Theory Meet Practice | Caroline Flammer

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Welcome to Theory Meet Practice, our video series about academic research into sustainable finance and the lessons investors can take from it. I'm Uma Reshwak, Research Director at the MSCI Sustainability Institute. How can companies and investors help to tackle society's biggest challenges like climate change and inequality? That question runs through the scholarship of Carolyn Flemmer, the Barton Hepburn Professor of Economics at Columbia University.

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She serves as the Vice Dean for Research and Faculty Affairs at Columbia School of International and Public Affairs. She is also a research associate at the National Bureau of Economic Research, a research fellow at the Center for Economic Policy Research, and a research member at the European Corporate Governance Institute. She has received numerous honors and awards for her work, including being named among the top 100 highly-cited researchers in economics and business over the last decade by the Web of Science.

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and twice being named Dean's Research Scholar at Boston University's Weistrom School of Business, where she taught before coming to Columbia University. I'm thrilled to be in conversation with Professor Carolyn Flammer today. Welcome, Carolyn. Great to see you again. Great seeing you too. Thanks so much for the invitation. A key contribution of your study is the definition and measurement of diversity, equity and inclusion. You provide a more holistic definition that goes beyond mere demographic diversity.

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Can you elaborate on this point and share why taking a more holistic approach is important?DEI clearly is a first order importance for many companies, investors, policymakers and citizens. But the key question is, what actually is DEI? Typically, the way we think about it is diversity, equity and inclusion. So let's try to unpack this at first, correct? So diversity, this is about...

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bringing a range of perspectives and backgrounds into an organization. This includes gender, it includes race, ethnicity, age, disability, religion, marital status, sexual orientation, experience, education, political views. I could go on. Then equity, which is about providing fair access, opportunities, rewards and resources to all. And lastly, inclusion is about ensuring that people of all backgrounds are respected, made feel comfortable and that.

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employees feel encouraged to actually contribute, to speak up, to express their opinions, their thoughts and be themselves without pressure to conform. Now, if you think about how do we typically measure DEI, that paints a totally different picture because very often when we look at

how we measure DEI is really we focus on demographic diversity only and most often we only consider. Among all these factors I mentioned before, very often we just consider

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gender and race. And so arguably, if we talk about DI, and we think about DI and how to implement it in organizations, we should really look at it as much more holistically than just gender or just race and really think about, so how can we really ensure diversity, equity and inclusiveness? Thanks. And much of the academic and practitioner research study, demographic diversity and its implications for the firms.

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financial performance. And in your research, you mentioned that demographic diversity alone doesn't explain the positive performance associated with diversity and inclusion. And as a follow up to my previous question, could you elaborate on what aspects your diversity score captures beyond simple demographic representation? How does a strong DEI culture foster these additional dimensions? So let me start again with kind of demographic diversity that we

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Many companies have been practicing it, correct, but also academic research. So I would say probably quotas, quotas of women, quotas of minorities, quotas of XYZ. That's a very typical measure, how we look at DI. But quotas, I mean, by all means, this is very important, but unlikely sufficient. Because if you think about it, a quota gives you a seat at the table, but it's not going to give you the voice.

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Another example is awareness days. Many companies have awareness days. Now we have 365 days in a year of last time I checked. Typically, if you just have one day devoted to be aware of something, I mean, one day is better than nothing, but do we really think that one day alone is going to trigger some substantial changes in an organizational cultural organizational performance if the whole rest of the year, we are negligent of whatever we pay attention to.

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that one day. And the question is, how can we not only consider more demographic diversity and actually cognitive diversity to bring that into a company, but also how can we make sure that fair access opportunities and rewards and resources to all are ensured and that to ensure that all people feel included, that we listen to the voice, we not only give them voice but also we listen to their voices, respect their opinion.

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and so that they can bring themselves into the company. Digging deeper into your research, so you find that companies with strong diversity and inclusion practices, using your more holistic definition of diversity, tend to perform better financially in the long run. They make more money than expected, which means that they have positive earnings surprises, they have higher

valuation ratios, they perform better than peers on a number of financial metrics and are more innovative.

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Interestingly, and something I also found quite surprising, your research finds no link between demographic diversity and financial performance. This is in contrast to previous practitioner studies that have been highly cited in the popular press and claim that there is a business case for demographic diversity. Can you discuss the possible reasons for these seemingly opposing results compared to existing studies? Thanks for the question. Some of the studies out there, including the McKinsey study that we're sure to, they are just fundamentally flawed.

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So for example, in that specific study, they regressed DI on past financial performance, which would rather point to an opposite story, Craig. If you actually look at academic studies that look at also in this case, as the McKinsey study, they look at demographic diversity, most of them look at just gender, nothing else. So if you look at the academic work out there, they find no positive correlation between demographic diversity and financial performance. So this is consistent with our findings in our study.

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where our study differs from existing academic work, and what I think is an important difference in contribution is that if you actually move beyond just demographic diversity and instead consider this more holistic definition of DEI, meaning diversity, equity, and inclusiveness, we find that indeed there is a positive correlation between diverse equity inclusion practices and future financial performance, suggesting that the...

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engaging in these more holistic inclusion practices could be value enhancing for companies. Thank you for that. In MSCI's most recent Women on Boards report, we found that boards in general were more diverse than executive suites, board in terms of gender and ethnicity. We found that women held 26% of board seats at large and mid-cap companies, which is up from the 25% in 2022, but growth has slowed compared to previous years.

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Data on the percentage of women among executive management and senior management teams is not yet as widely available as board data. As of October 2023, only 15% of the constituents of the MSCI All Country World Index had disclosed the gender composition of their senior management teams. Based on that 15% number, we found that 30% of companies had no women in their executive or senior management teams. How do you explain this discrepancy?

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in the percentage of women on the board versus in top management? Well, there could be many reasons, multiple reasons out there, but I would say one potential reason might be

explained by the fact that it's much easier to appoint a board member and basically check the box as opposed to hire and promote talented employees from within, especially if there is a pipeline issue. So in a sense of this, again, highlights the importance of really improving our

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processes in ensuring diversity and equity and inclusiveness. And we need to start early with this. So it's not just sufficient to look at the top management, like the, you know, near top and then, oh, who can we promote? But rather most likely, we actually need to start much earlier, for example, at primary school to ensure that as we move up the ranks within a company,

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that we can draw on a diverse pool of candidates and promote more women and other unrepresented groups to the top management. So I think it's a severe pipeline problem. If we just think about quotas, it could mean that you poach a very talented woman from a competing company. So it's a win for your own company. It does not mean that you solve social inequality issues.

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Because in a broader system, nothing has changed. It's because just one woman who benefited from moving from one top company to the other, but it does not mean greater accessibility, greater social mobility, greater equality. Really good point. I'm wondering if you can tell us why systems level thinking matters there. What exactly is systems level thinking? Good question. And let me maybe, you know, go back to what we discussed earlier and try to also link the study that we discussed with this topic.

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So I mentioned the example about if you just focus on quotas, for example, it does not mean that we really tackled one of the grand societal challenges that we are facing and that is the mitigation of social inequality. You can make a similar example with climate and investing. Let me start with disclosure. So as you know, the SEC has been considering to mandate the disclosure of scope one, maybe scope two.

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Now, if we were to mandate anything, going back to greater disclosure, it would likely be a major progress in this world, because in most countries around the world, there's no mandatory disclosure at all in terms of non-financial information. Having said this, if we only were to mandate Scope 1 disclosure, while this is an improvement compared to the status quo, it's unlikely sufficient, because all it might lead to is an outsourcing of the most...

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emission intensive operations of a company to a supplier, so scope 1 becomes scope 3. So on file, the way we currently assess the environment performance of companies and what they would need to disclose, it looks like they clean up their act. Take hatching climate risks. There are some studies out there as well saying, you know, I'm exaggerating here a little bit, but don't

worry about climate change. You can just hatch away the risk. Can you really hatch climate risks? Unlikely.

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What you can do, and this is what basically the authors mean, is you can hedge the portfolio's risks against climate news in the short term. But that does not take into account the long-term implications of our investments on climate change, nor does it take into account the increasing risks and costs of climate change on your portfolio's financial performance in the long term. The underlying assumption of the most important theory that we use in academia and practice is that systemic risks are exogenous.

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So we just assume away any relationship between our investments and climate and vice versa. Another example is think about companies practices. Let's go back to DEI. The way we currently assess the social performance of companies, both as corporate disclosure, but also the investors assessing the companies is we, for example, ask how many women and minorities do you have on the board and in top management? Not criticizing these measures.

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they are unlikely sufficient. What could be also happening is that the company has quite a few minorities and women on the board in top management, but behind the scene, the company is gonna lobby against women's rights, abortion rights, human rights, LGBT degree rights, et cetera, at the federal level. So the way we currently assess the social performance of companies, for example, there was the equity inclusion.

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is only capturing a fraction of all the activities that companies actually engage in that potentially change the broader social system. That's why I'm saying we need to move away from just portfolio level and form level thinking and really take into consideration what are the implications for the broader planetary and societal system and vice versa. If we don't take care of our implications on society and the planet.

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How do these increasing risks and costs impact our business? And so this is very often missing at the moment, even those that engage in ESG and sustainable finance practices. That's a good way to weave what you were discussing with systems thinking. So one of the key aims of the global climate negotiations led for COP29 conference later this year will be to mobilize private capital to advance the climate transition, particularly in developing countries.

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Thomas Geerocks and Jeffrey Heal have examined so-called blended finance, the use of public or philanthropic funds to crowd in private capital. Relatedly, you have launched the Sustainable Investing Research Initiative at Columbia University that aims to foster systems-level investing

through research, teaching and dialogue. Its main focus areas are the development of better measurements to allow us to track progress towards the mitigation of systems-level challenges.

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and the adoption of a systems-focused approach and blended finance. This is an incredibly ambitious goal, a target, and can you tell us a little bit more about this initiative and especially about your efforts around blended finance? Happy to do so. And I think we talked already a lot about the need to move towards a more system-focused approach, towards a more holistic approach. We also touched on kind of disclosure and there's improvement needed in terms

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type of measures we have at this moment, the measures that exist very often, they would not allow us to really help us track progress towards mitigation of the system level changes we are facing, be it climate change, biodiversity loss, social inequality, poverty, et cetera. So these are two of the focus areas. And the third one is about planet finance. If you take a step back and think about...

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How has the mitigation of climate change by the world's laws, social inequality, poverty, et cetera, been funded? Traditionally, it has been funded through development funding and philanthropic funding. But there's an enormous financing gap that we are facing to mitigate those issues. And that financing gap is especially severe in the global south, where we need the capital the most. And so a key question then becomes is how can we crowd in more private capital to close this financing gap?

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finance innovative solutions in renewable energy, climate tech, nature-based solutions, social innovation, etc. And this is where blending comes in. So philanthropic funding as well as development funding, concessional funding can help subsidize and help de-risk private capital investments and therefore help improve the risk return profile of these investments. And this is how it

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then becomes attractive for other investors, for private investors to come in. We need much more, a much better understanding. For example, how do you create these public-private philanthropic partnerships? What is the ideal risk allocation across these funds? What is the role of rating agencies, data providers? Like what are the effective practices on the land and how can we actually help develop and scale up the global market place for blended finance in order to serve as a catalyst to

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crowd in more private capital and close this financing gap. And so this is where we engage in multiple discussions, conferences, but also research and education. I'd like to wrap up with a question that we've asked all of our guests. If you were stranded on a desert island and you

could only have one academic paper on sustainable finance, just one, can't be your own. And it has to be one that's close to your heart and one that you would recommend and want to read over and over. So which one?

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Would you? So if you know me even just a tiny little bit, you know my incentive is to stay on that island for a longer period of time. So one paper is not going to cut it. Okay. So I would like to take a book, another paper and ideally two books. And I think the two ones I would recommend is the 21st century investing, redirecting financial strategies to drive systems change by William Burr-Court and Steve Leidenberg.

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And the second book I would take with me is Moving Beyond Modern Portfolio Theory, Investing That Matters. This is by John Lukumnik and Jim Hawley. Thank you so much, Carolyn, for joining us. This was an incredibly enriching discussion for us, and I'm sure it's going to be resonating with not just the investors, but also society at large, systems thinking, the role of the cognitive diversity in not just the boardroom, but also senior managements. That those are things that

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I often think about and it's great to learn from a practitioner and an academic. Well, thank you so much for the invitation. A pleasure was all mine. Looking forward to seeing you again.