Racial and Gender Diversity's Effect on Corporate Performance

Executive Summary:

- Many corporate diversity measures, such as boardroom race and gender quotas, are based on a series of McKinsey reports linking executive diversity to corporate outperformance. Those reports are deeply flawed.
- Even if McKinsey's asserted correlation were true, it does not provide any evidence that racial and gender executive diversity cause outperformance and it only considers one narrow measure of financial success.
- The correlation the reports find is the product of multiple kinds of cherry-picking.
- It is more likely that financial success causes corporations to adopt diversity measures than the reverse.
- Strive believes that career opportunities should be distributed according to merit, to whomever would use them to make shareholders the most profit.

Introduction

In theory, diversity of thought strengthens organizations by preventing groupthink; in practice, the business world's pursuit of diversity has become skin-deep. Goldman Sachs recently implemented quotas requiring its portfolio companies and IPOs to have at least one woman and one racial minority on their board of directors.[1] A 2020 Nasdaq Stock Market rule requires listed companies to meet similar board diversity quotas or explain their failure.[2] To support such measures, financial leaders often claim that racial and gender diversity among a company's top ranks improves corporate performance, though academic studies often disagree.[3] After the Supreme Court's decision striking down university affirmative action,[4] courts will likely enforce Title VII's ban on the corporate version, but this paper concerns itself only with evaluating the evidence suggesting these diversity measures increase profit. That evidence is flawed.

These quotas, along with a host of other corporate diversity measures, are largely founded upon a series of reports from management consulting firm McKinsey & Company. "Why diversity matters" argued that companies with greater executive racial and gender diversity were more likely to outperform financially. Two follow-ups claimed that the link between diversity and outperformance was becoming even stronger. The McKinsey studies are influential, partly because they were accepted uncritically by mainstream financial publications like *Financial Times*[5] and *The Wall Street Journal*.[6] A recent *New York Times*

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[1] Ross Kerber, "Goldman Sachs Ups Diversity Targets as Demographic Data Improves." *Reuters*, 2 Dec. 2021, www.reuters.com/markets/us/goldman-sachs-ups-diversity-targets-demographic-data-improves-2021-12-02/.

[2] Brian V. Breheny et al, "SEC Approves Nasdaq Board Diversity Listing Standards." *Skadden, Arps, Slate, Meagher & Flom LLP*, www.skadden.com/insights/publications/2021/09/quarterly-insights/sec-approves-nasdaq-board-diversity-listing.

[3] Jesse M. Fried, "Will Nasdaq's Diversity Rules Harm Investors?" *European Corporate Governance Institute*, March 31, 2021, Law Working Paper No. 579/2021, available at SSRN: https://ssrn.com/abstract=3812642 or http://dx.doi.org/10.2139/ssrn.3812642. For an influential study finding that female board members have a negative effect on share value, see Renée B. Adams and Daniel Ferreira, "Women in the Boardroom and Their Impact on Governance and Performance." *Journal of Financial Economics*, Vol. 94 No. 2, November 2009, 291-309, https://doi.org/10.1016/j.jfineco.2008.10.007.

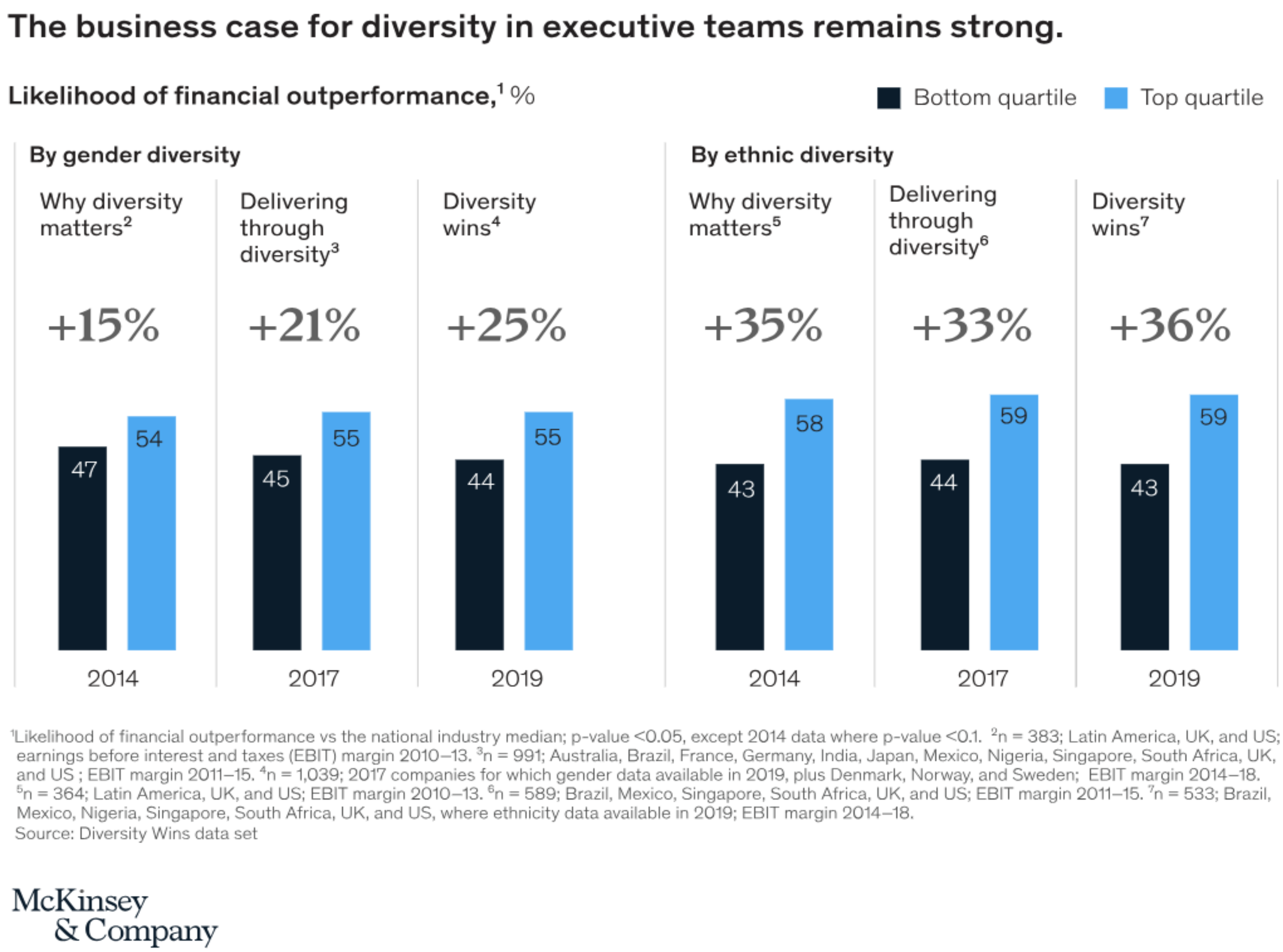
[4] *Students for Fair Admissions v. Harvard*, 600 U.S. ___ (2023)

[5] Oliver Ralph and Laura Noonan, "Diversity brings boost to profitability," *Financial Times*, 4 April 2017, https://www.ft.com/content/1bc22040-1302-11e7-80f4-13e067d5072c.

[6] Vanessa Fuhrmans, "Companies With Diverse Executive Teams Posted Bigger Profit Margins, Study Shows," *The Wall Street Journal*, 18 Jan. 2018, https://www.wsj.com/articles/companies-with-diverse-executive-teams-posted-bigger-profit-margins-study-shows-1516322484.

piece critiquing the Supreme Court's affirmative action decision, for instance, cites McKinsey's work as concrete proof that racial diversity improves corporate performance.[7]

The most recent report, "Diversity wins," illustrates McKinsey's argument by showing how likely the most and least diverse companies were to outperform their industry's average earnings margin:[8]



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[7] Darren Walker, Repeal of Affirmative Action is Only the Beginning," *The New York Times*, 30 June 2023, https://www.nytimes.com/2023/06/30/opinion/affirmative-action-supreme-court-repeal.html.

[8] Sundiatu Dixon-Fyle et al, "Diversity Wins: How Inclusion Matters." *McKinsey & Company*, 19 May 2020, www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters.

If gender diversity had no effect on earnings margin, companies in both the top and bottom quartiles of gender diversity would have a 50-50 chance of outperforming their industry's average—a coin flip. Instead, the top quartile has a 54% chance of outperforming the average and the bottom quartile has only a 47% chance. That indicates gender diversity is correlated with a slightly improved chance of outperformance. In any case, the chart's first footnote admits that this 2014 data does not meet the standard threshold for statistical significance, a p-value below .05.

Notably, McKinsey's studies never say what the earnings margin of diverse companies actually is; it could be below-average, for all readers know. Readers want to know how *much* money diverse and non-diverse companies make, but the studies occupy themselves only with the question of how *likely* they are to make money. This approach is like comparing how likely lottery tickets are to win prizes without caring that some have a payout of ten dollars and others win a million. The scale of successes and failures matters, not just their probability.

Not only that, earnings margin only produces actual earnings when combined with revenue. The authors must have had the data about executive diversity's relation to revenue, margin, and earnings growth, but chose to show one narrow measure of financial performance and hide the most fundamental ones.

But the biggest problem with McKinsey's argument is that it is only about correlations. Boardroom diversity quotas and race and gender-based hiring and promotion policies are founded on the belief that these kinds of diversity *cause* corporate outperformance. But the research they are based on disavows any causal claims.

McKinsey was upfront about this limitation in its summary of its first report. The second paragraph begins, "While correlation does not equal causation (greater gender and ethnic diversity in corporate leadership doesn't automatically translate into more profit), the correlation does indicate that when companies commit themselves to diverse leadership, they are more successful."[9] In other words, the correlation indicates a correlation. By the second report, the acknowledgment that correlation is not causation drops to the end.[10] In the third, this disclaimer no longer appears in the public summary at all. It is buried at the end of a 50-page version: "Correlation is not causation. There are real

[9] Dame Vivian Hunt et al, "Why Diversity Matters." *McKinsey & Company*, 1 Jan. 2015, www.mckinsey.com/capabilities/people-and-organizational-performance/our-insights/why-diversity-matters.

[10] Dame Vivian Hunt et al, "Delivering through Diversity." *McKinsey & Company*, 18 Jan. 2018, www.mckinsey.com/capabilities/people-and-organizational-performance/our-insights/delivering-through-diversity.

limitations, and we are not asserting a causal link… Yet, while not causal, the relationship is real."[11]

This is baffling. What does it mean for there to be a real but non-causal relationship between executive diversity and corporate performance? Without evidence that diversity causes outperformance, why should companies expect diversity measures to improve their performance? The relationship between ice cream consumption and murder is in a sense real, but entirely correlational; both happen more often during warm weather. Causation is what matters.

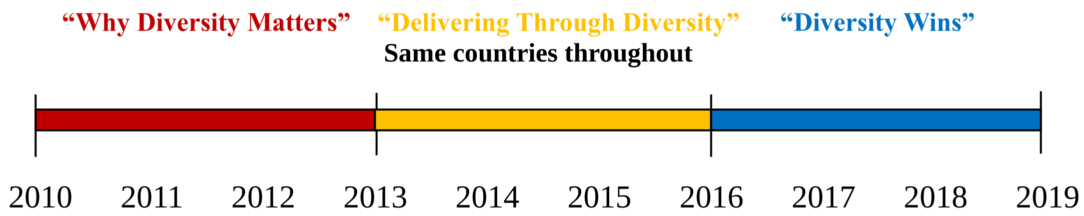
Even if all McKinsey's claims were true, this is hardly an analysis worth restructuring the corporate world over. The correlation between executive diversity and earnings margin outperformance is minor, the relation to earnings itself is unclear, and the authors refuse to assert any causal connection. But there are good reasons to think the correlation itself is just the product of a deeply flawed statistical methodology.

Cherry-picked data

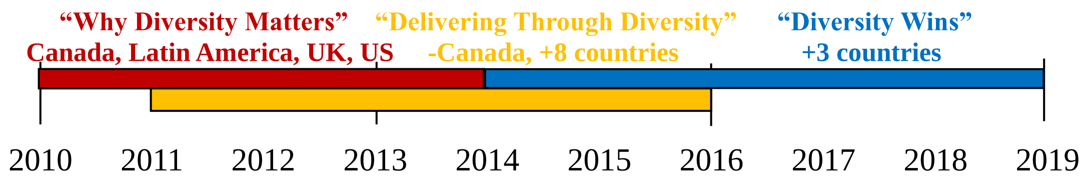
McKinsey's hope is that the sheer robustness of its correlation across time and space can remove the need to prove causation. This is why its chart aims to demonstrate that the gap between the most and least gender diverse companies' chance of financial outperformance is widening over time. That argument requires a consistent underlying dataset—readers need reassurance that what is changing over time is the performance of the companies in the dataset, not the dataset's composition. Yet across the three reports, the underlying dataset is always shifting, displaying arbitrary choices in the timeframes it covers and companies it includes.

[11] "Diversity Wins," 51, https://www.mckinsey.com/~/media/mckinsey/featured%20insights/diversity%20and%20inclusion/diversity%20wins%20how%20inclusion%20matters/diversity-wins-how-inclusion-matters-vf.pdf.

Here is what we might expect the reports' datasets on gender diversity to look like:



Instead, they look like this:



The choice of timeframes raises multiple red flags. Inexplicably, the reports do not cover *consecutive* time periods; instead, their datasets overlap in strange ways. The first report covers 2010-2013. The second includes data from 2011 to 2015, omitting the first year of data from the prior report, including the other three, and adding two more years. Then the third report includes data from 2014 to 2018, omitting the first three years of data from the prior report, keeping the next two, and adding three more years of data.

This research methodology is highly suspect, especially when so many inconsistent decisions come with no justification and are disclosed in the fine print. It is also suspicious that after failing to find a statistically significant correlation in its first report's dataset, McKinsey adds more countries, removes Canada without comment, then finds one—it raises the question of whether Canada had less diverse companies that performed well financially. Cobbling datasets together in this patchwork way to show a strengthening correlation is arbitrary at best, dishonest at worst. It displays all the signs of p-hacking, the statistical trick of adding artificial criteria until one's data supports a predetermined conclusion.[12] Most people call it cherry-picking.

These problems make it even more important to see whether independent researchers reach the same results as McKinsey; they do not. Texas A&M accounting professor Jeremiah Green and UNC business professor John R.M. Hand attempted to

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[12] This webcomic illustrates how one can use p-hacking to find a statistically significant correlation between green jellybean consumption and acne: https://xkcd.com/882/.

replicate McKinsey's analysis using S&P 500 data from 2015 to 2019. They found no correlation between executive racial diversity and chance of EBIT margin outperformance. They also checked whether it had any correlation with EBIT margin itself, sales growth, gross margin, return on assets, return on equity, and total shareholder returns. They again found no correlations.[13] McKinsey declined to comment on their results.[14]

The McKinsey studies do apply appropriate rigor at one stage: they group companies together by industry and geography and then measure how well diverse companies perform compared to the earnings margin of their peers.[15] But the fact that they correctly account for industry and geography when measuring *financial performance* makes it confounding that they chose not to when measuring *diversity*. They write, "For gender diversity, quartiles were based on the percentage of women at a given level, and set relative to the total ("global" sample) of 15 countries."[16]

That opens the door for successful industries and countries to skew the results. American big tech companies like Google and Amazon tend to have more executive gender diversity than Mexican textile companies. Grouping them in the same pool means that McKinsey's top quartile by diversity will be filled with successful Western companies. Only then does it control for industry and geography by measuring whether the Googles and Amazons outperform other American tech companies. Selectively choosing when to account for those two factors is a subtle but effective way of putting a thumb on the scale.

Correlation and causation

Instead of diversity causing corporate outperformance, outperformance may cause diversity. McKinsey acknowledges this possibility at the end of "Diversity wins": "Just as we cannot assert causality, we cannot say definitively what drives the correlations we find. It is theoretically possible that the better financial outperformance enables companies to achieve greater levels of diversity. Companies that perform well financially may choose to deploy more of their resources toward more advanced talent strategies, thus allowing them to attract more diverse talent, for example."[17] Google and Amazon are good illustrations.

[13] Jeremiah Green and John R.M. Hand, "Diversity Matters/Delivers/Wins Revisited in S&P 500® Firms," 6 Aug. 2021, available at SSRN: https://ssrn.com/abstract=3849562 or http://dx.doi.org/10.2139/ssrn.3849562

[14] https://qz.com/work/2038103/is-mckinsey-wrong-about-the-financial-benefits-of-diversity

[15] "Diversity wins," 49.

[16] Id. at 48.

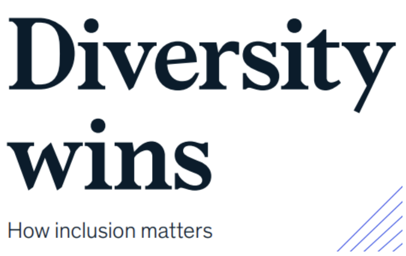
[17] Id. at 51.

After McKinsey's studies, as the economy sputtered and big tech companies laid off employees, DEI (diversity, equity, and inclusion) jobs have been hit hardest: one-third of DEI professionals have left their jobs within the last year, compared to a non-DEI attrition rate of 21%.[18] If successful companies thought these employees increased profitability, they would not be among the first to be fired. Some major companies conducting layoffs have also had sharp declines in racially diverse hires.[19] These facts suggest companies adopted diversity measures during boom times and are backing away from them now that profit is harder to come by.

Diversity quotas could easily hurt profits. "Diversity wins" recognizes that quotas may force STEM-related businesses to loosen their standards, given the limited pipeline of qualified candidates.[20] Lower hiring standards could lead to lower profits. Performance could further suffer if employees lose motivation upon seeing peers receive career opportunities based on race or gender instead of merit.

This is why showing a mere correlation between diversity and corporate outperformance is not enough: people's careers are at stake. Jobs, promotions, and salaries are scarce resources. American capitalism promises workers that those goods will be distributed fairly—career opportunities are merited by whoever who would use them to maximize shareholder profit. That promise of fairness is broken when employers give out opportunities based on irrelevant traits like race or gender.

The subtitle of "Diversity Wins" gives a hint about which factors really drive business performance:



[18] Kiara Alfonseca and Max Zahn, "How corporate America is slashing DEI workers amid backlash to diversity programs." *ABC News*, 7 July 2023, https://abcnews.go.com/US/corporate-america-slashing-dei-workers-amid-backlash-diversity/story?id=100477952#:~:text=The%20job%20losses%20owe%20to,DEI%20professionals%20told%20ABC%20News.

[19] Reyhan Ayas, Paulina Aceves, and Devan Rawlings, "Cutting Costs at the Expense of Diversity," *Revelio Labs*, 7 Feb. 2023, https://www.reveliolabs.com/news/social/cutting-costs-at-the-expense-of-diversity/.

[20] Id. at 42.

As its title promises, though it spends most of its time talking about diversity, the report concludes that inclusion is what really matters.[21] The authors elaborate, "Our evidence is that an emphasis on representation is not enough; employees need to feel and perceive equality and fairness of opportunity in their workplace."[22] At the end of its trail of cherry-picking, McKinsey arrives at the conclusion that companies do better when they treat their employees fairly and make them feel like they belong. On this, at least, Strive can agree.

But the big question is what diversity quotas have to do with inclusion. Treating employees equally and fairly is incompatible with giving out career opportunities based on race or gender. And it is hard to see how employees from disfavored groups can feel like they belong in a workplace if they see favored groups valued more highly there.

We are left with common wisdom: businesses should treat their employees fairly and well. They should hire, promote, and reward those who contribute the most to shareholder profit. Race and gender appear to have nothing to do with it.

[21] "Diversity wins," 6.
[22] Id. in preface.