Diversity and Firm Performance: A Comprehensive Study!

Introduction

Diversity for the longest part of human history has not only been a tricky issue to solve, but also one that's been thorny. In ways, it's been so tricky because of how thorny it is. So, the recent consensus around the benefits of diversity has been a breath of fresh air. The benefits of diversity predominantly revolve around a couple of major points:

- Diversity fosters creativity and innovation by considering a great variety of perspectives.
- Diverse firms are likely to be more informative, bringing about a diverse range of information, and hence make better decisions.
- Diverse firms, that better represent their customers also better understand their needs.

While the previous points make perfectly reasonable sense, the general discussion around diversity is limited along, race and gender. The discussion though misses a few additional tenets that though present through certain race characteristics ought to be part of the bigger discussion. Tenets such as socio-economic status, geographical diversity and perspectives. The neighborhood effect which is an economic and social science concept that posits that neighborhoods have either a direct or indirect **effect** on individual behaviors is strikingly missing from most studies when it comes to research on Diversity. The neighborhood effect is even more interesting because it has a direct causal relationship with the exposure effect that takes into account the strong positive association with future successes that early exposure has for example on innovation and diversity. Hence, this is an attempt to extrapolate some of the hidden tenets surrounding research on diversity and present my own findings on the value add of it on firm performance.

Prior Research

Given the extensive research that surrounds diversity in developed countries, this paper is going to focus on diversity research that surrounds developing countries. The paper primarily focuses on the work of Aggarwal et al, Board level diversity and its effect on firm performance, board diversity in emerging markets (Ararat et al, 2015), and Board diversity and firm financial performance (Darmadi, Salim 2010). Aggarwal focuses its findings on India which presents a fascinating case simply because of how diverse a country like India truly is. Diversity in India revolves not only around, race and gender, but also, religion, caste/socio-economic status, language, geographical diversity, etc. India truly reflects a basket case that’s perfect for a research such as this. Ararat focuses its work on Turkey which is interesting because Turkey had high structural homogeneity in its boards until recently and is a high collectivist society. The third paper (Darmadi 2005) focuses on Indonesia for some of the same reasons; Indonesia like India and Turkey, is a high collectivist society and has a greater number of family-controlled firms. But unlike other developing countries Indonesia by law is required to have a two-tiered board structure comprising of Board of Management (BOM) that handle day to day operations and a Board of Commissioners (BOC) that the BOM reports to. It’s an important distinction that has a profound impact on the different degrees of diversity.

Results

The papers when focusing on board level diversity tries to make a distinction between a board that has primarily monitoring duties and a board that has resource driven/advisory capabilities. The paper also distinguishes between boards of standalone firms, and of firms that are family/business group affiliated, thus testing their status as an independent or non-independent board member. Distinctions that come in handy while evaluating the extent of diversity within boards. Firm level performance on the other hand is separated by general firm level performance such as Return on Assets (ROA), Return on Equity (ROE), etc, and Tobin’s Q which describes the ratio between a physical asset’s market value and its replacement value.

Aggarwal et al, for instance go on to extrapolate data from the top 500 firms on the NIFTY 500 index and finds something truly Indian in that sixty percent of the top 500 firms in India are family run. Something that in a sense is exceptionally unique to India. While other developing economies might have a lot of state-run enterprises, India only has a few, thus in a way allowing for stringent regulatory compliance. The paper finds that there indeed is a very strong positive correlation between demographic diversity and Tobin’s Q of a firm ($p<0.05$), but alas that correlation withers out and turns negative when that diversity comes from family members in a business group firm. If the point of diversity is to bring varying perspectives to a firm, it’s easy to see why that’s the case. The other finding relates to diversity in the independence of board level directors; the paper finds that firms with greater independence at board level generally have better firm level performance along standardized metrics such as ROA,ROE etc.

To contrast in Turkey and Indonesia understanding the varying degrees of diversity comes in handy. For example, demographic diversity is of greater help when the firms are more controlled ala family owned or not. Age diversity too is of greater importance to controlled firms because it might decrease groupthink. The other interesting insight comes from a similar study by Ben-Amar et al (2013) which studies the effect of demographic diversity in Canada on the service role of boards by constructing a demographic diversity index (DDI). The study finds a positive effect of demographic diversity on merger and acquisition performance in Canada at lower levels of diversity and a negative effect at higher levels.

The other benefit of a diversity index is that we’re able to account for firms that constitute a wedge situation, where wedge is described as “agency conflict between the controlling shareholders and minority investors augmented by deviations from control rights.” Inter-agency conflict while common in developed countries where boards have a mixture of independent and appointed members, is less common in developing countries where you have a large number of family owned firms. The wedge hence is able to account for agency conflict at firms in developing countries that might not have shown up otherwise. Ararat (2015) explains that boards are less effective monitors of family controlled firms, while demographic diversity is a helpful mitigator of the negative effects of wedge on monitoring.

Darmadi (2010) on the hand, considers the Blau index which is a quantitative measure of two individuals chosen at random from the population of being of different race or ethnicity. Darmadi finds that in Indonesian society, age diversity has a significant positive association with market performance. Whereas, nationalistic and gender diversity has little or no benefit with firm performance. We could from this concur that Indonesians in general remain unresponsive to incentives to increase gender and nationalistic diversity, while being a risk averse culture.

Discussion & Conclusion

The extensive prior research done on this topic though has been quite conflicting. While the majority of research is centered around developed economies, this paper focuses on developing economies, which is a marked difference. As mentioned, prior research has also failed to take into account the neighborhood effect which has a massive impact on a person's life and future studies need to take those into account. Overall, while it might seem that the paper substantiates on-going research on Diversity, its contributions on the independence of directors and business group affiliations are novel approaches. Diversity is a truly tricking thing to tackle and hence doesn't have a one size fits all solution. While we might all agree that diverse firms in general do perform better, it's harder to point out specific drivers of such along different firms and sectors. The issue currently surrounding Diversity can best be summed up as this- It’s an a la carte issue that’s currently being dealt with by a buffet approach. That needs to change