News and Analysis

Analysis | Pension Plans

Public pensions show uneven progress toward diversity goals

Progress remains uneven as pension funds look to invest their assets with more women-owned and minority-owned firms

Dietrich Knauth | 28 Jul 2017

The investment profession is slowly moving away from the stereotype of "pale, male and stale," as newer and smaller money managers take advantage of opportunities.

Public pension funds are increasingly interested in diversity, seeking to invest their assets with more women-owned and minority-owned firms. But how to how to achieve diversity — and even what it means — remains open for debate, and differing legal frameworks and practical challenges have contributed to uneven progress toward diversity goals.

Pension plans cite a wide range of reasons for improving diversity among their internal staff and external managers, including social responsibility, better returns, growing the ecosystem of potential investment partners, and hedging against over-commitment to an investment class that thinks the same way. While those goals are not universally shared throughout the

U.S. yet, California, Illinois, New York, Oregon, Ohio, Michigan, Maryland, Pennsylvania, Texas, and North Carolina are among the places where pension funds have active diversity outreach programs.

So far, pension funds have found willing partners among investment consultants, managers of funds of funds, and advocacy groups devoted to advancing the interests of women- and minority-owned businesses, **California State Teachers' Retirement System** (CalSTRS) CIO **Christopher Ailman** said at a *May Diversity Forum* co-hosted by **California Public Employees' Retirement System** (CalPERS) and CalSTRS.

"People have really realized that groupthink is a problem and you want to diversify away from that," Ailman said. "Maybe they're giving us lip service, but some managers seem genuinely interested in trying to break that mold. They have too many people from East Coast Ivy League schools who all think alike…It's not just a California interest, it's broadly shared, not just in the U.S."

California and Illinois represent two different approaches to diversity within U.S. pension funds. California is prevented by Proposition 209 from considering race, sex, or ethnicity, in spending or investing public money. On the other end of the spectrum, a recent Illinois law requires its pension funds to attempt to allocate 20% of their assets to businesses owned by women, minorities, or persons with a disability.

Pension funds' diversity outreach efforts may present opportunities for smaller firms, but keeping track of different rules can be difficult, according to **Johnita Walker Mizelle**, head of business development at the minority-owned investment firm **LM Capital Group**.

"I view that as a challenge, because there's no standardization across all states," Mizelle said. "So where we may qualify in the state of Illinois, we may not qualify in another state."

In California, size matters most

California's framework presents unique challenges, especially in a progressive-leaning state with a diverse population. Instead of setting explicit goals for women-owned or minority-owned firms, California plans seek diversity by propping up smaller managers.

"It's been an interesting challenge for us," Ailman said at the May diversity forum. "In California, we've got a state law that makes it a bit cumbersome on how we do this so we define small firms as the ones that we think are likely going to be more diverse, but they're just small in size."

California pension boards sometimes struggle with how to articulate those goals and hold consultants accountable when progress doesn't match their desires. **Portfolio Advisors**, a private equity consultant, said that its relationship with the **Los Angeles City Employees Retirement System** (LACERS) has frayed over pressure from the board to recommend and hire more women- and minority-owned private equity firms. **Tom Lopez**, CIO of LACERS' sister fund, **Los Angeles Fire and Police Pension Fund**, said boards have to work harder to get both sides on the same page.

"It just makes it easier when you can have it all spelled out," Lopez told *MMR*.

Illinois sets more concrete diversity goals

Illinois law, on the other hand, requires public employee retirement systems, pension funds, and investment boards to set separate targets for investment managers that are minority-owned businesses, women-owned businesses, and businesses owned by a person with a disability. As of January 2016, Illinois funds are legally required to aim to have 20% of their investment advisors be minorities, females, or persons with disabilities.

The **Illinois Municipal Retirement Fund** is one fund that has reached the 20% target, utilizing 56 investment firms in those three categories to manage $7.2bn in assets, or 20.1% of the total IMRF portfolio.

Illinois is helped in one other respect in reaching diversity targets – its law allows companies to count as minority businesses when it is at least 51% owned "by any combination of minority persons, females, or persons with disabilities, even though none of the 3 classes alone holds at least a 51% interest." That means that a company equally owned by one black man, one white woman, and three white men, one of whom has a disability, could qualify as a minority-owned business.

0 - 12

Challenges and opportunities

IMRF has increased its allocation to minority-owned businesses by approximately $1bn since October 2015, using a number of strategies. IMRF uses fund of funds programs, often graduating firms from its fund of funds program in more direct relationships with higher allocations, and periodic requests for proposals that specifically target minority- and women-owned firms. IMRF also takes walk-in meetings and referrals from its investment consultant, Callan Associates.

Those strategies are familiar to CalPERS, which uses a fund of funds strategy for emerging managers in private equity, and an emerging manager mentoring program in its real estate portfolio. CalPERS also uses a transition manager program, which aims to help small investment firms continue to grow with CalPERS in that awkward middle ground when they are too large to qualify as emerging managers and too small to compete on equal footing with the fund's established managers, CalPERS CIO **Ted Eliopoulo**s said at the May forum.

"In many cases those small firms just aren't ready to handle a $1bn or $2bn portfolio because they just don't have the infrastructure to hold it, but we'd like to be able to grow with them over time," Eliopoulos said.

CalSTRS has similar outreach efforts, but it also works with California universities to recruit and develop a diverse pipeline of talent. It offers internships and mentoring, and, more broadly, tries to spread the message that you don't have to be a white guy living in New York to get a job in finance, Ailman said.

Beyond a strategic level, different states also define diversity differently. While many have programs that encourage hiring of minority-owned firms, several also focus on diversity of their internal staff, and diversity among the staff and boards of the larger investment companies they work with. Some, like CalPERS and CalSTRS, even push for diversity among portfolio companies owned by funds they invest in. The effort to get data among partner companies and portfolio companies has been somewhat

0 - 12

controversial, Eliopoulous said, and he and Ailman agreed that funds would have to be careful not to overwhelm companies with diversity data requests.

"I think we can make it more standardized," Ailman said, "There's no question that people are getting hit with questionnaire fatigue and we don't want to be the noisy bothersome client all the time."

EXPORT

Investor Profile

California State Teachers Retirement System (CalSTRS)

CalPERS

Los Angeles City Employees Retirement System (LACERS)

Illinois Municipal Retirement Fund

Topics

California Public Employees' Retirement System California State Teachers' Retirement System Christopher Ailman Illinois Municipal Retirement Fund Johnita Walker Mizelle LM Capital Group Los Angeles City Employees' Retirement System Los Angeles Fire And Police Pension Fund Portfolio Advisors Ted Eliopoulo Tom Lopez

Recommended

Investors | Public DB | Searches & Hires

LACERS chooses new private equity consultant

The $17bn retirement system had been leaning toward a different consultant, but balked because its fees were nearly double the next-ranked competitor.

Dietrich Knauth |04 Jun 2018 Pension Plans

0 - 12