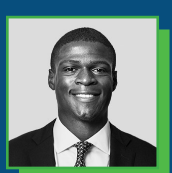
THE KRESGE FOUNDATION:
IN PURSUIT OF ALPHA BY INVESTING IN DIVERSE FUND MANAGERS

FALL 2022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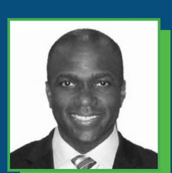

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Introduction

> ***"We are not pursuing diversity, equity and inclusion for the sake of the pursuit; we are doing this because we know it leads to better investment returns."***
>
> *John Barker, Chief Investment Officer, The Kresge Foundation*

The U.S. asset management industry has historically wrestled with diversity, equity, and inclusion (DEI). As of September 2021, 1.4% of U.S. based assets were managed by women and minority-owned firms, despite women and ethnic minorities representing 70% of the U.S. population (Exhibit 1). Capital allocation to diverse-owned firms has long paled in comparison to that of other firms; this reality has persisted over time despite the demonstrated financial benefits of diverse teams and the stated willingness by allocators to address the issue.

In this context, The Kresge Foundation ("Kresge" or "the Foundation"), founded in 1924 with an initial $60 million gift from Sebastian S. Kresge, set out to encourage change. By FY2021 the Foundation reached its peak, managing more than $4.5 billion assets (Exhibit 2). This makes Kresge among the 25 largest private foundations in the United States. Kresge's mission was established by its founder "to promote human progress." Today the foundation works to build and strengthen pathways to opportunity for low-income people in America's cities, primarily through the use of grants, loans and other social investment tools which total approximately $160 million annually.

Kresge's aim of addressing diversity, equity and inclusion in asset management began in 2016. Initially, Kresge's efforts were focused internally. Under the leadership of former CIO Rob Manilla and current CIO John Barker, the Foundation began reviewing its hiring practices, employee demographics and culture. In Barker's words, "We knew change was needed, but we recognized that we first had to dig deeper and gain a better understanding of the structural barriers that existed in the investment industry."

In 2019, the Kresge investment office formally and publicly shared its commitment to DEI. This included a strategy to combat the structural barriers to diverse ownership in the asset management industry. Their approach was three-pronged and focused on:

1. ***People–***reimagining and rebuilding their talent networks in order to purposefully create a more diverse and inclusive team, thereby improving their internal team's decision-making
2. ***Portfolio–***intentionally sourcing, vetting, and investing in the best diverse-owned firms across all asset classes to boost portfolio performance
3. ***Pulpit–***meaningfully and systematically championing DEI initiatives within the industry to break down the barriers facing diverse industry talent and diverse-owned firms

Former CIO Rob Manilla announces the $2 million Student Managed Investment Fund at Wayne State University in 2018. A similar fund was established by the foundation at neighboring Oakland University in 2015.

People

Since 2008, Kresge has maintained an analyst program to attract new candidates to its Investment Office. Upon review, leadership found that from 2009-2017, their analyst class consisted of >80% white males. Further investigation identified that the team's hiring procedures relied heavily on recruiting at colleges and in academic majors that had heavy concentrations of white males. In response, Kresge leadership implemented a series of initiatives including blind resume reviews and broadening their recruiting network through partnerships with several nonprofits that serve more diverse populations. Those organizations included Modern Guild, a recruiting platform that broadly sources collegiate talent, the Toigo Foundation, Girls Who Invest, and John W. Rogers Fellows.

Kresge continued broadening its pipeline of diverse talent via local college partnerships. In September 2015, Kresge established a $2 million student-managed investment fund at Oakland University (Manilla's alma mater) which complemented a new course designed to teach the essentials of portfolio management, stock selection and portfolio evaluation. Kresge then replicated this initiative in April 2018 at Wayne State University. While the original purpose of these programs was to raise awareness of careers in finance, according to Manilla, the partnerships also "blossomed into important sources of diverse talent" for the metro Detroit market.

Within the broader foundation, foundation staff developed the Kresge Operationalizing Racial Equity (KORE) initiative in 2017. KORE, a cross-departmental initiative with executive sponsorship from Manilla, started as a 14-person DEI task force with a goal of developing the skills, comfort and competency of Kresge employees to have better discussions about racial equity. At the time, the investment team was approximately 71% male / 29% female and 93% white / 7% people of color. As a result of its intentionality around recruiting and team composition, in 2022 Kresge's investment team was 46% male / 54% female and 69% white / 31% people of color.

Kresge's Investment Office annually hosts high school students from the Detroit-based summer financial literacy camp, Money Matters for Youth, for an Investments 101 session.

Portfolio

Given the hundreds of U.S. foundations with over $1 billion in assets, it is important to understand where Kresge landed within the LP landscape as it related to promoting diverse ownership of asset management firms. Since 2017, the John S. & James L. Knight Foundation published several reports about the state of diversity across the asset management industry. The 2021 iteration, Knight Diversity Of Asset Managers Research Series: Philanthropy ("KDAMP"), assessed the representation of diverse-owned firms in the investment portfolios of 30 of the country's top 55 charitable foundations.

According to the 2021 report, the average foundation (as measured using a simple average) invested 16.3% of its assets in diverse-owned firms while the median value landed at approximately 16.0%. When benchmarked against the 30 participating foundations, The Kresge Foundation ranked 13th, having invested 20% of analyzed AUM, or $360 million with diverse-owned firms.

In 2018, The Kresge Foundation began to independently evaluate its level of investment in diverse-owned firms. It quickly identified a structural barrier that existed within its manager sourcing process. Many of the new partners Kresge had invested with over the preceding five years were initiated from current partnerships or internal networks, both of which Manilla described as predominantly old, white and male. The foundation took action in 2019 and announced its 25% by '25 initiative, which aimed to direct 25% of the foundation's U.S. investable assets to diverse-owned firms by 2025. The initiative formalized Kresge's belief in improving investment performance by allocating to diverse fund managers. Additionally, it signaled to other capital allocators that transparency in investment practices was an industry imperative. The Foundation's philosophy of continuous learning means that the initiative will evolve as Kresge gains a deeper perspective on the nuances of successfully allocating to diverse-owned managers.

For its measurement, The Kresge Foundation defines diverse-owned firms as those whose ownership group is at least 50% racially diverse and/or 50% female. There is active debate within the industry about how to define ownership - be it through equity stake or representation among key decision makers - and whether these definitions have unintended consequences. Kresge acknowledges the complexity of the issue and is willing to re-evaluate its thinking as the industry evolves and its own three-pronged approach matures.

When partnering with managers, Kresge employed a thorough, rigorous process that was largely consistent, regardless of manager background. Kresge focused on identifying six key attributes with prospective managers: i) partnership mentality; ii) performance-orientation; iii) mission-alignment; iv) a definable, repeatable competitive advantage; v) a rigorous risk management framework; and vi) fit between a manager's target fund raise and the investment strategy they are pursuing. While many capital allocators remain reticent about investing in first-time funds, which tend to be more diverse than longer-tenured firms, Kresge welcomed the risk/reward opportunity. "While many perceive first-time funds to have more operational risk, we do not believe that is always the case," Barker said.

Leadership recognized that their support of diverse managers post-investment could be influential. Kresge staff typically placed several calls to peer allocators to support their diverse managers' fundraising efforts. Kresge's approach to this type of portfolio construction and the resulting investment performance served as a model to other institutions who sought to establish Emerging Manager programs.

MLT Perspective

MLT's viewpoint, informed by its research and discussions with both allocators and managers, is that specific diversity goals must be established to ensure progress. MLT believes that setting broad diversity goals can be a helpful first step but often results in unintended consequences.

MLT has found that organizations that do not focus specifically on Black, Hispanic and Native American representation – the groups that are most marginalized and typically most underrepresented in the alternative investments industry – often increase diversity broadly, but fail to move the needle on representation of these specific race and ethnicity groups.

In MLT's experience, many of these organizations find themselves with unbalanced outcomes several years into their diversity initiatives causing them to implement more specific efforts focused on Black, Hispanic and Native American representation.

Pulpit

Kresge's aforementioned operational changes centered on the well-researched theory about the quality of decisions made by diverse teams. That research, attributed to Professor Scott E. Page at the University of Michigan[1], concluded that diverse teams make better decisions and therefore produce better financial returns.

While the process of defining Kresge's approach to generating alpha via diverse managers was initiated at the senior level, it was refined and implemented collaboratively throughout the foundation. Board member Paula Pretlow, an African American finance executive who was appointed to Kresge's board in 2015, noted that comprehensive datasets and honest conversations solidified the investment committee's "buy-in" to the strategy from the outset, and that Kresge's commitment to metrics and transparency have been important factors in the foundation's success.

In 2020, Kresge and the John D. and Catherine T. MacArthur Foundation ("MacArthur") came together to espouse the need for investment transparency and a more diverse, equitable, and inclusive asset management industry. Kresge and MacArthur joined in partnership with Lenox Park Solutions, a financial technology company, to conduct a survey to understand the racial and gender composition of the U.S. asset management firms that are entrusted with investing a combined $10.8 billion on their behalf. Aside from gaining a greater understanding of their asset managers' demographic makeup, the goal was that the data would begin to inform conversations and promote transparency from other comparable capital allocators and among their portfolio of asset managers. MLT's research and discussions with both institutional allocators and general partners found transparency, intentionality and data integrity to be key actions attributed to advancing racial equality in the investment industry.

Conclusion / Future Challenges & Opportunities

Kresge acknowledged the work that still exists and identified several obstacles and concerns that remain top of mind.

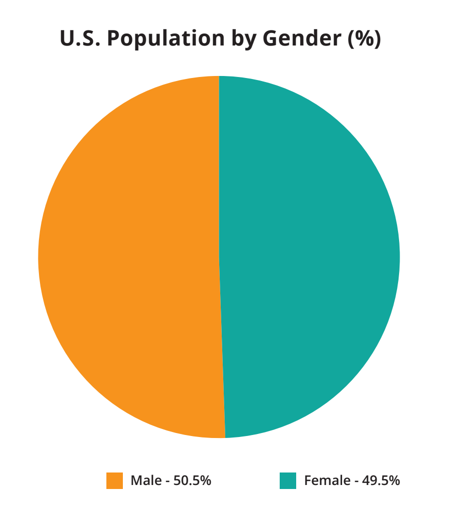
The first is sourcing. Many of the new diverse managers seen by Kresge are launching in the venture capital space, an overallocated asset class for the foundation. The institutional investor community should continue to support first-time, diverse managers that are executing private equity, real estate, or hedge fund strategies. This would benefit Kresge's goal of greater racial proportionality. As an institutional investor, Kresge is committed to surfacing the existing supply of diverse managers and to support the pipeline development of new potential diverse managers. There are structural challenges that exacerbate the lack of diverse managers in the private equity, real estate and hedge fund space. For example, the industry's reliance on investing in spin-out teams with auditable

1 Long, Hu and Page, Scott. Groups of diverse problem solvers can outperform groups of high-ability problem solvers. PNAS November 16, 2004, vol. 101, no. 46.

track records from large private equity managers who are themselves not diverse, presents a substantial challenge. Additional structural challenges are the increased operating costs and larger fund size requirements new fund managers face when pursuing later stage investment strategies. The increased capital requirement hurdles are more acutely borne by diverse managers as they may lack both the level of social capital and financial capital to execute these investment strategies.

The second is performance. A persistent, discriminatory practice in the industry has been to overly and unfairly scrutinize the returns of diverse managers. According to Barker, "Studies have shown that diverse-owned firms are held to a different standard when it comes to periods of underperformance – they're simply given less time to prove themselves." For instance, diverse managers, both in the diligence phase and the post-investment/portfolio phase, often have a shorter runway than their white-male led peer firms to recover from a temporary down quarter or an underlying portfolio company that has missed a single monthly growth target.

Acknowledging this, Kresge's approach is to hold all its managers to the same performance standards. Barker was steadfast and optimistic in Kresge's strategy: **Diverse managers are the key to untapped alpha.** "I'm fully confident that our performance will be improved over the next 10 years because of the diverse-owned firms we've identified and partnered with since launching 25% by '25. And I'm also confident that our entire industry will benefit as others come to similar conclusions and fully embrace greater diversity within their teams and investment partners."



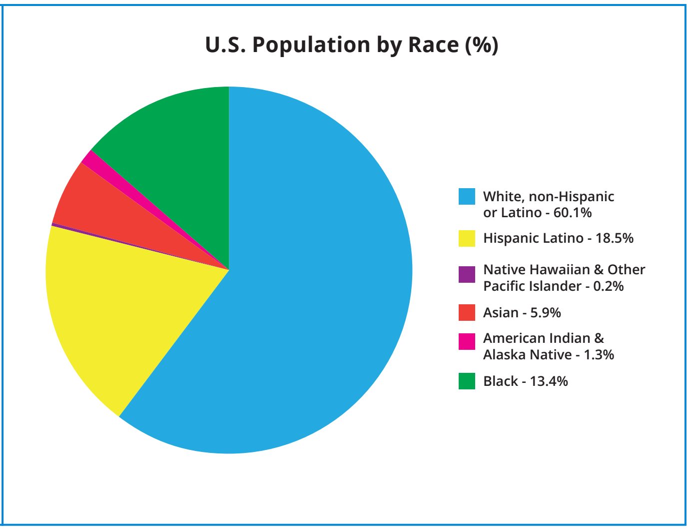


Exhibit 1: *Breakdown of U.S. population by Gender and Race*
United States Census Bureau: ***https://www.census.gov/quickfacts/fact/table/US/PST045221***

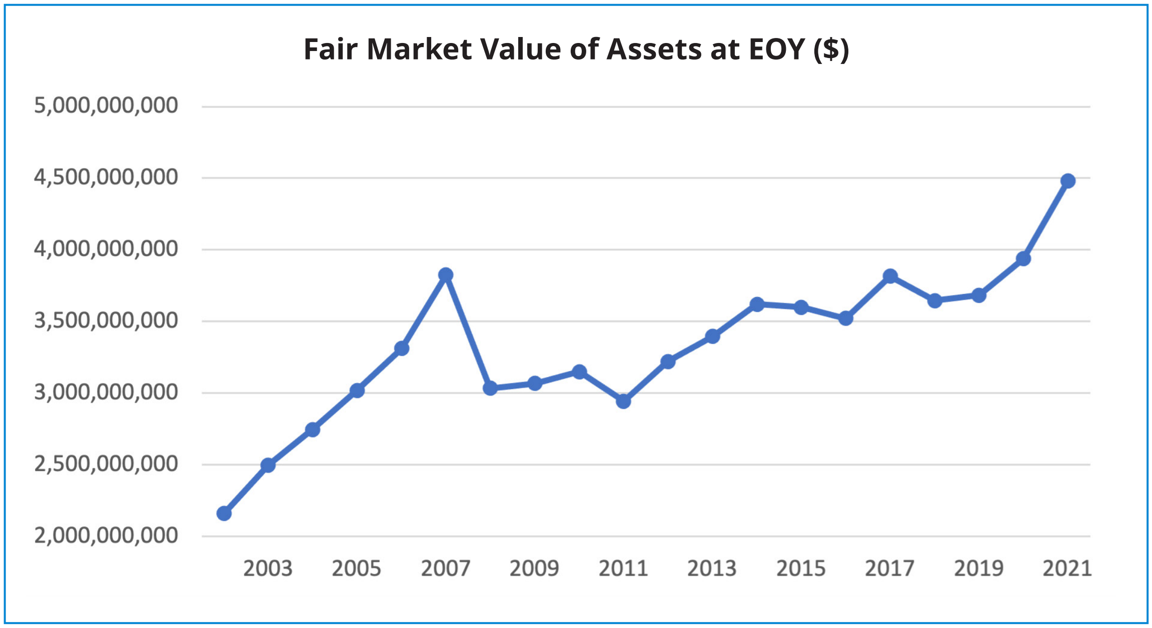


Exhibit 2: *Fair market value of Kresge's assets under management per Part II, Line 16 of Kresge's Form 990, and estimated 2021 endowment Source:* ***https://regeneration.kresge.org/2021-financials***