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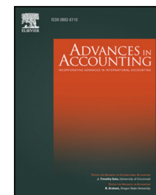

Does diversity improve profits and shareholder returns? Evidence from top rated companies for diversity by *DiversityInc*

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ABSTRACT

In this study, we examine the relationship between the diversity efforts of firms listed in *DiversityInc's* list of Top 50 Companies for Diversity and their financial performance. We examine both an announcement effect and the risk-adjusted performance of diverse firms to a matched sample and the S&P 500 index. We find a positive effect related to the announcement of the *DiversityInc* Top Companies for Diversity list. When examining long-term performance using the risk-adjusted performance of listed companies, *DiversityInc* firms outperform the S&P 500 index but have performance that is either indistinguishable or inferior to a matched sample. *DiversityInc* firms exhibit superior return on assets compared to the matched sample, but this difference is explained by differences in firm size. Overall, we find limited support that inclusion in *DiversityInc's* list of top firms for diversity indicates improved performance over a matched sample.

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The issue of diversity in the workplace garners much attention in the popular press and in policy discussions. Demographic shifts are rapidly occurring in the population and workforce in the United States. As of November 2016, approximately 152 million individuals were employed in the United States. While unemployment has declined to less than 5%, the job participation rate in the United States stands at its lowest point in decades at less than 63% (Bureau of Labor Statistics, 2016). The Center for American Progress (Burns, Barton, & Kerby, 2012) reports people of color make up approximately 33% of the U.S. workforce, including 16% Hispanic, 12% African-American and 5% Asian workers. By 2050, a racial or ethnic majority will no longer exist. In addition, nine million gay and transgender adults reside in the United States, of which one million work in the public sector (i.e. government jobs) and seven million work in the private sector.

What do these workforce statistics mean for productivity, economic growth, and, on a more granular level, shareholder returns? When diversity and inclusiveness in the workforce are discussed or reported, the common assumption is that they improve productivity, lead to more creative and diverse thinking in the workplace, and benefit companies financially (Badal, 2014; Smedley, 2014; and Deleon, 2015). Inclusiveness opens firms up to broader talent pools, giving companies access to potentially top talent in a highly competitive environment.

Some companies explicitly reward diversity in hiring. For example, Lockheed Martin considers improvement in diversity hiring goals as part of the metric used to award CEO and other top executives' annual bonuses (Lockheed Martin Corporation, 2008). In the entertainment industry, the Board of Governors of the Academy of Motion Picture Arts and Sciences (Oscars, 2016) approved a sweeping series of substantive changes designed to make the Academy's membership, its governing bodies, and its voting members significantly more diverse. These changes occurred after the Academy came under harsh criticism for the lack of diversity in 2016 Academy Award nominees.

The issue of diversity in the workplace is a topic of discussion at all levels from top policymakers such as former President Barack Obama, who made diversity in hiring a priority of his administration (Epstein, 2013), to workers and managers at all levels of companies. On June 10, 2015, six agencies including the SEC, the FDIC and the Federal Reserve issued proposed standards for assessing an entity's diversity policies and practices in several areas (Securities Exchange Commission, 2015). In early 2016, leading Democratic lawmakers urged the SEC to speed up review of the proposal (U.S. House Committee on Financial Services, 2016). Some argue that the rules do not go far enough and that the requirements may still not give investors enough information about racial, ethnic and gender diversity on boards. Some argue that "group think" lead non-diverse boards to hire people who look and think like the incumbents, missing out on diverse talent pools that can drive company success (Petrilla, 2016). The primary criticism of the requirement is that it is not explicit enough. Many firms interpret diversity not in terms of race, ethnicity, age or gender, but as diversity of

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experience. The fuzzy definition of diversity makes it easy to avoid. Also, some argue that it may be costly to smaller firms and may be viewed as mandating diversity quotas.

Much of the literature on diversity focuses on qualitative factors – how inclusiveness promotes creative thinking and improves competiveness, how workers are more inclined to stay in an inclusive environment, and how diversity shrinks hiring costs. The general benefits are touted and economic benefits are assumed, but little work has been conducted to determine whether a diverse workforce provides financial benefits to firms. While institutional investors are increasingly requesting information on workforce demographics, companies are loathe to share the information publicly (Ellis & Keys, 2015). Ellis and Keys find that investors are forced to examine shareholder resolutions to understand firms' diversity efforts. An alternative is to use published shareholder rankings in the business press that analyze the diversity efforts and accomplishments of firms. One such source is *DiversityInc*.

In this paper, we explore the benefits of diversity by analyzing the returns to shareholders of companies cited for being leaders in the area of diversity. We compare a group of companies listed in *DiversityInc's* Top 50 Companies for Diversity to a matched sample of firms to determine whether shareholders benefit from a diverse workforce. (See the Appendix 0 for information about the *DiversityInc* survey and evaluation criteria). We examine whether shareholders of firms identified as the Top 50 in *DiversityInc* receive above-average financial rewards. We find an announcement effect associated with the release of the survey. Longer-term performance is mixed: the portfolio outperforms the S&P 500 index, but fails to outperform a matched sample. We do find that the Diversity portfolio outperforms a matched sample based on operating performance measured by ROA, although this result can better be explained by firm size measured by total assets.

This study contributes to the existing body of work on the benefits of (or not) a diverse workforce in several ways. First, we consider the value of diversity beyond the board of directors and c-suite. A majority of studies in this area, no doubt in part due to data availability, focus on c-suite and board diversity. We focus on a broader definition of diversity that includes the talent pipeline, talent development, supplier diversity and the commitment of upper management to diversity and diversity initiatives. Second, the survey itself takes a broader look at diversity relative to *Fortune*. *Fortune* surveys diverse workers about their feelings about their companies' diversity efforts. *DiversityInc* takes a broader, more objective look at firms' policies (though efforts are reported by management). Finally, it is clear that it is a timely topic, as evidenced by the SEC and other government agencies' attentions to the issue. We add to the literature regarding whether the efforts are rewarded in in terms of shareholder returns.

The next section of the paper presents the theoretical basis for our study, reviews prior literature, and states our hypothesis. The paper then discusses the sample and research methodology. Results of analysis and implications are discussed at the end of the paper.

1. Theoretical basis for the impact of diversity on shareholder returns and prior literature

Diversity can impact shareholder returns because the benefits of diversity outweigh the costs, increasing returns to shareholders. Alternatively, the costs of diversity can outweigh the benefits, reducing shareholder returns. Finally, the benefits and costs of diversity may offset each other, resulting in no impact on shareholder returns. In a study of workplace diversity, Harrison and Klein (2007) note that the empirical evidence on firm performance as it relates to diversity is weak, inconsistent, or both.

Prior studies of the impact of gender diversity on corporate performance have been underpinned by theory. Upper Echelons Theory (UET) advances that the cognitive frames of people are developed by their prior knowledge, experiences, and values (Hambrick, 2007; Hambrick & Mason, 1984). The cognitive frames of people in top positions of an organization impact their strategic decision-making, and ultimately strategies that are implemented for their organizations. Prior research finds differences between men and women in, among other things, moral reasoning and orientation (Chodorow, 1974; Jaffee & Hyde, 2000) and ethical attitudes (Borkowski & Ugras, 1998). Consequently, UET has underpinned some gender diversity studies because gender diversity can alter strategic decisions due to different cognitive frames.

Post and Byron (2015) find a positive impact on accounting returns when women serve on boards of directors. However, they find the impact on stock returns is contingent on the country in which the company operates – a positive (negative) impact in countries with high (low) gender parity. Byron and Post (2016) find that the presence of women on boards of directors positively impacts companies' corporate social performance. Women are more likely to attend board meetings than men, and overall board attendance is better for gender diverse boards, according to Adams and Ferreira (2009). Also, women are more likely to join monitoring committees and gender diverse boards put more effort into monitoring activities. However, Adams and Ferreira find that gender diversity is negatively associated with firm performance. This result is driven, according to the authors, by the fact that these firms have fewer takeover defenses. As such, they argue that gender diversity quotas for boards of directors may actually reduce firm value, especially for well-governed companies.

Because the failure to express minority views may distort the behavior of company boards, Amini, Ekström, Ellingsen, Johannesson, and Strömsten (2016) develop an experiment to examine the degree of conformity in groups with varying gender composition. They find little evidence that gender composition affects the expression of minority views. Rather, in their experiments, high individual ability is more effective than group gender diversity in combatting conformity.

Using a sample of Chinese listed firms, Ye, Zhang, and Rezaee (2010) find that no differences between earnings quality measures based on the gender composition of companies' top executives. However, Gul, Srinidhi, and Ng (2011) show that stock prices better reflect firm-specific information for companies with gender-diverse boards. Gender-diverse boards particularly improve the relationship between stock prices and firm-specific information for companies with weak corporate governance. Gender diversity also leads to increased public disclosure by large companies. Similarly, Gul, Hutchinson, and Lai (2013) find that gender diversity on corporate boards is related to improved transparency and the accuracy of financial reports. Women also bring unique skills and specific functional expertise that is often missing from corporate boards. This increases the heterogeneity of boards, which Kim and Starks (2016) show can increase firm value.

Field, Souther, and Yore (2016) broaden the examination from gender diversity to gender and minority diversity in an examination of board compensation. The authors find that larger, more visible firms are more likely to appoint women and minorities to boards of directors, increasing their pay relative to "non-diverse" directors on average. However, within those higher paying board positions, women and minorities earn less. The authors conclude that this is because women and minorities are less likely to serve in key leadership positions on boards and on committees that are more generously compensated.

Because cognitive frames are developed by prior knowledge and experiences, they may differ between ethnic, racial, and religious groups as well. Thus, UET provides support that companies with diversity in top management and board of directors may behave, or be perceived to behave, differently than those with a more homogeneous top management and/or board of directors. For example, upper managers make decisions regarding funding of research and development and other innovations. In a study that supports the benefits of diversity at higher levels in a firm, Carter, D'Souza, Simkins, and Simpson (2010) finds a positive relationship between ROA and firms with ethnically diverse boards of directors.

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