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INVESTMENT MANAGEMENT

Key Practices Can Provide More Opportunities for Minority- and Women-Owned Asset Managers

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Financial Markets and Community Investment

Accessible Version

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GAOHighlights

Highlights of GAO-22-105588, a testimony before the Subcommittee on Diversity and Inclusion, Committee on Financial Services, House of Representatives

Why GAO Did This Study

Asset management firms manage trillions of dollars in the U.S. for a variety of clients, including institutional investors. Federal entities also use asset managers. But MWO asset managers face challenges when competing for investment management opportunities. For example, institutional investors often prefer to contract with large asset managers with brand recognition and with whom they are familiar.

This statement discusses (1) key practices institutional investors can use to increase opportunities for MWO asset managers and (2) how selected federal entities have used these practices.

This statement is based on a 2017 GAO report (GAO-17-726) and also describes actions taken to implement the report's recommendations.

For the 2017 report, GAO identified key practices by examining practices nonfederal retirement plans and foundations used, reviewing industry reports, and validating the practices with input from 10 industry stakeholders and experts. GAO also reviewed investment policies of eight entities that manage or sponsor federal retirement plans, an endowment, and an insurance program.

View GAO-22-105588. For more information, contact Michael E. Clements at (202) 512-8678 or clementsm@gao.gov.

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What GAO Found

GAO identified four key practices institutional investors, such as retirement plans, can use to increase opportunities for minority- and women-owned (MWO) asset managers. These practices are consistent with federal interests in increasing opportunities for MWO businesses.

- **Top leadership commitment**. Demonstrate commitment to increasing opportunities for MWO asset managers.
- **Remove potential barriers.** Review investment policies and practices to remove barriers that limit the participation of smaller, newer firms.
- **Outreach.** Conduct outreach to inform MWO asset managers about investment opportunities and selection processes.
- **Communicate priorities and expectations.** Explicitly communicate priorities and expectations about inclusive practices to investment staff and consultants and ensure those expectations are met.

The key practices are closely related; improvements or shortfalls in one may contribute to improvements or shortfalls in another. The practices do not require investors to develop targets or allocations for MWO asset management firms or change performance standards.

In 2017, the federal entities (retirement plans, an endowment, and an insurance program) GAO reviewed varied in their use of the practices. GAO recommended that four entities that made partial or no use of the practices take steps to more fully apply them. Since 2017, the four entities have addressed these recommendations by taking actions to implement key practices in their asset manager selection processes. Specifically,

- The Navy Exchange and Command Service and the Army and Air Force Exchange Service issued letters asking their retirement plan consultants to include MWO firms in their databases and when searching for investment managers.
- The Tennessee Valley Authority Retirement System documented its commitment to equal opportunity for MWO firms in its service provider evaluation policy.
- The Federal Retirement Thrift Investment Board awarded a new contract in which Thrift Savings Plan participants will have access to a mutual fund window with over 5,000 mutual funds. A tool will allow participants to screen for funds managed by MWO firms.

Implementing the key practices allows institutional investors to widen candidate pools in their asset manager searches and help ensure they find the most qualified firms meeting their needs. The practices also could eliminate some of the barriers MWO firms face and increase opportunities for these firms.

Chairwoman Beatty, Ranking Member Wagner, and Members of the Subcommittee:

Thank you for the opportunity to testify today about our prior work on asset management firms owned by minorities or women (MWO asset managers). Asset management firms registered in the United States manage trillions of dollars, but MWO firms manage very few of these assets.[1]

MWO firms face challenges when competing for investment management opportunities with institutional investors, including investor and consultant brand bias (for larger asset managers with brand recognition) and the perception that MWO firms do not perform as well as non-MWO firms. The size and limited infrastructure of smaller, newer MWO asset managers also may pose challenges. For example, such firms may be unable to meet threshold requirements set by institutional investors, such as minimum limits established for assets under management, liability insurance, and length of track record. As we reported in 2017, the federal government has an interest in helping address these barriers and increase opportunities for minority- and women-owned firms, including MWO asset managers.

My testimony today is based on our September 2017 report on MWO asset managers. Specifically, I will discuss (1) four key practices we identified that institutional investors can use to increase opportunities for MWO asset managers and (2) the use of these practices by federal retirement plans and other entities we reviewed.

For our September 2017 report, we reviewed federal retirement plans, an endowment, and an insurance program administered or overseen by eight entities: Army and Air Force Exchange Service, Federal Reserve System, Federal Retirement Thrift Investment Board, Railroad Retirement

[1]More specifically, we reported these firms managed more than $70 trillion as of May 2017 and that MWO asset managers or firms managed less than 1 percent of these assets. See GAO, *Investment Management: Key Practices Can Provide More Opportunities for Minority- and Women-Owned Asset Managers,* GAO-17-726 (Washington, D.C.: Sept.13, 2017).

Board, Smithsonian Institution, Pension Benefit Guaranty Corporation, Navy Exchange Service Command, and Tennessee Valley Authority.[2]

To determine how the entities identified and selected asset managers and their efforts to include MWO firms, we analyzed investment policies; documentation on selection processes and criteria; and documentation on programs, policies, or initiatives related to MWO asset managers. We interviewed representatives from the entities to learn more about selection processes and efforts related to MWO asset managers.

We assessed the extent to which the entities used key practices to increase opportunities for MWO firms. We identified key practices by examining practices used by selected nonfederal plans and foundations and by reviewing industry reports. We then validated the practices by obtaining input from 10 industry stakeholders and experts, selected based on factors such as depth of experience working with MWO firms and published research.

The work on which this statement is based was performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The eight entities we reviewed administered or oversaw defined benefit retirement plans, defined contribution plans, an endowment, and an

[2]A separate, nonfederal entity, the National Railroad Retirement Investment Trust, manages retirement assets for the Railroad Retirement Board. But the Trust is not a department, agency, or instrumentality of the federal government, and is not subject to title 31 of the U.S. Code, which governs the financial operations of the federal government and establishes the powers and duties of the U.S. Government Accountability Office. *See* 45 U.S.C. § 231n(j)(2). The inclusion of the Trust in our 2017 report was limited to describing its asset allocations, use of MWO firms, and asset manager selection process. Additionally, a federal entity, the Tennessee Valley Authority Retirement System, manages retirement assets for the Tennessee Valley Authority. In our 2017 report, we referred to the System when describing the Tennessee Valley Authority's externally managed retirement assets.

insurance program (see table 1).[3] To make investments, the defined benefit plans, endowment, and insurance program generally retained external asset managers to select individual investments in accordance with the asset allocation frameworks in their investment policy statements. The defined contribution plans generally retained external asset managers to provide plan participants with investment options. Asset management firms typically select investments on behalf of the investors that hired them and regularly report on investment performance.

Table 1: Overview of Eight Entities GAO Reviewed

Entity	Description
Federal Retirement Thrift Investment Board	Administers the Thrift Savings Plan, a defined contribution plan for federal employees and members of the uniformed services, including the Ready Reserves.
National Railroad Retirement Investment Trust	Responsible for investing assets that fund railroad retirement benefits, some of which are similar to a private sector defined benefit plan.
Federal Reserve System	Administers a defined benefit plan for eligible employees of the Federal Reserve Banks, the Board of Governors and Office of Employee Benefits of the Federal Reserve System, and the Consumer Financial Protection Bureau. Also administers a defined contribution plan for employees of the Federal Reserve System.
Tennessee Valley Authority Retirement System	Administers a defined benefit plan covering most full-time and part-time annual employees of the Tennessee Valley Authority. Also administers a defined contribution plan for members of the Tennessee Valley Authority Retirement System.
Army and Air Force Exchange Service	Administers a defined benefit plan covering regular full-time civilian employees who are citizens or residents of the United States.
Navy Exchange Service Command	Administers a multiemployer defined benefit pension plan covering substantially all civilian employees of the Navy Exchange Service Command and the U.S. Coast Guard Community Services Command.
Smithsonian Institution	Manages an endowment consisting of approximately 600 individual funds established for a variety of purposes.
Pension Benefit Guaranty Corporation	Manages an insurance program to protect pension benefits in private sector defined benefit plans.

Source: GAO analysis of information from eight entities. | GAO-22-105588

The entities we reviewed are fiduciaries that have responsibilities similar to those of private-sector retirement plans. That is, they are required to act solely in the interest of participants and beneficiaries in the plans. These responsibilities may include acting with the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of plan administration; carrying out their duties

[3]Generally, defined benefit plans provide participants a retirement benefit amount using a formula based on factors such as years of employment, age at retirement, and salary level. Defined contribution plans are those in which employees and employers contribute to an account directed by the employee into investment options offered by the plan.

prudently; following the plan documents; and diversifying plan investments.

Key Practices Can Be Used to Increase Opportunities for MWO Asset Managers

In our prior work, we identified four key practices that can be used as part of investors' selection processes for asset managers to help ensure that qualified MWO firms are considered (see table 2). The key practices are closely related; improvements or shortfalls in one may contribute to improvements or shortfalls in another. The practices do not require investors to develop targets or allocations for MWO asset management firms or change performance standards.

Table 2: Key Practices for Increasing Opportunities for Minority- and Women-Owned (MWO) Asset Managers

Key practice	Definition/Description	Examples of how practice can be implemented
Top leadership commitment	Demonstrate commitment to increasing opportunities for MWO asset management firms	• Document commitment to asset management diversity in investment policies
Remove potential barriers	Review investment policies and practices to remove barriers that limit the participation of smaller, newer firms	• Adjust thresholds for assets under management, insurance, and length of track records to ensure that requirements are proportional to size of firm • Develop emerging manager programs—generally geared towards newer, smaller firms—or similar initiatives that may increase opportunities for MWO firms
Outreach	Conduct outreach to inform MWO asset managers about investment opportunities and the selection process	• Meet with industry associations and participate in networking events with MWO asset managers • Invite MWO asset managers to make marketing presentations directly • Publicize asset management opportunities through avenues such as trade associations, databases, or a central website

Key practice	Definition/Description	Examples of how practice can be implemented
Communicate priorities and expectations	Explicitly communicate priorities and expectations about inclusive asset management practices to investment staff and consultants and ensure those expectations are met	• Communicate expectations to staff and consultants for including MWO asset managers in asset manager searches • Ask investment consultants to develop an inclusive process for sourcing, evaluating, and recommending investment managers and ensure accountability by asking consultants to report on the number of diverse managers evaluated • Require that at least one qualified MWO asset manager be invited to present to the investor's decision-making body

Source: GAO analysis of information from selected state, local, and private retirement plans and foundations and industry reports. | GAO-22-105588

Our prior work also identified examples of how some institutional investors implemented the key practices, which might provide insights to other investors undertaking or attempting to improve their own initiatives related to MWO firms. The examples are not exhaustive, and each institutional investor may implement the identified practices in its own way.

As we previously reported, many nonfederal plans and foundations implemented these practices and told us that using the practices did not conflict with their fiduciary responsibilities. They said the MWO firms they used were selected based on track record and could provide certain benefits in generating profit for their clients. The plan representatives and other industry stakeholders also told us that diversifying plan investments to manage risk could be accomplished through diversification of asset managers. Industry reports and industry stakeholders, including plan representatives, further noted that implementing a more inclusive selection process for asset managers could widen candidate pools, which can help ensure retirement plans and foundations identify the best asset managers.

Updates on Actions Federal Entities Have Taken to Increase Opportunities for MWO Asset Managers

Since our 2017 report, four entities we reviewed have more fully implemented the key practices we identified to increase opportunities for MWO asset managers. In that report, we found three of the entities we reviewed (Federal Reserve System, Smithsonian Institution, and Pension Benefit Guaranty Corporation) used all the key practices. The other four—

Army and Air Force Exchange Service, Navy Exchange Service Command, Tennessee Valley Authority Retirement System, and Federal Retirement Thrift Investment Board—made partial or no use of the key practices.

For example, the Army and Air Force Exchange Service conducted outreach to MWO asset managers and communicated to its consultant to include the firms in searches, but had not completed actions related to top leadership commitment and removing potential barriers. The Navy Exchange Service Command and Tennessee Valley Authority Retirement System removed potential barriers to MWO asset manager participation (minimum size or track record requirements). But they had not used the other three practices (top leadership commitment, outreach, and communication priorities and expectations). The Federal Retirement Thrift Investment Board had not used any of the practices. Accordingly, in our 2017 report, we recommended these entities fully implement the key practices.

Since we issued our report, the four entities have addressed our recommendations by taking actions to implement key practices as part of their selection processes. Specifically,

- In September and October 2017, respectively, trustees for the Navy Exchange and Command Service and for the Army and Air Force Exchange Service issued letters to their retirement plan consultants asking them to include MWO firms in their databases and when searching for investment managers for the plans.
- In December 2017, the Tennessee Valley Authority Retirement System amended its service provider evaluation policy to document its commitment to equal opportunity for MWO firms. System representatives told us their consultant conducted outreach to MWO firms and has worked with them to develop a process for providing them with information on potential MWO asset managers.
- In November 2020, the Federal Retirement Thrift Investment Board awarded a new contract that includes providing Thrift Savings Plan participants access to a mutual fund window with over 5,000 mutual funds. A screener tool will allow participants to screen for different funds, including funds managed by MWO firms, to the extent that such data are publicly available.

Addressing the barriers that prevent MWO asset managers from accessing investment management opportunities continues to be important today. By implementing the key practices, institutional investors could widen the pool of potential candidates in their asset manager searches and help ensure that they are finding the most qualified firms that meet their investment needs. Furthermore, the practices could eliminate or mitigate some of the barriers MWO firms face and increase opportunities for these firms.

Chairwoman Beatty, Ranking Member Wagner, and Members of the Subcommittee, this concludes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

GAO Contact and Staff Acknowledgements

If you or your staff have any questions about this testimony, please contact Michael E. Clements, Director, Financial Markets and Community Investment at (202) 512-8678 or clementsm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony are Kay Kuhlman (Assistant Director), Erika Navarro (Analyst in Charge), Rachel DeMarcus, and Barbara Roesmann.

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