The Future of Diversity and Inclusion in Private Equity: Can the Industry Meet the Challenge?

A Webinar Hosted by the Private Capital Project at the Harvard Business School and the Private Capital Research Institute

On September 9th, 2020, a group of limited partners (“LPs”) and general partners (“GPs”) met to discuss and share their thoughts on the challenges of diversity and inclusion in the private equity industry. The discussants were Marlon Nichols (Managing General Partner, MaC Venture Capital), Jasmine Richards (Head of Diverse Investing, Cambridge Associates), Kirk Sims (Head of Emerging Manager Program, Teachers Retirement System of Texas), and Willie Woods (President and Managing Director, ICV Partners). Josh Lerner (HBS and PCRI) served as moderator. Below is a summary of the discussion.

The Challenge

The current momentum for societal change is prompting the private capital industry, along with a wide variety of institutions in the U.S. and elsewhere, to re-examine diversity, equity, and inclusion within their organizations. The data show a severe lack of people of color—especially disadvantaged minorities—and women managing private capital investments: the total share of private capital assets under management by diversely-owned firms is less than four percent, with most of it concentrated in a few diversely-managed firms.¹ At the same time, diversely-owned private equity firms face more significant challenges when raising capital, despite investment returns that do not appear to be appreciably different from that of majority-owned groups.

The September 9th PCRI panel discussed the roots of the industry’s lack of diversity, pointing to inherent biases and systemic racial inequality. Academic research has shown that implicit biases shape human behavior in many arenas, and private markets are sadly no exception. One intriguing study showed, for instance, that venture capital founders who fathered more daughters had an increased propensity to recruit female partners, a step that enhanced the performance of their funds.²

Implicit biases manifest themselves in many different ways. For instance, LPs typically become comfortable with investing in new managers by checking references in their existing networks. Often these networks which themselves lack diversity make it difficult for minorities to get the needed “stamp of approval.” Because disadvantaged minorities manage such a small fraction of the industry, this network bias can be self-perpetuating. To confront these issues, the panelists spoke of the need to challenge “business as usual” and to creating opportunities in the industry, especially for disadvantaged minorities.

Building the Pipeline

The panel highlighted the key steps in fostering a more inclusive environment within the industry. Finding and attracting talented, disadvantaged minorities to the established players in the private capital industry and providing the mentorship for them to succeed was the first issue addressed. Without a strong pipeline of diverse professionals from these firms, progress in creating diversely-owned funds is likely to be slow.

The panelists identified several reasons for the “pipeline problem.” Private capital managers predominantly come from the investment banking industry, which itself is not very diverse. Furthermore, hiring decisions are too often made by unseasoned junior associates who are less cognizant of the broader goals of the organization and less experienced in finding talented minorities. As a result, junior associates end up hiring people with backgrounds similar to their own.

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In order for change to occur, there needs to be an infrastructure for disadvantaged minorities to get experience at large firms and create a track record that can serve as a foundation for successful fundraising. This change will require the involvement of the most senior people at the organizations. It also may require a change in mindset: a thoughtful, concerted effort to look for talent outside the usual places and with different backgrounds than the usual job candidates.

Investment Criteria

On the funding side, many investors concede that getting to scale can be difficult for the relatively few diverse groups that are in business. Typically, LPs play a passive role, reviewing and typically rejecting incoming fundraising documents that do not meet their criteria.

The panelists emphasized the need to consider adopting a new mindset to be successful in underwriting a broad set of diverse managers. For instance, some LPs require a ten-year performance track record as a minimum criteria for prospective fund managers. This approach disproportionately rules out many diverse managers who are newer to the industry. In other cases, overcoming the relationship gaps highlighted above are critical. Diverse managers may need help getting introductions and initial meetings with asset allocators.

Finding strong diversely-owned firms requires patience and more due diligence. The panelists believed that if LPs succeed in embracing diversity, the benefits would be great. In particular, they emphasized that success in private equity was driven by differentiated strategies and networks. Non-diverse managers may overlook potentially important markets geared to the growing minority population, or may not access the most promising entrepreneurs.

Of course, the responsibility here does not fall on LPs exclusively. Recent efforts on the part of established venture capital firms to aggressively involve their diversely-owned peers in co-investments can help these groups build up scale and networks. Such deal-sharing has long been a part of the venture landscape, but diversely-owned firms have frequently been excluded. These initiatives can hopefully be replicated elsewhere in the private capital industry.
The Role of Activism

The panelists discussed the disparities across limited partners in investing in diversely-owned managers. Many public pensions have been extremely successful in engaging diverse managers. The panelists believed that endowments and foundations have much work to do on the diversity front.

In the past year, there have been a number of concerted efforts to encourage endowments to increase their allocation to diverse managers. While all agreed on the desirability of the goals of these efforts, there was debate about the efficacy of the tactics. On the one hand, the long and sorry history of race relations in the United States suggests that change does not happen easily. Incumbent institutions in many arenas have frequently found reasons to delay embracing diversity and inclusion. Only when political and social pressures became intense have substantial changes occurred.

On the other hand, there was worry that this tactic may backfire. In particular, groups that feel pressured to invest in diversely-owned firms may be inclined to terminate their relationships with these managers once the intense spotlight on these issues has dimmed. Consistent with these concerns, academic work suggests that minority-owned GPs face an “intolerance of failure,” whereby disappointing investment returns—which all investors inevitably face at some time or another—are punished more harshly: the effect of underperformance on fundraising appears to be much more severe for diversely-owned firms, even after controlling for the experience and strategy of the group.3

Final Thoughts

Longstanding attitudes towards diversity and inclusion in private capital, as in many other sectors, are being viewed critically today. The extremely modest share of capital in the hands of diversely-owned managers is deeply disturbing, and calls out for action. While the challenge is substantial, there appear to be clear steps that LPs and GPs alike can take to address these disparities.