with respect to female employment (*i.e.*, women as a percentage of all employees) across function and seniority.

Table 2

	All	Junior	Mid-Level	Senior
Hedge Funds	18.6%	26%	21%	11%
Investor Relations and Marketing	47%	72%	45%	26%
Finance and Accountancy	25%	35%	33%	17%
Operations	21%	25%	25%	15%
Portfolio Management	9%	18%	10%	5%
Investment Team	10%	16%	13%	6%
Board of Directors	5.8%	-	-	

KPMG's 2016 "Women in Alternative Investments Report" paints a similar picture.[5] The report found that, across all alternative investment firms, women lag well behind men in C-level position representation. Table 3 below summarizes the findings.[6]

Table 3

Position	**% Women**
CEO	15.66%
Portfolio Manager/CIO	22.73%
Operating	36.36%

Table 3

Financial	35.16%
Compliance	46.59%
Technology	9.38%
Legal	29.85%
Risk	13.24%
Marketing/Investor Relations	51.85%

The report also found that, of the funds surveyed, 42% had no women on their investment committees and 45% had no women general partners.

In addition, in a Bella Research Group report, entitled "Diverse Asset Management Project: Firm Assessment," the authors noted that, although the number of women- and minority-owned hedge funds has increased since 2010, a mere 4.3% and 8.0% of hedge funds are owned by women and minorities, respectively.[7] Furthermore, those firms "control less than 1% of total industry assets."[8]

What Prevents Equal Representation in the Industry?

According to the KPMG report, the "overwhelming majority of respondents" believe that it is "harder for women to succeed in the industry." This may be, in part, due to poor work-life-balance policies.

The dearth of women and minority role-models, as well as smaller pipelines for talent, also contribute to the issue. "If individuals from underrepresented groups don't see people like themselves, they will begin to question whether they can succeed there," said Patrick McKay, professor of human resources management at the Rutgers University School of Management and Labor Relations who focuses his research on, among other things, the effects of race-ethnicity and diversity on recruitment outcomes.

As more fully discussed in the second article in this series, however, there are steps that fund managers can take to counteract these issues – including instituting women- and minority-targeted recruitment programs and mentoring, as well as increasing transparency in hiring.

See "2017 Compliance Salary Survey: How Do Fund Managers Compare?" (Jan. 4, 2018).

Ernst & Young, in its 2017 Global Hedge Fund and Investor Survey, found that, relative to five to ten years ago, 68% of hedge funds have changed the "profile" of employees that they evaluate, interview and hire, including diversity. The survey also found, however, that only 16% of hedge funds have targets regarding diversity in the workforce.[9]

For a more detailed discussion of the survey, see our two-part series: "Hedge Fund Strategic Priorities; Hedge Fund Offerings and Investor Allocations; Evolution of Front Offices; and Industry Risks" (Dec. 14, 2017); and "Hedge Fund Operations; Talent Acquisition and Retention; and Steps Hedge Funds Can Take to Remain Competitive" (Dec. 21, 2017).

Overestimated Diversity

Despite the lack of diversity within the industry, organizations may perceive themselves as more diverse than they really are. Researchers have observed a "spillover bias" in diversity judgements – *i.e.*, "when there is more diversity along one dimension (*e.g.*, race, clothing color), people also perceive more diversity on other dimensions (*e.g.*, gender, skill)."[10]

This bias may help explain why organizational decisions surrounding diversity are often suboptimal. The study's authors also found that the spillover bias may impact how individuals view affirmative action policies – *e.g.*, individuals who perceive their organizations as more diverse are more likely to view those programs as fair. Without further action, spillover bias may, therefore, hinder an organization's efforts to promote diversity.

The Benefits of Diversity

Better Performance

In one longitudinal study, Cornell and Georgia State researchers found "a positive relationship between diversity reputation and firm performance."[11] They posited that investors may view diverse companies as being "less of a financial risk given a reduced likelihood that earnings and stock returns will be influenced by financial losses associated with not managing diversity." Moreover, investors may view diverse companies as more concerned with social issues, which may "be attractive . . . for shareholders interested in social responsibility."

The authors of that study also found a "curvilinear U-shaped relationship between leader diversity" and performance. They suggested that low to medium levels of management diversity may lead to breakdowns in communication and increased conflict, while high levels of diversity may decrease "barriers to social interaction . . . thus increasing the likelihood that the firm may draw on such diversity as a unique resource."[12]

"The benefits of diversity can only be realized when the work climate is amenable to diversity," said McKay. "Many practitioners think that diversity begets a good climate, but it is the other way around. Diversity in and of itself is insufficient."

McKay added that, in the retail context, when climates were more favorable to diversity, sales increased across all groups "Although the gains were larger for minorities, everyone still sold more," he said. "That's the beauty of a work environment that is seen as fair and inclusive for all workers. People stay longer, work harder and serve clients better. It's amazing how consistent the positive effects are."

Increased Market Efficiency

One study found that ethnically heterogeneous markets are less likely to experience price bubbles.[13] The authors noted that bubbles are deleterious to individuals, the markets and the world economy.

Price bubbles, the study notes, emerge "when traders err collectively in pricing, causing misfit between market prices and the true value of assets." These errors are more likely to occur in homogenous markets, they argued, because traders are "less likely to scrutinize others' decisions . . . and more likely to accept prices that deviate from true values."

In particular, the authors found that "market prices fit true values 58% better in diverse markets" and that heterogeneous markets experience less severe market crashes.[14] Thus, diversity can not only increase intra-firm effectiveness but also industry-wide effectiveness.

Greater Creativity and Cooperation

Diversity can lead to conflict, however, given that "[p]eople tend to be more trusting of the perspectives, actions, and intentions of ethnically similar others."[15] Studies have shown, for instance, that heterogeneity can impair group communication, decrease morale and undermine performance.

Nevertheless, diversity can also lead to "increases in group creativity, information sharing, flexibility, and thoughtfulness," particularly when it comes to complex tasks that "require[ ] divergent thinking. . . ."[16] Moreover, the very friction caused by diversity can lead to less superficial thinking. Ethnically diverse juries, for example, "deliberate[ ] longer[,] . . . consider[ ] a wider range of information[,] . . . [make] fewer factual errors" and are more likely to correct inaccuracies or errors.

See "Point72 Complaint Ignites Discussion on Relevant Facts in 'Hostile Environment' Lawsuits" (Mar. 22, 2018); and "Portfolio Manager Accuses Former Employer and Supervisor of Retaliation for Reporting Sexual Harassment" (Feb. 15, 2018).

Greater Empathy

Empathy is a meaningful trait in business. According to one study, empathy "plays an important role in social interaction by facilitating both making sense of other people's behaviour and in responding appropriately to their behaviour."[17] Numerous studies demonstrate that women are more empathetic than men. For example:

- One longitudinal study found that, among adolescents who completed the "Index of Empathy for Children and Adolescents" and "Interpersonal Reactivity Index" tests, females displayed a "greater empathic response," which grew with age.[18]
- Another study found a "significant female advantage" on the Empathy Quotient, a self-reported measure of empathy. The authors noted that prior studies, which have identified sex differences "in the developmental precursors to empathy," suggest that "sex differences in empathy are at least partly biological."[19]

In a recent study that analyzed leadership, culture and management practices of service industry organizations in Australia, the authors found that high-performing workplaces (HPWs) – *i.e.*, workplaces that scored one standard deviation or greater above the mean in an index composed of 18 performance measures (such as employee innovation, job satisfaction and profit margin) – exhibited more than one culture type.[20] In particular, they found that organizational cultures that were centered on results (*i.e.*, on "achieving outcomes and results"), people (*i.e.*, on "caring, collaboration and a concern for people") and change (*i.e.*, on "innovation, responsiveness and adaption") were positively and significantly correlated with high performance. On the other hand, a control culture (*i.e.*, one in which the "focus is on management control and stability") was negatively and significantly correlated with high performance.

The authors observed that HPWs possessed higher quality leaders. Specifically, those leaders:

- were authentic (*e.g.*, by being "receptive to feedback . . . and [using it] as a learning opportunity to improve leadership skills and performance.");
- focused on strong development (*e.g.*, by encouraging, enabling and motivating employees to "contribute to their full potential."); and

- prioritized people management (*e.g.*, by showing "genuine interest in and care for [employee] growth opportunities" and truly caring "about the members of their team.").

In other words, HPWs are more likely to employ empathetic and compassionate leaders. "Of a broad range of possible contributors to an individual's performance at work," argued the authors, "strong leadership skills have consistently been recognised to be amongst the most important factors to consider."[21]

Associated with the foregoing, the authors noted that employees experience a wide range of emotions in the workplace, many of which are derived from an employee's relationship with his or her coworkers and supervisors. Unsurprisingly, employees in HPWs experience positive emotions, such as pride and optimism, "much more prevalent[ly]." The authors also found that employees in HPWs were more committed to their organizations, which leads to, among other things, "higher levels of discretionary effort," improved performance and greater creativity.

Thus, although fund managers should engage in efforts to increase empathy among all employees, given that women are – on average – more empathetic than men, it is likely that a more gender-diverse workforce could lead to a more positive organizational culture and thus stronger employee performance.

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[1] Available at https://www.bls.gov/cps/cpsaat18.htm.

[2] For more granular data on gender and racial diversity in the financial sector – including employment as officials, managers and professionals, as well as entry into management – see the U.S. Equal Employment Opportunity Commission's 2006 report entitled "Diversity in the Finance Industry," available at https://www.eeoc.gov/eeoc/statistics/reports/finance/index.html. The report relies on data from Standard Form 100, which must be filed by all private employers that are subject to Title VII of the Civil Rights Act of 1964 (as amended by the Equal Employment Opportunity Act of 1972) with 100 or more employees, and it provides diversity data for five different sub-sectors: central banking, banking/credit, securities, insurance and funds.

[3] Note that "[p]ersons whose ethnicity is identified as Hispanic or Latino may be of any race."

[4] Available at http://docs.preqin.com/reports/Preqin-Special-Report-Women-in-Alternative-Assets-October-2017.pdf. Note that the survey excluded all administrative and other support staff.

[5] Available at https://assets.kpmg.com/content/dam/kpmg/us/pdf/the-time-is-now.pdf.

[6] Note that the percentages have been adjusted in this article to reflect the removal of the "Don't Have/Not Applicable" option.

[7] Available at https://bellaprivatemarkets.com/diversity-report.pdf.

[8] Prior analyses have suggested that diverse-owned hedge funds have stronger absolute and risk-adjusted returns, but they fail to "control for confounding factors such as fund size, structure, and strategy," observed the authors. After conducting a series of regression analyses on hedge fund performance, the authors found no "significant difference in performance between funds managed by women- or minority-owned firms and non-diverse funds." One academic study has suggested, however, that while female-managed funds may "struggle to raise capital," those that do survive outperform surviving male-managed funds. See Aggarwal and Boyson, "The Performance of Female Hedge Fund Managers," *Review of Financial Economics*, 2015, available at https://ssrn.com/abstract=2726584.

[9] Or, just 40% of the 20% that have a formalized talent management program and 10% of the 80% that do not have a formalized talent management program.

[10] See Daniels, Neale and Greer, "Spillover bias in diversity judgment," *Organizational Behavior and Human Decision Processes*, 2017, available at https://www.sciencedirect.com/science/article/pii/S0749597816307932?via%3Dihub.

[11] See Roberson and Park, "Examining the Link Between Diversity and Firm Performance: The Effects of Diversity Reputation and Leader Racial Diversity," *Group & Organization Management*, 2006, available at https://doi.org/10.1177%2F1059601106291124.

[12] See also Hoogendoorn, Oosterbreek and van Praag, "The Impact of Gender Diversity on the Performance of Business Teams: Evidence from a Field Experiment," *Managerial Science*, 2013, available at https://doi.org/10.1287/mnsc.1120.1674. The study found that "teams with an equal gender mix perform better than male-dominated teams."

[13] See Levine *et al.*, "Ethnic diversity deflates price bubbles," *Proceedings of the National Academy of Sciences of the United States of America*, 2014, available at http://www.pnas.org/content/111/52/18524.

[14] *Id.* The authors argued that because "[r]eal markets are less transparent and more uncertain" than the experimental markets used in the study, their results likely "underestimate the detrimental effect of homogeneity."

[15] *Id.*

[16] See Sommers, "On racial diversity and group decision making: Identifying multiple effects of racial composition on jury deliberations," *Journal of Personality and Social Psychology*, 2006, available at https://www.apa.org/pubs/journals/releases/psp-904597.pdf.

[17] See Warrier *et al.*, "Genome-wide analyses of self-reported empathy: correlations with autism, schizophrenia, and anorexia nervosa," *Translational Psychiatry*, 2018, available at https://www.nature.com/articles/s41398-017-0082-6.

[18] See Mestre *et al.*, "Are Women More Empathetic than Men? A Longitudinal Study in Adolescence," *The Spanish Journal of Psychology*, 2013, available at https://doi.org/10.1017/S1138741600001499.

[19] See "Genome-wide analyses."

[20] See Boedker C., Vidgen R., Meagher K., Cogin J., Mouritsen J., and Runnalls J. M., "Leadership, Culture and Management Practices of High Performing Workplaces in Australia: The High Performing Workplaces Index," 2011, University of South Wales. Note, however, that the organizations used in the analysis did not comprise a random sample.

[21] Note that the study found no statistically significant correlations between controls (*i.e.*, demographics, external environment and business strategy) and the HPW index, suggesting that "the management practices examined . . . significantly influence workplace performance."

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