<u>Juan Martinez oral testimony to the Subcommittee on Diversity and Inclusion – June 25, 2019</u>

Madam Chairwoman and Members,

Thank you for the opportunity to testify about Knight Foundation's history and experience investing with minority and women-owned firms, as well as the research Knight has sponsored on the state of ownership diversity in the investment management industry and different treatment received by diverse managers.

Analyzing and exploring diversity in asset management is vital given the industry's sheer enormity and the wealth it generates. The industry manages $69 trillion globally and generates some $100 billion in profits annually.

Before we jump into that, I think it will be helpful to provide a little background on Knight itself, for context.

The John S. and James L. Knight Foundation is a private foundation based in Miami, Florida. Knight supports informed and engaged communities through our grants and charitable programs in journalism, 26 U.S. communities and the arts.

Since its inception in 1950, Knight has spent $2.5 billion on this important mission, an average of $116 million a year over the past 10 years and an average of 6.5% of assets annually.

<u>Those funds</u> come primarily from the investment of the $668 million contributed by the Knight brothers and their mother, Clara. The future

grants from that investment portfolio, which has grown to $2.3 billion because of our investments, will allow us to continue Knight's impact.

So, how Knight invests is a vital concern, critical to allowing us to pursue our mission. We believe the results demonstrate we've done a good job. We once assumed that because we'd had good returns and we knew that diversity adds value, there must have been diversity in our investment program; we were wrong.

In June 2010, we were asked how much of our portfolio was invested by minority- or women-owned firms. When we looked, it was only $7.5 million managed by one African American-owned firm. That was, to say the least, a surprise.

With the support of our Board of Trustees, we became intentional in searching out opportunities to invest with women- and minority-owned managers.

As of the end of the last quarter (March 2019), 34% of our portfolio, or $749 million, is being managed by 14 women- or diverse-owned firms. And that part of our portfolio is meeting our return expectations.

As we exceeded $100 million under diverse management, we heard from other investors that the problem Knight was trying to solve was not unique. As a foundation built on the values of fact-based journalism, we knew we needed to study this further. There was an opportunity to add solid research and objective facts to inform the discussion.

As a first step, we engaged Bella Private Markets to conduct a rigorous study on the state of diversity in the investment industry. Both Bella and its co-founders, Josh Lerner from Harvard Business School and Ann Leamon, are recognized industry experts.

That study was published in May 2017 and was updated in January of this year. The three major findings have stayed consistent:

- A very small share, about 1.3%, of the assets held by U.S.-based asset managers were managed by firms with female or minority ownership. The median fund size of diverse-owned firms typically was significantly smaller than their non-diverse peers.
- Importantly, Bella found no evidence of differences in investment performance between women- and diverse-owned firms and their non-diverse-owned peers.
- Public funds and high net worth individuals and family offices represent a disproportionately large percentage of the investments in diverse-owned funds.

The study notes that the low level of assets under management is affected by the existence of several large, publicly traded firms and privately-owned managers, as well as large investments in passive index funds that require economies of scale to set up and manage effectively. Nonetheless, the difference in the average size of funds between women- and diverse-owned firms and their non-diverse peers is significant given the findings on investment performance.

Bella rigorously examined the question of investment performance in two ways:

First, it performed a statistical analysis to measure differences in performance between diverse-owned and non-diverse-owned funds while controlling for fund characteristics and risk profiles. For each asset class tested—mutual funds and other marketable securities, hedge funds, private equity and real estate—Bella found no statistically significant evidence that women or minority ownership negatively affects investment performance.

Next, Bella looked at the distribution of investment performance for women- and minority-owned firms compared with all funds. It found that diverse-owned firms were overrepresented in the top quartile of all fund investment performance. That is, it is assumed that 25% of funds owned by women and minorities should be in the top quartile of performance, because that's what a quartile represents. However, Bella found that more than 25% of women- and minority-owned funds were represented in the top quartile of their asset classes.

This contradicts the long-held belief that investing with women- and minority-owned firms results in lower returns. Rather, we would argue that it supports that there are a number of top-performing managers seeking investors. In effect, outperformance is being left on the table.

In a separate Knight-funded study, Bella's research found that the penalty for underperformance is larger for diverse-owned managers. Looking at non-diverse-owned managers, the data suggest that an underperforming manager is 9.6% less likely to raise a new fund compared with an overperforming peer. The corresponding penalties for underperformance for women- and minority-owned managers were almost twice as large or more—at 27.9% and 17.3%, respectively.

While a number of factors can affect whether a manager is able to raise another fund, and the study doesn't establish a causal relationship between diverse ownership and an intolerance of failure, Bella has attempted to account for many of these in its analysis.

These studies provide new insights into the state of diversity in the asset management industry, and they also raise new questions for future research such as:

- Do investors see diverse-owned firms as inherently riskier even though performance data don't support that?

- Why do public pension funds and high net worth individuals make up a larger percentage of investors in women- and diverse-owned firms rather than other types of institutional investors?

The data for the Bella studies came from several leading commercial data providers used in academic research, supplemented by publicly available lists of diverse-owned private equity and real estate firms. This ensured that the analysts would have the highest quality data available on which to base their work.

Still, an important finding of the reports is the relative difficulty of obtaining data on ownership diversity in the industry.

Knight Foundation and a growing number of other investors see an investment opportunity here. We hope that the research we continue to fund, and important venues such as this, will spur others to join us and to pursue this conversation further.

Thank you.

Attachments:

1. **2018 Diverse Asset Management Firm Assessment, Bella Private Markets, January 2019**
2. **2018 Diverse Asset Management Enhanced Performance Analysis, Bella Private Markets, January 2019**
3. **Intolerance of Failure? Evidence from U.S. Private Equity, Bella Private Markets, January 2019**