

How Diverse Is Your Board, Really?

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June 11, 2020



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Influenced by state legislation as well as the efforts of institutional investors and other diversity advocates, companies have been adding more diverse directors to their boards than ever before. In 2019, a record 59 percent of the directors added to the boards of S&P 500 companies were women or were men belonging to a racial or ethnic minority group. Now, as companies seek to navigate numerous issues few have faced before, including a worldwide pandemic, a lingering trade war, changing consumer demands, and widespread protests regarding racial inequality, even more may be seeking to increase their diversity. But what characteristics should boards look for when adding directors to improve gender, racial, and ethnic diversity to ensure that these new directors also enhance diversity in the boardroom from a practical perspective?

While it is commonly assumed that individuals who differ in demographic characteristics will bring new backgrounds, viewpoints, and perspectives to a boardroom, often this is not the case, at least in how many public companies have historically recruited demographically diverse candidates. The problem is that too often

demographically diverse candidates are chosen because they have backgrounds similar to those of incumbent directors; they “fit in” well with others on the board.

In our experience, public companies wishing to increase their diversity benefit the most by recruiting candidates who also help improve cognitive diversity in the boardroom. Our views are derived from a study of the effects of cognitive diversity on board performance we conducted involving eight underperforming companies that were subject to past shareholder activism by our firm. At each company, an employee of our firm, an activist hedge fund manager, or one or more other individuals we nominated or approved, was added to the board. We interviewed on a confidential basis 18 directors who served on the boards of these companies both before and after changes were made to its composition. Through these interviews we were able to ascertain whether the directors added helped improve cognitive diversity in the boardroom and, if so, gain insight into the impact that any increase in cognitive diversity had on board performance.

The benefits of a cognitively diverse board

Our research revealed that improving cognitive diversity on a board can significantly enhance its performance, particularly when cognitively diverse directors are added with professional backgrounds, skills, and perspectives in areas pertinent to a company’s business or strategic plans who lack ties to the CEO and other directors. Cognitively diverse directors were frequently able to share valuable insights with their fellow directors, expanding the board’s understanding of the company and the strategic and operating issues it faced. We also found that they were more likely to ask tough questions and challenge the proposals of management and their fellow directors than incumbent directors who were long-tenured or had personal or professional relationships with others in the boardroom. As one incumbent director we interviewed said, “It is hard to vote against the CEO if you are going to see him that weekend at the country club.” Over time, however, the presence of engaged, cognitively diverse “outsiders” in the boardroom made incumbent directors more comfortable asking questions, suggesting alternatives, and expressing dissent. This, in turn, helped boards more effectively oversee management and improved decision-making.

Another director we interviewed said, “The new directors [on our board] brought not just a diversity of opinions and perspectives, but a diversity of behavior — a willingness to openly challenge management and other directors, which was missing from the boardroom. By having more open debate, it created an environment where others saw it was good and healthy to have frank discussions regarding important decisions. When members of the board began challenging each other — and listening to each other’s viewpoints — it led to positive outcomes. Good healthy disagreement led to good decision-making.”

Expanding cognitive and demographic diversity in the boardroom

To improve both cognitive and demographic diversity in the boardroom, we recommend that boards recruit racially, ethnically, and gender diverse directors who enhance diversity on two additional levels: first, by adding professional backgrounds, skills, and experiences in areas that are needed to meet the company’s strategic and operating needs; and second, by introducing new views, perspectives, and approaches to problem solving.

Improving the diversity of professional backgrounds on a board by adding directors with skills and experience that are needed in the boardroom is an efficient way to expand a board's knowledge base as well as improve its ability to advise and oversee management. Identifying directors who can introduce new views, perspectives and approaches to problem solving is a more time-consuming undertaking, given that these qualities typically are not discernable without speaking at length to candidates and their references. Taking the time to do so, however, can significantly improve board decision-making. Directors we interviewed informed us that they observed "healthier debate," "more robust discussions," and "more focused and fact-based decision-making" after the boards they served on became more cognitively diverse.

Cognitive diversity complements demographic diversity

Significant benefits can accrue from having a demographically diverse boardroom. Among other things, a demographically diverse board is more likely to represent the composition of a company's employees, customers, and suppliers and can therefore provide a board with a better understanding of the company's key constituencies. Thus, a demographically diverse board may help a company identify and respond to market shifts and changes in consumer expectations more effectively than a homogenous board. While such insights can be invaluable, demographically diverse directors with strong business backgrounds in areas that are needed on a board may be better able to incorporate their insights into the context of a company's business. It is for this reason that we recommended in 2019 that L Brands — which was subject to criticism that the marketing of its Victoria's Secret business was no longer aligned with women's evolving views of beauty, diversity, and inclusion — add more female directors to its board with experience in areas including merchandising, marketing, and international business development.

Recommendations to achieve a cognitively and demographically diverse board

Based on the results of our study, we compiled recommendations for boards interested in improving gender, racial, and ethnic diversity to incorporate into their director recruiting process to help them identify demographically diverse directors who also help improve cognitive diversity and board performance. These recommendations include the following:

- Recruit demographically diverse director candidates who have strong business backgrounds. More than half of the directors we interviewed raised this point unprompted. As one director we interviewed stated, "A director must have the business background and experience to ask intelligent questions and hold management accountable ... Without such experience, it is less likely that a new director will add significant value."
- Focus on identifying demographically diverse director candidates who have experience in areas that are required on the board to meet the company's current and anticipated needs. Utilize board and director-level assessments to determine what professional backgrounds, skills, and experiences are needed in the boardroom and whether such needs are being adequately met by the board's current members.
- Recruit from new talent pools and venture beyond using board member networks and historical recruitment practices to help identify diverse director candidates who lack ties to incumbent directors and management and can share new views and perspectives and different approaches to problem solving.
- Carefully review a candidate's background and life experiences and have in-depth discussions with the candidate and the candidate's references to determine whether he or she is cognitively diverse from other

members of the board. Ask questions to determine whether the candidate readily shares unique perspectives and new approaches to problem solving.

- Involve multiple directors in the interview process and conduct interviews in a variety of settings to get an accurate read of the candidate.

While labor intensive, diligent director recruiting can help boards identify candidates that maximize the diversity they bring to the boardroom. If a board approaches addressing diversity concerns solely as a “check-the-box” exercise, we believe it is doing a disservice not just to itself but also to the company and its shareholders.

Don't forget about board culture

Finally, our study revealed that the work of a board is not over once it has assembled a demographically and cognitively diverse group of directors. To make sure that a board benefits from enhanced diversity in the boardroom, it must have a culture that values diverse perspectives. Directors with strong professional credentials and unique perspectives are of little benefit if this is not the case. As an experienced female director we interviewed stated, “You can have all the diversity in the world, but it won't matter if you don't have the right culture.”

We therefore recommend that boards work diligently to establish a culture that embraces diverse insights and ensures that they are shared and incorporated into the decision-making process. A survey of 700 directors conducted by PwC in 2019 revealed that 43 percent of the respondents found it difficult to voice a dissenting view in their boardroom. These findings indicate that many boards may benefit from examining their culture to ensure that diverse perspectives are truly welcomed in the boardroom.

If a board is truly committed to fulfilling its role and responsibilities effectively, improving diversity in the boardroom — both demographically and cognitively — and fostering a culture that welcomes diverse perspectives must be made a priority. In today's dynamic and competitive global business environment, ensuring that boards are performing to the best of their abilities and are able to help companies innovate and respond to challenges and disruption is a business imperative. The competitiveness of our companies and the long-term success of our economy depend on it.

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