HARVARD Kennedy School
Center for Public LEADERSHIP

Racial Equity as a Topic for Responsible Investment

why and how investors should engage

David Wood

Support for this research was provided by the **Robert Wood Johnson Foundation**. However, the views expressed in this paper are those of the author.

The author would like to thank the following individuals and organizations who provided feedback in the research process for this paper:

The Public Finance Initiative
Renaye Manley and Maguette Diop, SEIU

Introduction

There is a long history of racial equity as a topic of concern for responsible investment – and related fields of practice variously labeled socially responsible, community, mission-related, impact, and ethical investment -- in the United States. Community investment emerged in the 1960s from the civil rights movement as a way for investors to tackle disinvestment particularly in minority communities; the Community Reinvestment Act of 1977, which has provided an enduring federal policy structure, found a vital impetus in the redlining of black communities in Chicago. The current practice of shareholder engagement has roots in the divestment campaign against South African apartheid. For many years, advocates have urged institutional investors to adopt emerging manager programs to redress the exclusion of minority run investment firms from manager selection processes, or urged investors to use their leverage to diversify overwhelmingly white corporate boardrooms.[1]

In the US, the civil uprisings in response to the murder of George Floyd in the summer of 2020, meant that investors, along with the broad range of institutions in the US, received intensifying scrutiny of racial equity practices and impacts within their own enterprises. It also intensified investors' examination of the role that racial (in)equity plays in their investment strategy and practice.[2] Internationally, racial (in) equity has also become a focus for investors, sometimes in response to flash points like the destruction of the Juukan Gorge caves, a sacred Aboriginal site in Western Australia, by mining company Rio Tinto in May of 2020; and sometimes through extended engagement with organizations such as the the Canadian Truth and Reconciliation Commission. In all of these cases, the work of civil society activists accelerated public focus on the systemic challenges of racial injustice. This changing social context has led to increased salience of the topic within the responsible investment community, in the US and abroad, and wider interest in directly addressing the challenge.

This short paper draws on extended engagements with a set of practitioners to systematically address the role of racial equity as a topic in responsible investment. In peer cohort sessions and targeted interviews, we engaged investors with the question of racial equity in investment across asset classes, including municipal bonds, and across the agency chain of investment decision makers, including asset owners and managers. In particular, this paper draws on a series of engagements with a cohort of investors from pension funds, foundations, and the labor movement convened by the Initiative for Responsible Investment in 2021. The goal of this cohort was to explore an integrated approach to racial justice as a systemic concern in responsible investment. This paper builds on the work of the cohort, and subsequent interviews with practitioners, to address the ways that racial equity can be integrated into responsible investment practice. We also hope that the paper raises the stakes for responsible investors – that it foregrounds the systemic economic challenges of racial inequity in a way that builds on past practice and also responds to changing societal expectations and the urgency they feel in the moment. Though the paper is focused on the United States, its concerns for racial equity are applicable globally.

Why is racial equity a topic for responsible investors?

Racial equity is obviously a central concern for a just society, and the extent of systemic racial injustice in the United States is well-researched and distressing. Here we focus on those dimensions of racial equity that pose particular concerns for responsible investors *as investors*, acknowledging these as a subset of the concerns that all members of society should share.

Defining Racial Equity

The Government Alliance on Race and Equity at Race Forward (GARE) provide this definition:

"Racial equity is achieved when race can no longer be used to predict life outcomes and outcomes for all groups are improved."

Racial inequity is a systemic problem that constrains economic performance.

First, racial inequity in the United States, like climate change or economic inequality, is a systemic issue that runs through the entire economy and so demands investor attention. The history of US economic development and political institutions are indelibly linked to race and racism, which continue to structure economic activity today. People's race conditions where they live and work, how much they are paid, the goods and services they have access to, the kinds of infrastructure that get financed.

The results of racial inequity create systemic harms to economic growth, making the US less prosperous by restricting opportunity and leaving resources underutilized. Racial inequity, like economic inequality generally, makes society less resilient – social cohesion is an important determinant of how well an economy responds to shock.[3]

Recent work in responsible investment has emphasized the need for investors to tackle systemic issues.[4] Investment portfolios on the whole depend far more on the general performance of the economy than they do on their managers' ability to pick winners and losers. Racial equity is precisely this sort of systemic issue: it affects whole economies and demands from investors an integrated analysis of the ways that their investments contribute to systemic (in)equity.

Racial equity is an important lens to identify risks and opportunities in investment analysis.

Second, racial equity provides a lens through which to identify specific risks and opportunities in investment decisions. This is seen for instance in diversity, equity, and inclusion strategies. Research suggests that corporations with diverse boards and staff are stronger enterprises, with more engaged employees, better able to adapt to diverse communities and customers. Racial inequity is a sign of poor management as well as exposure to political and consumer risk. The same logic applies to asset management: diverse investment staff and fund managers bring new perspectives and relationships to their work.

The many commitments made by businesses in the summer of 2020 – to diversify their organizations, to invest in minority communities, to publicly acknowledge the depth of the problem of systemic racism -- are evidence that corporations themselves recognize the political and consumer risk that reside in racial inequity. That these public commitments do not always match corporate performance only highlights that risk. These kinds of risks are not limited to large publicly traded companies.

A racial equity lens can enhance risk analysis of municipalities that issue bonds: inequity and the social tensions it produces can increase risk of default; attention to racial equity can improve long-term economic outcomes.

This is the domain of ESG analysis, with racial equity as an essential element of the S in ESG. The increasing salience of racial equity to public discourse and investment analysis suggests that investors should strengthen their integration of the topic in their responsible investment practice.

> The Investor Statement of Solidarity to Address Systemic Racism and Call to Action [by....Racial Justice Investing] is a commitment endorsed by a group of investors and financial service providers. Signatories commit to five action steps, including:
>
> *"**Commit to integrating racial justice into investment decision-making and engagement strategies.** At the institutional level, commit to reviewing investment policies, due diligence, and risk management or controversy flags to investigate whether they adequately and explicitly integrate systemic racism concerns and update as necessary. Review portfolio holdings across asset classes to identify investments that reinforce systemic racism. Establish time bound goals to either engage with or divest from companies or issuers with practices or business relationships that further systemic racism or white supremacy, or that enable state violence and criminalization. Direct specific attention to those connected to the prison, military, and immigration industrial complex, including technology, communications, services, and financial sectors, and those that are complicit in state violence."*
>
> In their January, 2022 Vanderbilt Law Review article, **Duty and Diversity**, Georgetown University Law Professor Christopher Brummer and former Chief Justice of the state of Delaware Leo E. Strine reassure corporations that diversity, equity, and inclusion is not only allowed, but required by fiduciary duty:
>
> *"In fact, a proper understanding of corporate fiduciary duties supports the ability of corporations to put in place effective DEI policies. Indeed, fiduciary duty requires boards to attend to DEI by monitoring company policies and practices that assure the company's compliance with important laws that focus on the equal treatment of diverse applicants, employees, customers, communities, and business partners. Not only that, the fiduciary duty of loyalty requires affirmative efforts to promote the sustainable success of the corporation, and directors and managers must try to promote the best interests of the company. Substantial evidence exists that companies with good DEI practices will not only be less likely to face adverse legal, regulatory, worker, community, and consumer backlash from their conduct, but that their boards and workforces will be more effective and their reputation with*

> *an increasingly diverse customer base and public will grow, as will trust from institutional investors increasingly focused on sustainable profitability and the avoidance of harmful externalities costly to their clients, who have diversified portfolios tracking the entire economy."*
>
> *"As a matter of fiduciary duty, therefore, corporate leaders not only have broad authority to promote an inclusive and diverse corporate culture, their affirmative obligation to act in the best interests of the corporation can be understood to require it, given the important legal requirements for corporations to avoid invidious discrimination and growing societal and investor expectations that business contribute to reducing racial and gender inequality. Even more, foundational corporate law principles like the business judgment rule protect and support directors and managers who believe that committing their companies to help improve Diversity, Equity, and Inclusion is the right way to do business. And that fiduciary duty imposes minimal guardrails and even floors of basic activity that must be undertaken to ensure that corporations honor societal laws protecting against discrimination."*
>
> Brummer, Christopher J. and Strine, Leo, Duty and Diversity (January 2022). Vanderbilt Law Review, Vol. 75, p. 1, 2022, U of Penn, Inst for Law & Econ Research Paper No. 21-08, Columbia Law and Economics Working Paper No. 642, Available at SSRN: https://ssrn.com/abstract=3788159 or http://dx.doi.org/10.2139/ssrn.3788159

Changing societal expectations create obligations and risks for individual investors and finance as an industry.

Third, changing societal expectations around racial equity change the context in which investor and corporate behavior will be judged. The US is becoming a more diverse country, with younger generations having different views of the value of racial diversity. Legal scholars have argued that diversity and inclusion are mandated by corporate directors' fiduciary duty in this changed context – the same arguments apply to investors.[5] Which issues are material to investors change over time depending on social context.

The frame of human rights within responsible investment offers a further reason for investor focus on racial equity. Commitments to human rights come prior to economic analysis: they are part of the private sector obligations as laid out in the United Nations Guiding Principles on Business and Human Rights. These fundamental obligations shape expectations of investor behavior. As the Principles for Responsible Investment puts it, "failure to respond to these expectations can erode trust, jeopardizing the financial industry's social license to operate."[6]

In this light, investors should build integrated systems to analyze how their own strategies and practices relate to broader social concern for racial equity.

In sum, racial equity is a particular topic of concern for responsible investors because:

- 1. Racial inequity is a systemic problem that constrains economic performance.
- 2. Racial equity is an important lens to identify risks and opportunities in investment analysis.
- 3. Changing societal expectations create obligations and risks for individual investors and finance as an industry.

The nature of racial equity as a systemic issue, and the scale of racial inequity as a social problem, requires active engagement from investors, rather than piecemeal acknowledgments and programs. In what follows we offer an outline of what a holistic investment response might look like.

Building racial equity into responsible investment practice

Racial equity as a systemic issue requires investors to create an integrated approach to strategy, practice, and relationships. Here we identify four areas in which investors can work:

- **Governance and strategy**
- **Asset allocation and accountability**
- **Shareholder engagement**
- **Education and public engagement**

Together these comprise the many roles that responsible investors play in markets and society.

Governance and strategy

Responsible investment issues are often integrated into asset owner practice through investment beliefs and policy statements. These statements are reference points internally for board and staff, and externally across the agency chain of investment consultants and managers with which asset owners conduct business. Explicit identification of racial equity in these statements can strengthen commitments and provide a framework for engagement with external stakeholders. The process for shaping investment belief and policy statements can help structure a fuller review of the topic.

Investment Beliefs and Investment Policies

Boards use **Investment Belief Statements** to make explicit beliefs about markets and society that should frame investment strategy and authorize more effective board focus. For instance:

- Investment belief: systemic racial inequity constrains economic growth and reduces social cohesion.
- Funds use **Investment Policy Statements** to structure more effective engagement across the owners-consultant-manager investment agency chain, and focus attention on important issues during investment decision-making and review. For instance:
- Investment policy: we will incorporate evaluations of racial inequity into our underwriting and engagement activity to address potential risks and identify investment opportunities.

Internally, asset owners should review their own makeup and processes for racial equity implications. At the top, this means reviewing the composition of their board and the ways in which board members are selected, to ensure their commitments to diversity and inclusion extend inwards. Similarly, asset owners should review their hiring, pay, retention, advancement, and redress policies for staff, to assess their racial equity dimensions and improve performance where it lags.

Boards can review their tabling of topics to identify the ways in which racial equity does or should become a matter of attention. This may include a specific review of responsible investment and ESG policies and the role of racial equity in them, and also the identification of places – say, in climate risk evaluation, or in responsible contracting – where racial equity evaluation can deepen analysis and inform decisions.

Finally, asset owners can develop systems to review the racial equity implications embedded in their portfolios, asking questions such as: who is managing our money? What risks from racial inequity exist across our portfolios? How do our investments affect marginalized communities? And, asset owners can ensure that these questions receive consistent attention.

Asset allocation and manager accountability

Racial equity can be integrated into asset allocation practices in a number of ways. Doing so requires deploying accountability systems that allow for performance evaluation both at the level of institutions and their underlying investments.

As noted, one important area of focus in DEI programs has been on minority-owned and managed investment consultants and asset management firms. Emerging manager programs have been designed to counteract structural biases against diversifying asset management pools. Asset owners can engage consultants and managers on the diversity of management and staff, and the procedures they have in place to improve performance.

What trustees and staff can do

- Draw on Investment Beliefs and Policy Statement to formally engage consultants and managers on development of accountability systems.
- Integrate racial equity concerns into RFPs, contracts, and performance reviews of consultants and managers.
- Develop specific diverse manager selection, responsible contracting, and proxy voting guidelines that include racial equit criteria.
- Institutionalize racial equity evaluation as a component of board level review of ESG and/or impact investment performance across portfolios

They can also engage consultants and managers on the ways in which racial equity analysis is deployed within their ESG analysis: asking, how do these managers assess the risks and opportunities related to racial equity in their decisions? How do they assess the impact of investments on marginalized communities? These sorts of questions are a means to center racial equity in discussion of asset manager accountability on the S in ESG.

While there is no standard tool as of yet to assess the equity implications of investments, there are a number of developing methods that investors can call on to undertake this analysis. As important as any particular tool is the foregrounding of racial equity in discussions that take place between asset owners and managers.

Bond Markets & Racial Equity: Creating a New Framework

In fixed income markets, municipal bond issuers who choose to foreground racial equity in their issuances often will label the deal with a "social" designation, as a signal to sustainability focused investors seeking deals that are the mitigation of risks or impact focused investors. A majority of municipal issuers who engage in this practice often support a social designation via practices guided by the International Capital Markets Association Social Bond Principles, which emphasize reporting on the use of proceeds, project selection, and voluntary reporting on the management of proceeds.

Our collaborators on this project, The Public Finance Initiative, completed a national scan to understand how stakeholders are considering racial equity in municipal bond issuances. The noted effort was informed by perspectives from the responsible investment practitioners who engaged with us in this paper, focus groups with bond issuers in partnership with the National League of Cities, dialogues with rating agencies, and private sector dialogues led by the Equity & Excellence in Public Finance Program at The Milken Institute. That effort revealed a myriad of approaches to centering racial equity in municipal bond deals, and made clear a wide spectrum of practices that issuers are using to center racial equity in a bond issuance beyond the traditional use of proceeds and project-focused lens. For example:

- Issuers are applying investment earnings from bonds to fund racial equity programs.
- Issuers are implementing race-conscious community engagement strategies to provide populations that have disproportionately faced discrimination or racism avenues to provide meaningful feedback with respect to capital projects to be financed with bond proceeds.
- Issuers are engaging in self-directed racial equity audits that make visible their policies, practices, and realization of racial equity outcomes in a similar vein to private sector corporations.

- Issuers are adopting comprehensive frameworks that integrate race-conscious, and other equity focused principles into budgeting and capital planning processes holistically, which they are extending to the infrastructure projects financed by bonds.
- Issuers are engaging in race-conscious examinations of all, or part, of the revenue sources that often serve as the source of repayment for bonds in order to examine how a deal is secured and assess whether inequities in the plan of finance exist and populations who will bear the burden of repaying the bonds.

The noted strategies, and other emerging practices, signal a potential paradigm shift that is occurring in the municipal securities market and elevates our collective awareness of the myriad of way that racial equity can be integrated meaningfully in the fixed income securities. This approach serves as the foundation for a new racial equity in bond markets framework being developed by the Public Finance Initiative for issuers and other market participants.

Asset owners can actively target investments that promote racial equity. There is a long history of targeted investments in marginalized communities in the United States, in many cases linked to the development of the community investment industry and the investment case put forward by Michael Porter in his work on the competitive advantage of the inner city.[7] Investment strategies that target equitable economic development or environmental justice can potentially contribute to the mitigation of systemic harms caused by racial inequity. The assessment tools developed to ensure social benefits can be developed in tandem with asset manager accountability frameworks.

Shareholder engagement

Shareholder engagement strategies are essential tools with which investors can assert the importance of and their commitment to racial equity. Racial equity engagements have multiplied over the last two years, and while the existing infrastructure around racial equity issues is not yet as developed as that identified with climate change or human capital management, there are numerous opportunities for shareholders to engage on specific campaigns and to collaborate to build that infrastructure.

Investors have engaged corporations on disclosure of their employment policies. For instance, corporations in the US with more than 100 employees are required to compile equal employment information – EEO-1 data – by federal law, but they typically do not report this information to investors. Engagement on reporting EEO-1 data is an obvious step to enrich the information set with which investors analyze corporate performance.

Racial equity analysis can inform engagement strategies across a range of issues. Investors in the Human Capital Management Coalition, for instance, have focused on the implications of job quality for long-term corporate performance: workforce precarity, a potential indicator of risk, often falls hardest on BIPOC workers. Investors have engaged corporations on political giving: after the 2021 Capital Hill violence, investors foregrounded political giving from corporations to politicians who undermine democratic elections or promote voter suppression often targeted at BIPOC citizens.[8]

Essential Features of an Effective Racial Equity Audit

The shareholder organization Majority Action identifies these three features as essential for an effective racial equity audit:

- The audit should be independent, and conducted by a firm with civil rights expertise;
- There must be robust stakeholder engagement to uncover issues across a company's products and services, workforce practices, and corporate policies; and
- It must include a plan of action for resolution of issues identified, which should include responsibility and mechanisms for ongoing oversight and governance of racial equity related matters.

A major development over the past several years has been the emergence of racial equity audits as an object shareholder proposals. SEIU and Majority Action have spearheaded shareholder votes calling for corporations – across industries, and including large financial institutions – to independently audit their performance for racial inequity. As advocates define them: "A racial equity audit is an independent analysis of a company's business practices in an effort to identify and ferret out practices that may have a discriminatory effect. Such an audit could also evaluate a company's current efforts or efforts in response to the events in the summer of 2020."[9] (Racial Equity Audit Proposal Q & A, CtW Investment Group and SEIU). Many of these votes have received significant and often majority support, and the rapid growth of investor support for audits suggests a basis for collaborative investor focus on the topic as well as the development of a shared framework for corporate analysis.

Education and public engagement

The foregrounding of racial equity within responsible investment and ESG analysis requires education for and public engagement with stakeholders across the investment agency chains – asset owners, investment consultants, asset managers, the institutions in which they invest, the policymakers who shape markets, and not least the communities affected by investments. The importance of issues in the field changes over time, not by passive evolution but by sustained investor engagement with changing political, social, and economic contexts.

Asset owners can develop education programs for their boards and staff exploring the systemic implications of racial equity and its relationship to responsible investment. They can call for and participate in collective endeavors at investor organizations like the Council of Institutional Investors, USSIF or the Principles for Responsible Investment. These sorts of education and issue socialization are the ways in which the field of responsible investment has come to identify and wrestle with systemic issues like climate risk or economic inequality.

Public engagement is especially important in a political context where issues of racial equity can be reduced to partisan culture war. Investors can play useful roles in advocating for racial equity as essential to investment analysis, publicly articulating their concerns about the systemic and long-term economic consequences of inequity.

They can highlight the issue's importance in finance policy, for instance engaging with bond issuers in public and quasi-public authorities, informing ESG disclosure policy discussions at the SEC, or supporting the integration of racial equity into public investment strategies like the climate investments built into the Inflation Reduction Act.

Investors are not going to lead public discussion of racial equity generally, but their voice on the issue, as an investment issue, can be a valuable input into broader social discourse. Responsible investors can use that voice specifically to encourage the financial sector to take into account and improve performance on racial equity. Active public engagement is an essential element to building field awareness and capacity.

Conclusion

Racial equity fits squarely into the sorts of systemic concerns that responsible investment as a discipline was developed to address, but to date racial equity as a topic has tended either to be addressed in a piecemeal fashion or been treated, as sometimes happens with social issues in responsible investment, as something that is difficult to make tractable within investment conventions.

This paper, we hope, contributes to efforts that highlight both the salience of racial equity to responsible investors, and the ways that racial equity can be integrated into investment strategy and decision-making.

We end on a note of caution. There is no predetermined progression to a more racially equitable society to which responsible investors must adjust – rather, investors like any member of society should see racial equity as a fundamental goal towards which they like anybody else should actively reach. Any concern for racial equity by investors will likely invite reaction. This is typical for responsible investment approaches, perhaps necessarily so: the emergence of new topics of concern requires challenging conventional investment practice and existing political-economic structures. We believe that racial equity is important to the long-term interesting of investors and society; investors will have to actively assert the importance of racial equity to those long-term interests.

Endnotes

1. On the history of community investment see Cliff Rosenthal, *Democratizing Finance: Origins of the Community Development Financial Institutions Movement*, 2018; on the anti-apartheid divestment campaign, see Robert K. Massie, *Loosing the Bonds: The United States and South Africa in the apartheid years*, 1997; on diverse managers programs see Jenna Weinberg and Simon Greer, *Fiduciary Guide to Investing with Diverse Asset Managers and Firms*, Diverse Asset Managers Initiative, 2017.

2. For one collective investor response in 2020, see the "Investor Statement on Solidarity to Address Systemic Racism and Call to Action," found at https://www.racialjusticeinvesting.org/our-statement.

3. On the costs of racial inequity generally see, for instance, Heather McGee, *The Sum of Us: What Racism Costs Everyone and How We Can Prosper Together*; on the economic costs of the racial wealth gap, see for instance McKinsey Partners, financial costs of structural racism, see for instance Citigroup's report "Closing the Racial Inequality Gaps: the Economic Cost of Black Inequality in the U.S.," 2020, found at: www.citivelocity.com/citigps/closing-the-racial-inequality-gaps/; for an overview of the relationship of economic inequality to economic growth see Jonathan Ostry, Prakesh Loungani, and Andrew Berg, *Confronting Inequality: How Societies Can Choose Inclusive Growth*, 2018.

4. See the work of the The Investment Integration Project, at www.tiiproject.org.

5. Christopher J. Brummer and Leo Strine, "Duty and Diversity, "Vanderbilt Law Review, Vol. 75, 2022.

6. Principles for Responsible Investment, "Why and How Investors Should Act on Human Rights," 2020, found at: https://www.unpri.org/human-rights/why-and-how-investors-should-act-on-human-rights/6636.article

7. Michael Porter, "The Competitive Advantage of the Inner City," Harvard Business Review, 1995.

8. On workforce issues see the work of the Human Capital Management Coalition found at www.hcmcoalition.org; on shareholder engagement on racial justice issues see the work of Majority Action at www.majorityaction.us/racial-justice.

9. Change to Win Investment Group and SEIU, "Racial Equity Audit Proposal Q+A," 2021, found at: https://static1.squarespace.com/static/5d374de8aae9940001c8ed59/t/605cdec4e6861277202f0b46/1616699076603/Racial+Equity+Audit+QA_CtW_SEIU+%28002%29.pdf