CHIEF INVESTMENT OFFICE

Impactonomics®

Diversity Equity & Inclusion: A Lens for Investing

October 2023

THE INVESTMENT CASE FOR DIVERSITY EQUITY & INCLUSION

Diversity, Equity and Inclusion (DEI) is often seen as a "nice-to-have," but that motivation alone would ignore the significant amount of research on the direct financial and economic benefits of including diverse perspectives across the labor force, in investment management, and in markets attempting to transform and innovate.

Closing gender and race gaps in education and employment in the U.S. would have generated $2.6 trillion in additional output in 2019, and the cumulative gains from 1990 would have been $70 trillion in 2019 dollars.[1] Access to healthcare, education and job opportunities are only some of the drivers of the economic case for DEI, and a growing body of evidence suggests that the incorporation of DEI considerations can lead to economic growth and sustained long-term outperformance of investments,[2] making it an economic imperative that cannot be ignored.

Here, we examine the economic case for assessing investments through a DEI lens—in which we define diversity here as including not only gender and racial/ethnic minorities but also disability, lesbian, gay, bisexual, and transgender (LGBTQ+) identity and other forms of diversity—both the opportunities of harnessing this investment lens and the risks of ignoring it.

Inclusion Is an Economic Imperative

From a macroeconomic perspective, excluding productive members of a population—such as women, LGBTQ+ groups, people with disabilities and people of color—has proved to be costly to the economy. At the current rate, the gender gap in economic participation and opportunity, as defined by the World Economic Forum, will take 169 years to close,[3] leaving much on the table: The global loss of wealth due to gender inequality is estimated to be $172 trillion over the average lifetime.[4] Beyond gender, studies show that the exclusionary treatment of LGBTQ+ groups can cost economies up to 1% of their gross domestic product (GDP),[5] and excluding people with disabilities can cost as much as 7% of their GDP.[6] The racial wealth gap is expected to cost the U.S. between $1 trillion and $1.5 trillion in lost consumption and investment between 2019 and 2028,[7] having already cost the economy an estimated $16 trillion in the two decades leading to 2020.[8]

AUTHORED BY

Chief Investment Office
Due Diligence and
Sustainable & Impact Investing Team

CIO PEOPLE PILLAR OF SUSTAINABLE INVESTING

People
Commitment to engaged and healthy workers and sustainable communities

Empowerment & Inclusion

Diversity policies and programs

Women on the Board of Directors

Employee benefits and labor rights

Sustainable Communities

Affordable real estate

Human rights

[1] BofA Global Research, "Everybody Counts!" March 2, 2021. Latest available data as of 2019.
[2] McKinsey & Company, "Diversity Wins: How Inclusion Matters," May 19, 2020.
[3] World Economic Forum, "Global Gender Gap Report," June 2023.
[4] Quentin Wodon, Adenike Onagoruwa, Chata Male, Claudio Montenegro, Hoa Nguyen and Benedicte De La Briere, "*How large is the gender dividend? Measuring selected impacts and costs of gender inequality*," February 2020.
[5] Lee Badget, "The Economic Case for LGBT Equality," May 19, 2020.
[6] World Economic Forum. "Closing the disability inclusion gap with business leadership," May 23, 2022.
[7] McKinsey & Company, "The economic impact of closing the racial wealth gap," August 13, 2019.
[8] Citigroup, "The Economic Cost of Black Inequality in the U.S." September 2020.

On the other side of the coin, a growing body of academic research suggests that DEI factors could underpin key inputs to economic growth. According to the World Bank, long-run GDP per person would be nearly 20% higher, on average, if gender employment gaps were closed across countries.[9] The impact of minority health equity could bring an additional $1 trillion annually to the U.S. economy by 2040.[10] If the U.S. reached income equality between Black and White households, purchasing power would jump from $976 billion to $1.6 trillion in the U.S., which could improve GDP by 3%.[11] Further, research has found that including people from different backgrounds with unique perspectives leads to a workforce that cultivates innovation—if this type of "innovation mindset" was increased by 10% across countries, global GDP could increase up to $8 trillion by 2028.[12] These estimates make it clear that progress toward equality has the potential to significantly improve the health of all economic participants.

INVESTMENT OPPORTUNITIES

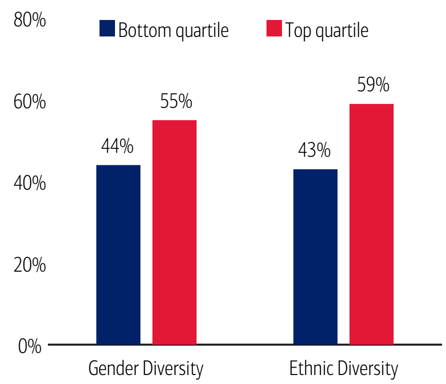
Company Considerations

At the company level, studies show that companies that perform well on different DEI aspects demonstrate superior business results, including better profitability, access and stability of top talent, greater innovation, and better risk management. Therefore, selecting companies to invest in without looking at DEI leaves an incomplete picture of the future competitiveness of a company.

Companies in the top quartile of gender diversity on executive teams were more likely to have above-average profitability than companies in the fourth quartile, and the difference was even more pronounced for ethnically diverse companies (Exhibit 1).[13] As You Sow, a leading shareholder advocacy nonprofit, also found that "higher representation of Black, Indigenous, and people of color (BIPOC) employees in management has a positive relationship to higher cash flow, net profit, three- and five-year revenue, and five-year return on equity (ROE), and stock performance [as well as] lower volatility."[14] From a gender perspective, gender diversity (as measured by women on the board and women in management) yields higher ROE and lower earnings risk.[15] Companies are also considering human capital-related DEI risks. Discrimination and harassment lawsuits can be costly and damage a company's reputation: In 2022, the U.S. Equal Employment Opportunity Commission (EEOC) obtained more than $513M in monetary benefits for victims of discrimination, an increase from the previous fiscal year.[16]

In all market environments, and especially challenging ones, it is in the company's best interest to source and retain the best human capital—this requires a talent pipeline that provides opportunities to diverse groups and allows companies greater access to underutilized talent pools. Similarly, greater DEI practices bolster employee retention, a particularly relevant consideration during periods of a tight labor market—according to Deloitte, more diverse companies have 22% lower turnover rates than peers with less diversity.[17] Deloitte also found that only 9% of women working for "gender equality leaders" plan to leave their current organization in the next one to two years, compared to 39% of women at "lagging" firms.[18] Additionally, as stated previously, including people with different backgrounds and perspectives fosters an innovation mindset. This cognitive diversity also reduces groupthink, therefore strengthening risk management[19] and decision making.[20]

Exhibit 1: Likelihood of Financial Outperformance as of 2019



Note: Likelihood of financial outperformance versus the national industry median. Data as of 2019. Source: McKinsey & Company, "How inclusion matters", May 19, 2020-latest data available.

Policy Tailwinds for Investing Through a DEI Lens

Through the Inflation Reduction Act and Bipartisan Infrastructure Law, federal agencies are making historic levels of investment to advance environmental justice while ensuring disadvantaged communities receive these new and existing federal benefits. President Biden's Justice40 Initiative has the goal that 40% of the overall benefits of certain federal investments flow to disadvantaged communities that are marginalized, underserved and overburdened by pollution. This significant flow of public capital serves as another clear indicator of the substantial opportunities available to investors interested in supporting diverse communities.*

* The White House: What is the Justice40 Initiative? 2022.

9 World Bank, April 2023.
10 Deloitte, "US health care can't afford health inequities," June 22, 2022.
11 Federal Reserve Bank of St. Louis, "The Association between Black Buying Power and Greater Income Equity," Feb 23, 2023.
12 BofA Global Research, Accenture, "ESG Matters – Global: Higher growth, margins, credit ratings? Diversity!" March 7, 2023.
13 McKinsey & Company, "How inclusion matters". May 19, 2020.
14 As You Sow, "Workplace Diversity and Financial Performance," November 17, 2022.
15 Refinitiv, BofA Global Research, "ESG Matters–Global: Fighting for DEI while battling inflation," March 3, 2023.
16 US Equal Employment Opportunity Commission, EEOC Releases Annual Performance Report for Fiscal Year 2022, March 2023.
17 Deloitte, "Inclusive Mobility: How Mobilizing a Diverse Workforce Can Drive Business Performance," 2018.
18 Deloitte, "Women at Work 2022: A Global Outlook." 2022.
19 Young Zik Shin, Jeung-Yoon Chang, Keyeongmin Jeon, and Hyunpyo Kim, "Female directors on the board and investment efficiency: evidence from Korea," 2019.
20 Christina Wood, "*7 ways diversity and inclusion help teams perform better*," October 24, 2023.

These considerations are driving certain market makers to require companies to meet DEI criteria. Goldman Sachs will only underwrite initial public offerings (IPO) in the U.S. and Europe of private companies with at least two diverse board members, one of whom must be a woman.[21] Nasdaq's Board Diversity Rules require Nasdaq-listed companies to disclose board composition demographics and for most to have a minimum of two self-identified diverse directors by 2023 (this includes women, other underrepresented minorities and LGBTQ+ people),[22] which should encourage boards to more effectively reflect the various stakeholders they serve. It is our view that other organizations will follow suit as the path to achieving diversity goals, and the recognition of the value that creating a diverse workforce can bring, are increasingly being recognized.

Portfolio Considerations

Investors can incorporate DEI into their portfolios in a variety of ways. First, investors should understand their capital allocation to diverse-owned investment managers. Women and people of color continue to experience significant underrepresentation in the asset management world. A 2021 Knight Foundation report found that just 1.4% of total U.S.-based assets under management is managed by diverse-owned firms.

Beyond firm ownership, investors must also consider who is investing their money. Teams with effective decision-making processes create better investment results, and diverse perspectives have a significant effect on these processes—one study found that investment teams in the top quartile of gender diversity outperforms those in the bottom quartile by 45bps per annum.[23] The flipside of this holds true as well: Investment risk is imbedded in nondiverse teams, with a report from Deloitte indicating that diversity of thinking enables groups to reduce risks by up to 30%.[24] Given nondiverse investment teams account for the vast majority of asset allocators, especially at the senior level, significant investment risk is present. A 2022 survey by Meketa Investment Group of over 500 asset management respondents found that women comprise, on average, only 24% of senior management and 16% of all portfolio managers, while minorities comprise 20% of all senior management and 23% of portfolio managers—and while representation is improving, progress is slow.[25]

The diversity of investment teams and their key portfolio decision-makers is a key differentiator—numerous studies reference the importance of increasing diversity in the asset management industry, citing notable performance benefits that demonstrate that having a diverse investment management team improves the portfolio decision-making process, including:

- Recent research from Vanguard looked at investment teams for over 2,600 U.S. active equity funds from 2008 to 2021 and found that mixed-gender funds where the fraction of females is greater than 50% but less than 100% exhibited the strongest performance, outperforming the benchmark by 47 basis points (bps) per year. All-male funds performed the worst, underperforming the benchmark by 12 bps.[26]
- One 2021 study of the Hedge Fund industry found that "over a three-year annualized period, women and minority managers posted a total return of 10.6% and 7.8%, respectively. Nondiverse managers had a 6.4% return."[27]
- A study of the Private Equity (PE) space found that an index of diverse PE funds outpaced their benchmark across the three primary PE performance measures (internal rate of return (IRR), Multiple on Invested Capital (MOIC) and Distributed to paid-in (DPI)) from 1998 to 2020.[28] (See side bar).

	1998-2020	
	NAIC PE Index	**Median fund – Burgiss benchmark**
Net IRR (%)	17.18	9.48
Median MOIC	1.62	1.28
DPI	0.64x	0.40x

Source: IRR, MOIC, DPI for National Association of Investment Companies (NAIC) Private Equity Index versus median fund in Burgiss benchmark, 1998–2020. **Please refer to glossary and index definitions at the end of this report.**

[21] Goldman Sachs, "Goldman Sachs' Commitment to Board Diversity," February 4, 2020; Goldman Sachs Corporate Board Engagement, 2022.

[22] Nasdaq Listing Center, February 2022.

[23] WTW, "Diversity in the asset management industry: on the right track, but at the wrong pace," March 2023.

[24] Deloitte, "The diversity and inclusion revolution: Eight powerful truths," January 22, 2018.

[25] Meketa Investment Group, "Diversity Equity & Inclusion Annual Questionnaire," May 2023.

[26] Lawrence, Stephen: "Diversity Matters: The Role of Gender Diversity on US Active Equity Fund Performance," The Vanguard Group, March 23, 2022.

[27] Bloomberg Hedge Fund Chartbook, Q3 2021.

[28] National Association of Investment Companies, "The Financial Returns of Diverse Private Equity Firms," 2021. See side bar chart for IRR, MOIC and DPI data for the diverse PE index vs nondiverse benchmark.

Together, these figures indicate that building diverse, equitable and inclusive investment firms and teams, and enhancing related reporting, requires more attention from asset managers and the broader industry.

The final investment opportunity lies in strategies that invest in diverse-owned businesses, products and services. Across public and private* markets,[29] investors have several investment opportunities available. This includes, for example, funds investing in companies with strong corporate policies or diverse senior leadership. Here, managers may track factors such as practices that support an equal and inclusive work culture, a low instance of discrimination issues, and robust workforce data on hiring, wages, and career development to make investment decisions. Products like these can offer valuable investment opportunities, given the strong and statistically significant correlation between the diversity of management teams and various profitability indicators, such as higher revenues, greater innovation and lower turnover.

The debt market offers investment opportunities as well. First, many municipal bond strategies now focus on the social impact of revenue bonds and the potential for the use of proceeds to address systemic inequalities in communities. One example of this includes bond projects focused on expanding and renovating affordable housing in communities with majority Black and Hispanic low-income residents and borrowers. Second, the social bond market[30] has grown from around $20 billion in 2019[31] to $130 billion in 2022,[32] a market inclusive of financing projects targeting marginalized populations/communities and women.[33] Bank of America has recently issued multiple combined social and green bonds where one of the key objectives includes helping advance racial equality in Black and Hispanic communities through a variety of projects. These projects include socioeconomic advancement and empowerment for Black and Hispanic populations through a variety of financing initiatives such as equity investments in Black- and Hispanic-owned/-operated certified minority business and expanding medical, dental and veterinary practices in predominately Black and Hispanic communities. Through these offerings, we see a greater institutional focus on diverse investments and more opportunities for investors to allocate their capital toward diverse businesses, products, services and communities.

*Investments in private equity involve a high degree of risk and therefore should only be undertaken by qualified investors whose financial resources are sufficient to enable them to assume these risks and to bear the loss of all or part of their investment. Investments in private equity include significant risks not otherwise present in public market investments. Furthermore, private equity investors are afforded less regulatory protections than investors in registered public securities.

INCORPORATING DEI INTO THE CHIEF INVESTMENT OFFICE INVESTMENT PROCESS

The CIO has for many years had a program to identify diverse owned managers. Based on the significant body of research presented here and, in the industry, and because of the importance of effective decision-making in our assessment of investment teams, in 2020, we also incorporated a DEI assessment into our holistic evaluation of all asset managers and investment teams under our purview.

[29] Many products that pursue Alternative Investment strategies are available only to qualified investors.

[30] PIMCO defines social bonds as bonds where "proceeds must finance or refinance social projects or activities that achieve positive social outcomes and/or address a social issue. PIMCO, "Understanding Green, Social and Sustainability Bonds," accessed September 26, 2022.

[31] Climate Bonds Initiative, 2019 Green Bond Market Summary, February 2020.

[32] Climate Bonds Initiative, Sustainable Debt: Global State of the Market, 2022.

[33] International Capital Market Association, Social Bond Principles, June 2023.

Glossary

Gross domestic product is a monetary measure of the market value of all the final goods and services produced and sold in a specific time period by countries.

Internal rate of return (IRR) is the annual rate of growth that an investment is expected based on cash flows to generate.

Multiple on Invested Capital (MOIC) is a metric used to describe the value or performance of an investment relative to its initial cost, commonly used within private markets.

Distributed to paid-in (DPI) represents the amount of capital returned to investors divided by a fund's capital calls at the valuation date.

Burgiss® Manager Universe (BMU) provides global investors with research-quality performance and behavioral data of unrivaled breadth and depth for private capital funds and their holdings that date back to 1978.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

National Association of Investment Companies (NAIC) Private Equity Index articulates, quantifies and captures all member data and present it in aggregate form to tell the comprehensive story about the impact of our members and the economic impact our member firms have on the global economy with hard data on portfolio companies (locations, number of employees, revenues, etc.).

Burgiss Index is an independent subscription-based data provider, which calculates and publishes quarterly performance information from cash flows and valuations collected from a sample of private equity firms worldwide.

Important Disclosures

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

This material does not take into account a client's particular investment objectives, financial situations, or needs and is not intended as a recommendation, offer, or solicitation for the purchase or sale of any security or investment strategy. Merrill offers a broad range of brokerage, investment advisory (including financial planning) and other services. There are important differences between brokerage and investment advisory services, including the type of advice and assistance provided, the fees charged, and the rights and obligations of the parties. It is important to understand the differences, particularly when determining which service or services to select. For more information about these services and their differences, speak with your Merrill financial advisor.

Bank of America, Merrill, their affiliates, and advisors do not provide legal, tax, or accounting advice. Clients should consult their legal and/or tax advisors before making any financial decisions.

This information should not be construed as investment advice and is subject to change. It is provided for informational purposes only and is not intended to be either a specific offer by Bank of America, Merrill or any affiliate to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

The Chief Investment Office (CIO) provides thought leadership on wealth management, investment strategy and global markets; portfolio management solutions; due diligence; and solutions oversight and data analytics. CIO viewpoints are developed for Bank of America Private Bank, a division of Bank of America, N.A., ("Bank of America") and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S" or "Merrill"), a registered broker-dealer, registered investment adviser and a wholly owned subsidiary of Bank of America Corporation ("BofA Corp.").

All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

Asset allocation and diversification do not ensure a profit or protect against loss in declining markets.

Social impact bonds are a relatively new and evolving investment opportunity which is highly speculative and involves a high degree of risk. An investor could lose all or a substantial amount of their investment.

Sustainable and Impact Investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

Impact investing and/or ESG investing has certain risks based on the fact that ESG criteria excludes securities of certain issuers for nonfinancial reasons and therefore, investors may forgo some market opportunities and the universe of investments available will be smaller.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks.

Alternative investments are speculative and involve a high degree of risk.

Alternative investments are intended for qualified investors only. Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk.

Private equity investments involve a significant degree of risk and should be regarded as speculative. They are only made available to qualified investors under the terms of a private offering memorandum. Holdings in a private equity fund may be highly leveraged and, therefore, more sensitive to adverse business or financial developments. Private equity investments are long term and unlikely to produce a realized return for investors for a number of years. Interests in a private equity investment are not transferable. The holdings of a private equity pool may be illiquid--very thinly traded or assets for which no market exists. A private equity investment may use leverage, which even on a short-term basis can magnify increases or decreases in the value of the private equity investment. The business of identifying private equity investment opportunities is competitive, and there is no assurance that the private equity pool will be able to complete attractive investments or fully commit its capital. In addition, a private equity fund's high fees and expenses may offset the fund's profits. Private equity investments should be discussed with financial, tax and legal professionals in light of an individual's objectives, liquidity needs and tolerance for risk.

The CIO has developed Impactonomics®, a sustainability-related analytic lens that includes societal and environmental factors while also examining a range of relationships between economic growth and investing for impact and profit, as well as the measurable social and environmental change sustainable investing can enable.