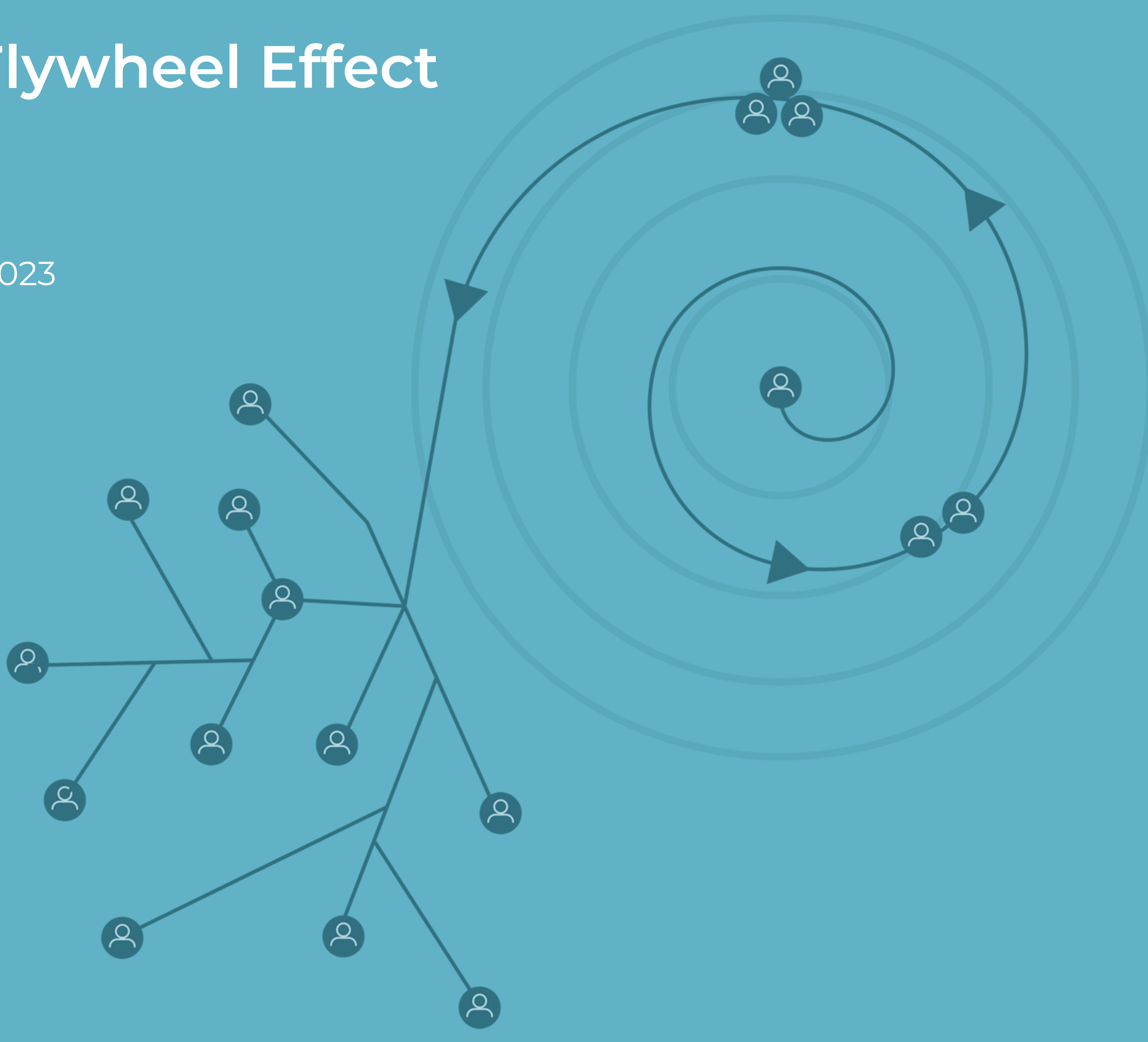
mpowered CAPITAL

Increasing Diversity in Alternatives

The Flywheel Effect

January 2023



Very little capital flows to diverse investment managers despite outperformance

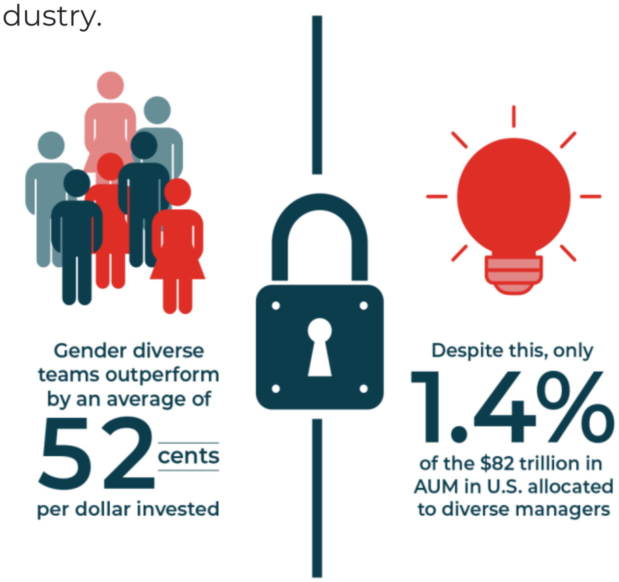
It is increasingly difficult to identify unique opportunities to generate returns, much less alpha, in today's intensely competitive world of investment management. However, as research continues to show, investing in diverse managers may be an overlooked opportunity for delivering outperformance.

Research conducted on teams and firms spanning a wide range of asset classes shows that relative to male-only deal teams, gender-diverse deal teams outperform. A 2020 study of more than 2,400 deals across 51 fund managers and 220 funds was conducted by HEC Paris through their Private Equity Observatory. Their research showed that relative to male-only deal teams, gender-diverse deal teams in private equity buy-out outperformed by an average of 12% of IRR and 52 cents per dollar invested. In addition, funds with gender-diverse teams saw 8-12% lower capital loss ratios.[1] Further, diverse Private Equity funds in the National Association of Investment Companies (NAIC) Index performed better than the median quartile in nearly 4 out of 5 vintage years from 1994 to 2018.[2]

Despite this data, according to the Knight Foundation's 2021 Diverse Asset Manager Study, **only 1.4% of the $82 trillion in institutional assets under management in the U.S. is allocated to diverse managers[3],** despite diverse managers being over-represented in the top quartile of performance.

Further illustrating the disproportionate share of capital for diverse managers, the 1.4% of assets are managed by the 10% of investing firms owned by women and other diverse talent, indicating that diverse-owned investment firms manage much smaller amounts of assets relative to non-diverse peers. A miniscule portion of a mammoth market. This underrepresentation and undercapitalization of diverse investing talent – despite outperformance that has been demonstrated - is contributing to what we believe is one of the most inefficient markets for capital formation in existence today.

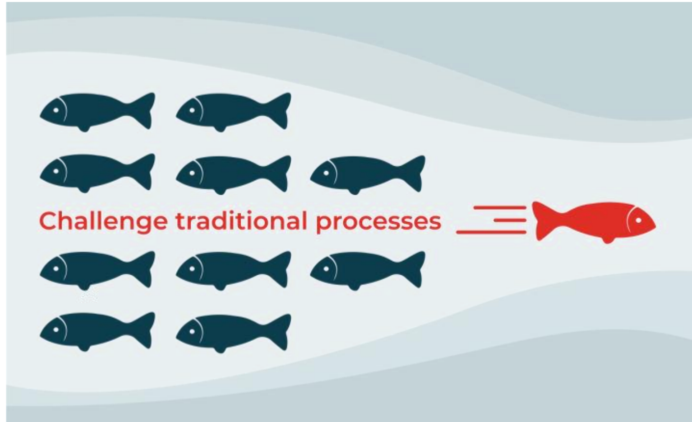
So why is it then, that so little capital is flowing to diverse managers and why does this market dislocation exist, especially given the recent focus across industries on Diversity, Equity, and Inclusion (DEI)? Simply put, it's a combination of unconscious bias and structural barriers that continue to plague the investment management industry.



(1) HEC Paris – hyperlinked here
(2) NAIC2021-Examining The Results – hyperlinked here
(3) Knight Foundation's 2021 Diverse Asset Manager Study – hyperlinked here.

The Power of Unconscious Bias

Perhaps it is helpful to start with a fundamental understanding of the term **"unconscious bias", which refers to a bias that we are unaware of; one that is inherent and unintended.** It is a bias that happens automatically and is triggered by our brain making quick judgments and assessments of people and situations, influenced by our background, cultural environment, and personal experiences. Unfortunately, these unconscious biases that we all have create a tendency to want to connect with and surround ourselves with people who look like us and who have similar interests and backgrounds as us. It keeps our world small and causes us to put up unintentional barriers. In business, and in investing environments, unconscious bias can squelch the benefits that research shows come from employing and welcoming diverse perspectives.



While we all have **unconscious biases**, the good news is that there are organizational processes that can be implemented to help **mitigate them**.

In her book *What Works: Gender Equality by Design*, Harvard Professor Iris Bohnet gives insight into the power of de-biasing organizations. She points to a great early example in the hiring strategy of large orchestras in the U.S., where in 1970 only 6% of the musicians in the five highest ranked orchestras were women. After that time, standard practices changed and blind **auditions behind curtains were instituted.** Interviewers could no longer see the people playing the music they were hearing. About that same time, they stopped allowing conductors to handpick musicians to hire. These changes resulted in female musicians in these larger orchestras increasing from 6 percent in 1970 to 21 percent in 1993. By 2014, the implementation of these small changes helped propel the participation of females in U.S. orchestras to nearly 50 percent.[4] A November 2022 article in the New York Times reported that for the first time in its 180-year history, the New York Philharmonic had more female than male musicians (45 vs. 44), further noting that in the early 1970s, before blind auditions were introduced, the number of females in the orchestra was 5.

Unfortunately, these changes did not have the same impact on non-white members, who constituted less than 15 percent of orchestra membership in 2014[5] and who still remain underrepresented today. We suspect that the lack of focus on creating an effective pipeline of candidates likely overpowered improvements that were made in the hiring process.

It is interesting to note that prior to instituting blind auditions behind curtains, orchestra interviewers had tried unsuccessfully to rely on sound only. Without the use of the curtains to block their view, they still had a tendency toward bias, indicating that **simply being aware of unconscious bias may not be enough to overcome it.**

(4) American Economic Review - hyperlinked here.
(5) League of American Orchestras report - hyperlinked here.

Steps that organizations can take to de-bias the hiring process include the removal of personal details (such as name and address) from candidate resumes and requiring at least two diverse candidates be included before the interview process can begin. It may be hard to believe, but a person's name alone can be a basis for bias. A study conducted by the National Bureau of Economic Research showed that candidates who applied to a job using a name associated as black were roughly 10% less likely to receive a callback than those with a name associated as white. For instance, when identical resumes, one with the name Emily and one with the name Lakisha, were sent to job openings, Emily's resume received substantially more callbacks.[6]

Additional areas that need to be assessed for unconscious bias are performance reviews and promotion processes.

It is common practice among investment (and many non-investment) firms to utilize a performance review process that includes a self-assessment that is shared with a manager prior to the performance conversation taking place. However, data from a 2019 study of 1500 workers[7] found that men rate their performance 33% higher than equally performing women. This self-rating often then impacts how a manager rates the employee which, in turn, impacts opportunities for promotion and/or additional job responsibilities. Removing this step or adjusting the timing to ensure that employee results are not shared with managers prior to managers completing their own assessment can greatly equalize the process.

Furthermore, research by women's leadership expert Tara Mohr showed that when advocating for a promotion or applying for a new position, women tend to hesitate unless they meet all the requirements for the new role.

Men, on the other hand, are generally more willing to assume that they can be successful even if they do not meet 100% of the job requirements. These gender-based tendencies cause males to put themselves up for promotions more aggressively than their female colleagues. One simple way to address this is to add a sentence to job descriptions stating that applicants do not need to meet all stated requirements to be eligible for consideration.

> We need to challenge these traditional organizational processes and effectively move women and other diverse talent up the ranks if we want to have a chance at seeing greater equity any time in the future.

Structural Barriers to Entry

In addition to unconscious bias, there are structural forces at play in the investing industry (arguably unintentional), that work against females and other underrepresented talent who are launching funds.

The first barrier to note is what we call "size bias." In recent years, larger investment management firms have captured an increasing share of a growing market. This is particularly true since the global financial crisis. Larger, well-established firms are simply growing at a faster rate than smaller funds. Larger funds generally get exponentially larger while smaller funds struggle to gain capital.

Institutional investors have increasingly shown a preference for consolidation, selecting fewer, larger managers with established track records. Many institutional investors, for instance, will not invest in funds with less than $1 billion in assets under management (AUM).

(6) National Bureau of Economic Research – hyperlinked here.
(7) HBR, Why Don't Women Self-Promote As Much As Men? - hyperlinked here.

Structural Barriers to Entry

MPowered's independently curated database of over 800 diverse alternatives managers across a range of asset types indicates that many are undercapitalized with AUM of less than $500 million and are generally more emergent in their firm and fund formation.

A bias we see with new managers is "track record" bias. Staying with institutional investors for a moment, many will not look at investment managers that do not have a five-year independent performance record. This creates hurdles that female and underrepresented managers often cannot overcome even though many have gained extensive investing experience and shown impressive returns while working at other firms with exceptional pedigrees. It is important to acknowledge that while many of these diverse managers are raising only their first or second funds, they are not first-time investors.

These well-established industry dynamics (size bias and track record bias) help to explain why the capital commitments to underrepresented talent may not seem to grow, despite expressions of interest from well-intentioned investors.

And yes, unconscious bias also plays a specific role here. You may find it interesting that **an investment pitch given by a female and a male, word for word, will result in a larger capital allocation to the male.**[8]

Further, it would not be inaccurate to say that senior leadership in the industry today is lacking in diverse role models. Seeing so few people that "look like me" does little to inspire the next generation of diverse talent to believe that they can be the next to run a fund, nor does it encourage a robust pipeline for diverse talent.

Finally, it is important to note that diverse managers face unique barriers in launching and scaling their own funds. Lower levels of personal capital can be the result of compensation received in prior positions tending to be lower, longer timelines for receiving promotion opportunities, or personal net worth that is largely tied up in illiquid carried interest.

They may also come from less privileged networks, limiting their ability to access the liquid capital needed to build infrastructure and a team to raise institutional-quality money and to have the staying power over what are typically longer fundraises.

To overcome these structural barriers to entry, the industry needs greater flexibility when underwriting diverse managers, along with a recognition and acceptance of the fact that they can and likely will look different. We need to consider alternate ways to evaluate the underlying criteria behind size, track record, and team that many institutional investors/allocators have historically relied on.

(8) PNAS– hyperlinked here.

Diverse talent flourishes when pain points are addressed

The good news in all of this is that the investable universe of diverse managers is large and untapped (as noted earlier, MPowered has identified 800+ in our own independent research).

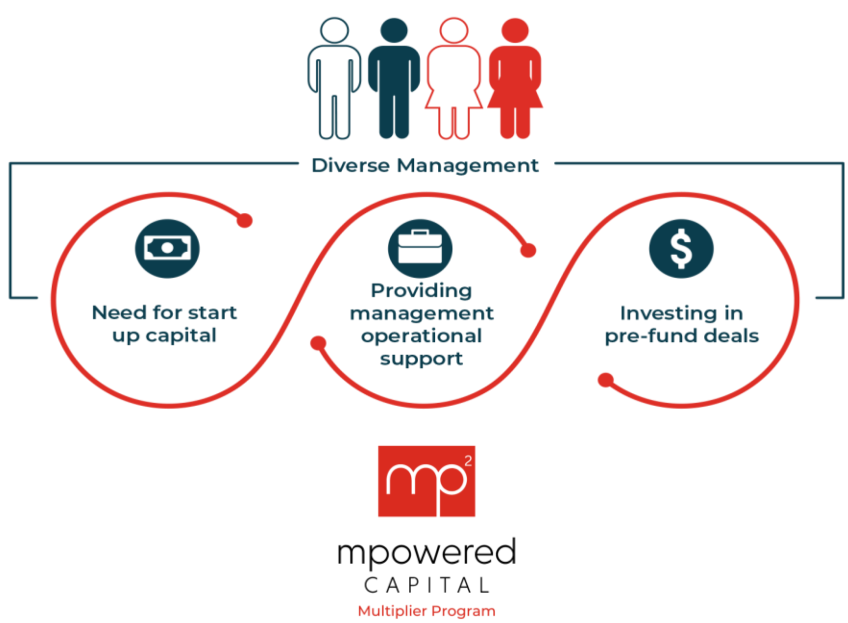
However, to enable these managers to flourish, we need to address three fundamental pain points that are unique to diverse talent:

1. **The need for start-up capital.** Providing working capital as a source of start-up funding is a key first step to establishing a strong foundation as it allows diverse managers to more quickly build teams and infrastructure to accelerate a fund launch and attract institutional capital. At MPowered we attempt to do this through GP Structured Partnerships where we combine working capital alongside a fund commitment.

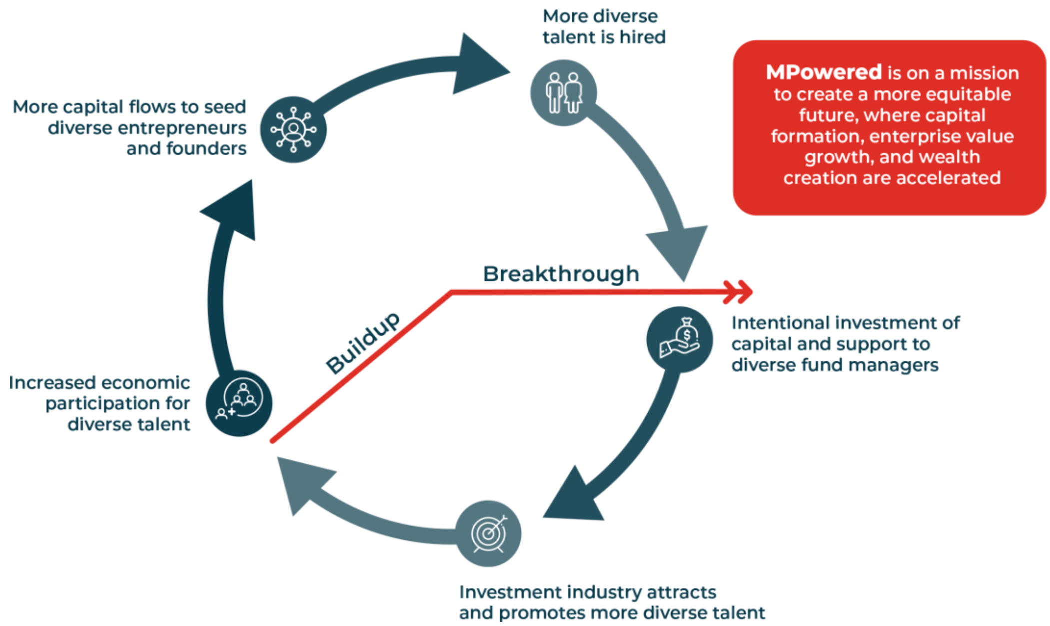
2. **The lack of an independent track record.** We believe we are strategically positioned and well equipped to help managers establish an independent track record, a key requirement for most institutional commitments, by investing alongside them in their pre-fund deals.

3. **The challenges inherent in fundraising.** This is a highly competitive industry. MPowered's commitment to a fund can serve as a signal to the market and potentially drive additional follow-on capital commitments. In addition, providing strategic guidance to these firms as they launch and scale may provide a measure of lift by reducing start-up friction and potentially accelerating the timeline for hiring and infrastructure development.

Working with diverse managers on these consistent pain points, MPowered was inspired to develop a "multiplier program" (which we refer to as MP²) to provide potential access to networks, resources, strategic advisory, and intellectual capital across business development, talent, and operations. We believe addressing these pain points increases the likelihood of attracting other institutional investors to these managers because there is more confidence that the firm and team will succeed.



This is the flywheel effect that we envision; all of us **working together, with intentionality**, until the industry begins to create its own momentum and propels diverse managers to success.



A few final critical points to consider:

- By increasing capital flows to diverse talent now, we are looking to shape and expand the industry to move beyond the meager 1.4% of an $82 trillion institutional capital market.
- When more capital flows to diverse entrepreneurs and founders, they hire more diverse talent by tapping into their own networks. For example, we know that female VC partners invest in 2X more female founding teams, and those female founders go on to hire 2.5X more women than startups with all-male founders.[9]
- Seeing more diverse talent at the top and in positions of influence expands the pipeline, following the notion, "you can't be what you can't see."

Think about how you might be part of this flywheel – possibly by advancing DEI efforts in your own organization. If you are involved in hiring or promoting talent, use some of the examples shared here to modify your processes to mitigate unconscious bias.

And you can most certainly drive change through your own investing choices.

All of these actions play a critical role in increasing economic participation and accelerating the pace at which capital flows to diverse talent.

Unfortunately, actions to-date have done little to increase the rate at which diverse managers are being funded. We need to take collective action now to move the needle.

At MPowered Capital, we are focused on this every day, and we are seeing the positive momentum. Just imagine what could happen if we improve diversity and equity in the investing industry (and beyond) - while generating the potential returns that research tells us are attainable. **It's time to act. Let's move this flywheel!**

(9) Kauffman Fellows – hyperlinked here.

About the Authors

Marcia Page | Founder & CEO

Marcia founded MPowered Capital and serves as CEO. She believes the time is now to commit resources to women and other underrepresented investing talent in a more structured and disciplined way.

Marcia is one of a handful of women founders of a global alternative investment firm (Värde Partners) with a successful 28-year track record and a history of investing in market dislocation.

As Co-Founder of Värde Partners, Marcia oversaw the $14 billion global alternative investment firm's growth ranging from raising and investing capital in dislocated opportunities, identifying talent and building investment teams across geographies, and portfolio company board representation. She served as Värde's Co-CEO and Co-CIO until 2016 and currently serves as the firm's Executive Chair.

Marcia graduated from Gustavus Adolphus College, Minnesota with a B.A. in Economics, and received an M.B.A. from the University of Minnesota. Marcia is active on external investment committees, evaluating investment talent and asset allocations, including serving as Chair of the Investment Committee of Gustavus Adolphus College. She is on the Board of Overseers of the Carlson School of Management at the University of Minnesota and serves on the Board of Directors for several non-profit organizations.

Andrea Schilling | Strategic Advisor, Talent & Culture

Andrea's advisory role at MPowered focuses on organizational design, talent, and strategic communications. In addition, she is responsible for the design and oversight of the Multiplier Program, MP^2. As an employee of Värde Partners dedicating her time to MPowered, Andrea serves as a bridge between the two organizations.

Based in Minneapolis, Andrea joined Värde in 2007 and led the development of the firm's Human Capital function as Global Head of Human Resources for more than a decade before transitioning into a role focused on internal communications. Prior to joining Värde, Andrea spent 10 years as Chief Human Resource Officer for a large national public accounting firm. In that role, she was a frequent speaker on the topics of flexibility/work-life balance and advancing women in the workforce. Andrea began her career in public accounting and is a licensed CPA (inactive).

Andrea holds a B.A. degree in Finance and Marketing from Bethel University in St. Paul, MN. She has served on the board of directors as an HR resource for several non-profit organizations and is currently a member of the Board of Trustees for Bethel University where she sits on the Academic Affairs committee. She is also a member of CHIEF.