



Chicago United

Closing the gap between race and business.

Chicago United's Board Trend Analysis: What Happens to Corporations When Boards are Diverse?

A Review of Eight Corporate Boards of Directors

November 2, 2005

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ACKNOWLEDGEMENTS

We gratefully acknowledge the members of Chicago United for their leadership on the issue of board diversity and for making this research possible. This paper could not have been released without the members of the Research Review Committee, whose thorough review and insightful questions broadened our perspective, making this document tremendously richer in content. We thank Albert Grace, president and COO, Loop Capital Markets, LLC, Jeffrey Noddle, chairman and CEO, Supervalu, Inc., and Tim Schwertfeger, chairman and CEO of Nuveen Investments.

I want to express my deepest appreciation to Judy C. Mathews, president, Community Interface, Inc. and diversity consultant to Chicago United for her professional and personal dedication in the research and writing of this document.

For the past two years, CU has conducted research in the area of corporate governance and business diversity; specifically, the impact diverse boards of directors have on shareholder value and increasing the utilization of minority professional service firms within large corporations. Through our research we have developed a professional services model that can be adopted in corporate supplier diversity processes, and have examined some trends present among corporations with diverse boards of directors.

Chicago United will continue to conduct research in the area of diversity in corporate governance, executive management and business partnerships. Our goal is to enrich conversations and create dialogue within corporate America that will assist key decision-makers and influencers support the value of diversity.

Sincerely,

A handwritten signature in cursive script that reads "Gloria Castillo". The signature is written in black ink on a light blue rectangular background.

Gloria Castillo
President
Chicago United

EXECUTIVE SUMMARY

The purpose of this study is threefold: 1) to examine recent research studies regarding the relationship between board diversity and firm performance; 2) to present the results of Chicago United's (CU) pilot corporate governance research study; and 3) to create continuous dialogue regarding the value of diversity in corporate governance. To achieve these objectives, CU reviewed three recent research studies on diversity in governance and then conducted independent research on a pilot basis. The studies reviewed were conducted between 2002 and 2004 by Georgia State University and Institutional Shareholder Services, the University of Oklahoma's College of Business Administration, and Milwaukee Women, Inc. The collective conclusions indicate a noticeable pattern of improved financial performance among corporations with diverse boards of directors.

In 2004, Georgia State University and Institutional Shareholder Services released a corporate governance study addressing the relationship between corporate governance and firm performance. The study concluded that companies lacking good governance are at greater risk and have increased volatility. Although not exclusively examining diversity, it revealed that board composition and its practices can have impact on company performance.ⁱ

In 2003, Milwaukee Women, Inc. commissioned a research study conducted by the Public Policy Forum, Inc. entitled, *Diversity and Tomorrow's Profits: A Census of Women in Corporate Leadership*, which concluded that as revenues increased, so did the likelihood that there was at least one female director on the board. Data findings were consistent with other studies similar in scope.ⁱⁱ

In March of 2002, a group from the University of Oklahoma's College of Business Administration performed a study entitled, *Corporate Governance, Board Diversity and Firm Value*, which concluded that there is a "significant positive relationship between the fraction of women or minorities on the board and firm value." This study used both comparison of means and regression analysis to determine the impact of board diversity and firm value.ⁱⁱⁱ

ⁱ Sri Media.Com, ISS Proxy Corporate Governance Study Links Bad Boards to Higher Risk and Increased Volatility, Posted by Louise Walcott, March 12, 2004

ⁱⁱ Diversity and Tomorrow's Profits: A Census of Women in Corporate Leadership
Research by the Public Policy Forum, Inc., Commissioned by Milwaukee Women, Inc.
October, 2003

ⁱⁱⁱ Corporate Governance, Board Diversity and Firm Value
Authors: David A. Carter, Betty J. Simkins, W. Gary Simpson
College of Business Administration, Oklahoma State University, Stillwater, OK
March, 2002

Chicago United's pilot research study examined the Fortune 100s between 2000 and 2004. The results of our analysis indicate that a strong relationship existed between board diversity and firm profitability, consistent with the results of the studies previously cited. To illustrate this point, after reviewing the Fortune 100 we targeted eight corporations with contrasting policies on diversity and examined the following three key performance ratios: net profit margin (NPM), return on equity (ROE) and return on assets (ROA). These companies were targeted based on significant ethnic board diversity or the lack thereof. The sample consisted of an equal distribution of companies with high and low percentages of board diversity. The results for the corporations with higher percentages of diversity indicated the following:

- Companies with diverse boards of directors had an average of 14 board seats.
- Companies with diverse boards of directors had an average of 25% return on equity.
- Companies with diverse boards of directors had an average of 5 ethnic board members.
- Companies with diverse boards of directors consisted of 10 or more members.

Overall ethnic minorities (male and female) hold a small percentage of board positions. Although their representation on corporate boards has been increasing during the past ten years, corporations are working more diligently to recruit minority candidates. To that end, the information presented in this document will likely encourage corporations to continue working at achieving racial parity in governance, engage in dialogue, ask the tough questions, and further examine what happens to corporations when its boards of directors become more diverse.

INTRODUCTION

The impact of board diversity in today's business environment is being discussed and addressed in the academic, business and investment communities. Many theories and hypotheses on board diversity have been tested to determine its impact on a corporation's productivity and bottom line. Some theorize that it positively influences corporate environments and key value drivers in a significant way. Others theorize that you cannot unequivocally determine a causal link between board diversity and firm value. Whether there is a valid connection or not between corporate governance and firm performance, requires further examination. As such, this pilot study begins to test the diverse-governance-and-profitability theory to determine if board diversity impacts financial performance.

Remaining profitable has become more challenging as the globalization of business continues to increase.

It has been reported by the Investment Responsibility Research Center and Institutional Shareholder Services that shareholders and investors have become increasingly concerned about the integrity of their investments.

Many are requiring diversity at the highest levels of an organization even to be considered a viable investment opportunity. Institutional investors such as the state of Connecticut have implemented a board diversity initiative. According to Connecticut State Treasurer Denise Nappier, “greater diversity leads to better corporate governance, which is good for Connecticut’s investments. There is a growing body of knowledge showing that diversity affects the bottom line.”^{iv}

Corporations are moving more strategically to respond to investor-standard strategies. For example, in 2005, Viacom, Inc. issued a *Board Diversity Resolution* “to ensure that every reasonable measure is taken to achieve diversity.”^v Included in the resolution is a commitment from the board that women and minority candidates would be considered for nomination.

Other corporations are moving more strategically to develop diverse leadership, and acquire and/or create diverse business units such as, Chrysler, McDonald’s, Wendy’s and Tribune, to name a few. At Chrysler, an African-American design team created the Chrysler 300C series and the PT Cruiser. Attempting to appeal to upper-middle-class African Americans, these models had mass appeal to both the African-American market and other cross-over segments achieving additional value for Chrysler. McDonald’s and Wendy’s each have had ethnic market success with its acquisitions of Chipotle Mexican Grill and Baja Fresh chains, respectively. Tribune has also seen the benefits of target programming and marketing with *Hoy*.

Why are corporations developing strategy around diversity? The following are a few noteworthy reasons: Demographics in ethnic minority populations are expected to grow 8-times faster than majorities by 2045. Ethnic minorities are currently 20% of the U.S. purchasing power at \$1.3 trillion and growing.^{vi} The rise in ethnic minority populations and income levels increase potential market opportunities. Global marketing and diversity are becoming key elements of corporate strategy for sustainable growth.

In corporate governance, large and small corporations are restructuring its boards to comply with Sarbanes-Oxley as well as reflect the ethnic and gender composition of its workforce, customers, suppliers, and other key stakeholders.

^{iv} WSJ.Com, The Wall Street Journal Executive Career Site
Corporate Governance Efforts Pressure Companies to Diversify

^v Viacom, Inc./CBS, 2005 Board Diversity Resolution

^{vi} Goldman Sachs Group, Inc. – What We See
Client Services Web Site Information

There is no debating that a great deal of focus and attention is being placed on the broad implications diversity intrinsically brings to an organization. It is important, however, to continue exploring policies to strengthen diversity in governance and developing methodologies designed to determine its value.

In the following section we will provide a detailed description of our research methodology used during this pilot study.

RESEARCH METHODOLOGY

This document is the result of research conducted on the Fortune 100 to identify and examine the performance of companies with diverse boards of directors. The purpose of this analysis is to examine whether company financial results have been positively impacted over the years as the boards became progressively more diverse. The assumption is that diversity has assisted in broadening thought perspectives as well as gaining access to untapped diverse markets; thereby playing a role in increasing firm value.

To provide context, companies with diverse boards were compared to those who historically, or otherwise, have not adopted a policy of inclusion for people of color or women. Studies of similar scope were referenced supporting the theory of board diversity and its impact to firm profitability.

Approach

In an attempt to establish a pattern three phases of research were conducted:

Phase One: Gather Data on Fortune 100 from 2000-2004

Phase one included gathering data, using publicly available resources, from 2000-2004 on all Fortune 100. Quantitative formulas were developed to highlight total board seats, the number of board members who were of ethnic minority origin including African Americans, Hispanic Americans, Asian Americans as well as majority women. The end result was information detailing gender and ethnic board participation of each company. Majority women were included in these data only to illustrate how diversity greatly diminished as they were eliminated from the equation.

Phase Two: Review Quantitative Data

Data were analyzed in five steps. Step one, we compiled data identifying the percentage of gender and ethnic board participation for each company. Step two, we eliminated all companies that were acquired or merged with another company during the sample time period. To provide continuity, step three consisted of eliminating all companies that were not listed in the Fortune 100 over the four-year period.

The rationale being to review company data that could be tracked consistently for the sample time period. Step four, we culled the lists to compare the performances of companies that exceeded a *diversity-participation-percentage* threshold against companies lacking significant board diversity. A threshold of 20+% was used as the “high” performance standard, and 0-10% was used as the “low” performance standard.

Using those thresholds, we further examined the list and selected twenty (20) companies: ten (10) meeting the high performance standard; and ten (10) meeting the low performance standard. In step five, each company was ranked by the highest and lowest percentages of ethnic minority board participation.

Phase Three: Gather and Review Qualitative Data

During phase three, we collected and reviewed additional information on each company and ranked them according to board diversity practices and other corporate diversity initiatives. This process included all qualitative data that highlighted each company’s policy and/or position on achieving a diverse corporate culture. Data included a review of each company’s overall diversity efforts such as workforce diversity, diversity among its executive management team, and its business partnerships with minority firms.

Data used included annual reports, proxy statements, board and committee charters, 10-Ks and company Web site diversity links. These documents provided detailed information on the board member’s names, ethnicity, gender and total number of board positions. Ethnicity and gender were verified from photos and historical data available in national publications and Web sites including *Ebony*, *Hispanic Business.com*, *USA Today*, and other previously researched data on file.^{vii} The diversity links provided detailed information of each company’s commitment and ongoing efforts to promote diversity within its corporate framework.

In the remaining sections of this document we will provide a detailed discussion of our key findings.

^{vii} *Hispanic Business.Com*, *Hispanic Presence on Corporate Boards Decreases*
January 29, 2001

Ebony, *Black Women on Corporate Boards*
Author: Lynn Norment, March, 2002

USA Today.Com, *Boards Seat Few Asian-Pacific Americans*
Author: Edward Iwata, April 15, 2004

KEY FINDINGS

Corporate leaders of publicly held companies have an obligation to increase shareholder value. Although there are other stakeholders' interest to consider (e.g., employees, customers, suppliers, etc.), a CEO's success or failure is predicated on the economic health and well being of their organization. With the competitive landscape expanding globally, corporations are increasingly relying on innovation as a means to a profitable end.

Diversity of thought and practice within an organization's workforce, supplier base and culture has demonstrated promise over the years. As a result, the practice of diversity is becoming more important in the boardroom and to the bottom line.

To validate this assumption we conducted a comparative analysis on eight of the final twenty companies identified with high and low board diversity percentages. Four companies were selected from the "high" performance category, and four from the "low" performance category. The companies in the sample represented a cross section of industries.

Understanding that over time any number of variables in the economy and marketplace can influence an outcome, this analysis illustrates a connection between board diversity and its impact on key financial ratios. We reviewed the performance of the eight companies noted above. The companies selected for review represent a cross section of industries, and equally represent companies with the highest and lowest diverse board percentages. The industries included consumer goods, financial services, retail, information technology, telecommunications, transportation and logistics, and goods wholesaler. The highest performing companies were as follows: Citigroup, PepsiCo, Target and United Parcel Service. The lowest performing companies included Costco Wholesalers, Hewlett Packard, Goldman Sachs Group and Sprint.

The analysis examined the net profit margin (NPM), the return on assets (ROA) and the return on equity (ROE) of each company from 2000-2004. After reviewing all of the data for the selected eight companies, the results indicated a positive relationship between diverse boards and firm performance.

Diverse boards of directors provide companies with the ability to tap into the unique skills, experiences and perspectives of a broader base. With the marketplace changing rapidly diversity of thought is an important element in business. Diverse board members contribute new and fresh perspectives making for robust discussion leading to innovation.

To validate our relationship theory we took the averages of total board positions, board composition and the ROE of each company from our eight company sample analysis.

The results for the high percentage companies indicated the following:

- The average number of board positions for corporations with diverse boards is 14.
- The average ROE for corporations with diverse boards is 25%.
- The board composition of companies with diverse boards had an average of 5 ethnic board members.
- Companies with diverse boards tend to consist of 10 or more members.

The results for the low percentage companies indicated the following:

- The average number of board positions for corporations with non-diverse boards is 10.
- The average ROE for corporations with non-diverse boards is 9%.
- The board composition of companies with a dearth of ethnic diversity had an average of 1% participation from women.
- Companies with non-diverse boards tend to consist of 10 members or less.

Although there are a number of other variables to consider, our analysis indicates that companies with diverse governance, supported by diverse management and business partners have higher ROEs. The consistent approach to diversity at all levels has a tendency to impact results. The results also suggest that in an industry where overall the market was down during the time frame, companies with diverse boards sustained profitability.

CONCLUSION

Shareholder and Investor Considerations

Diversity initiatives in whole are not new to corporate America. What is new is the increased level at which these initiatives are impacting investor considerations and investment requirements. Many investors now correlate the benefits of diversity to shareholder value.

Institutional investors such as the Connecticut Pension Fund recently initiated a resolution encouraging companies to promote diversity at the board level. The shareholder resolution requires that the board of a company under consideration must do the following: 1) make a commitment to identifying qualified women and minority candidates for nomination its board, and 2) provide a report to shareholders describing the effort to reach its goal.

Many companies sought to file grievances with the SEC charging that this type of resolution contradicted Title VII. The Fund with \$20 billion under investment, however, ultimately had the most leverage.^{viii}

Board diversity initiatives among institutional investor's dates back to 2000 when the president of Citizens Funds required Gateway and Kohl's "to recognize that diversity is essential to companies wishing to compete successfully in a global marketplace." Citizens Funds is a diversified family of six socially and environmentally responsible mutual funds which had \$1.7 billion in assets in 2000.^{ix}

This effort forced a number of major corporations to re-assess the value of diversity to its long-term objectives and its shareholders. The end result is companies have begun to further extend diversity efforts into the boardroom rather than risk losing large investors.

Business Imperative

Corporate boards were created to represent all shareholders. Board diversity provides a body that more closely represents all shareholder and stakeholder interests. As such, diversity has become an important ingredient for investor consideration and good governance. The demographics of the market will continue to become more diverse over the next twenty years. Consequently, there is great opportunity for growth potential tied to emerging ethnic markets, nationally and internationally.

Over the years, diversity initiatives have provided added value to major corporations. As ethnic markets continue to grow, board diversity will be an essential element in sustaining competitive advantage and building shareholder value. The business community and others will continue to debate whether or not a quantitative link exists between board diversity and firm value. Others will maintain that there is no plausible methodology that can unequivocally link a board's level of diversity to its financial performance. Although not firmly quantifiable, the results of this trend analysis, in comparison to cited research, further indicate that firms with diverse corporate cultures perform significantly better than those without.

Next Steps

In 1998 a study by three academics Amy J. Hillman (Michigan State University), Ira C. Harris (formerly University of Notre Dame), Albert A. Cannella Jr. (Texas A & M University, and Larry Bellinger (Michigan State) found that "ethnic and gender

^{viii} Social Investment Forum Advocacy & Policy Forum News Center Web Site
Press Release, Connecticut Pension Fund Proceeds with Shareholder Resolution Urging Board Diversity at
EMC Corporation, January 18, 2002

^{ix} Institutional Shareowner Web Site, News Release, Citizens Funds Makes Gains on Board Diversity, May 23,
2000

diversity on corporate boards is associated with superior stock performance. The study compared S&P 500 companies with differing numbers of women and minority directors and concluded that companies with more diversity had better stock returns and less risk of loss for shareholders.^x

As globalization in business continues to unfold, we recommend further research on the study of diversity and its impact on diversity in governance. Based on the research presented, we believe great value would be derived from further examining variations in key performance ratios, assets and revenues when diversity is present. Furthermore, it would be prudent to continue to examine the association between stock performance and board diversity.

Large corporations understand the importance of maximizing shareholder value; however, maximizing value requires superior performance and good governance. Chicago United will continue to produce independent research and provide a platform for continued dialogue on this increasingly important business imperative.

^x BSR Issue Briefs, *Board Diversity*, October 2003, Business for Social Responsibility

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