



THE WHITEPAPERS

INTELLIGENCE FOR INFORMED INVESTORS

Values-Based Investing Comes of Age

After enduring years of skepticism and a world-wide financial crisis, this global phenomenon has fully emerged as a way to align personal financial goals and performance with the prospect of a better world.

BY CHRISTOPHER J. WOLFE

Not even the global financial crisis could dampen enthusiasm for values-based investing (VBI), the strategy of putting investors' assets where they do society and the planet good. From 2007 through 2010, when total invested assets in the U.S. remained virtually flat, the nation's VBI increased by more than 13%. Since 1995 the increase has been 380%, nearly a

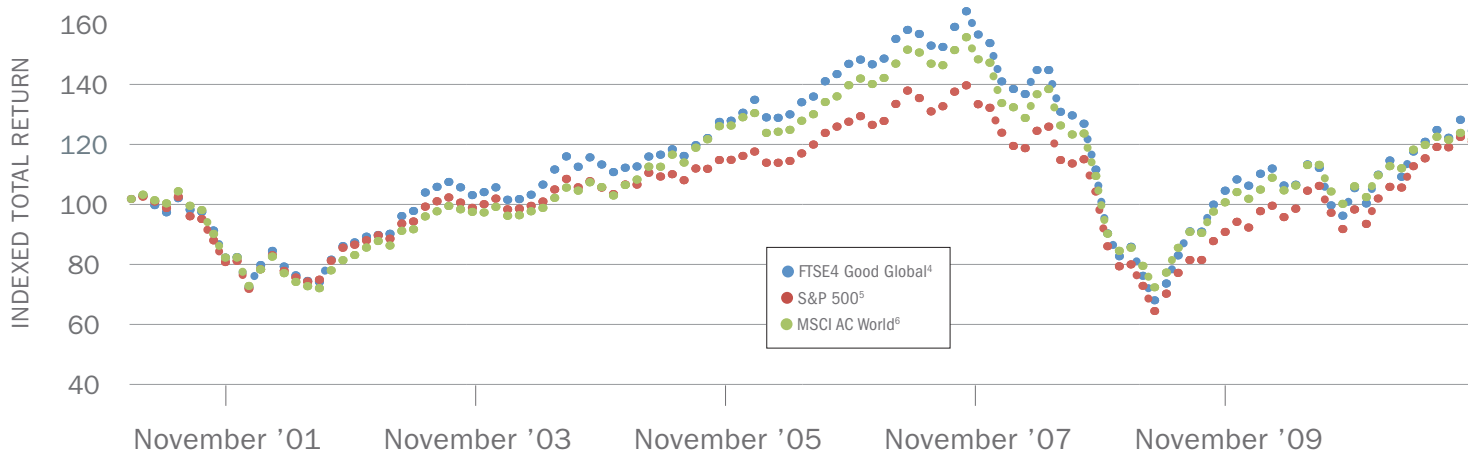
third higher than for all other invested assets.¹

What was once a niche phenomenon, derided as a feel-good money loser for more principled souls, VBI has become a pervasive approach broadly embraced by millions of individuals, institutions and financial advisors. Of the \$25.2 trillion in total assets under professional management in the U.S. in 2010, \$3.1 trillion was invested in assets screened for adherence to various environmental, social or corporate-governance values.¹ Globally the figures tell a similar story. Last year the United Nations' Principles for Responsible Investment, a pledge to consider social, environmental and governance principles when making investment decisions, drew the signatures of fund managers and other major investors representing \$25 trillion—10% of the world's investment capital.

For those of us who have spent years trying to improve the values-based investment choices for our clients, the evolution of VBI into a broad, sophisticated and influential part of the financial landscape has been nothing short of astonishing. Perhaps most gratifying is the fact that values and financial interests are no longer mutu

DOING GOOD AND DOING WELL

For the past decade, the leading VBI index has generally outperformed the major broad-market measures.



Data from Nov. 30, 2001, to May 31, 2011. Price return is denominated in local currency as defined by the index provider. S&P 500 is denominated in USD.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. The information provided is for illustrative purposes and is not meant to represent the performance of any particular investment. It is not possible to invest directly in an index. Please note that IMPORTANT DISCLOSURES are listed on the back of this Whitepaper.

ally exclusive. In 2007, when Merrill Lynch first helped popularize the term “values-based investing” (prior to that, the field had largely gone by the narrower “socially responsible investing,” or SRI, a term still used), there were 260 values-based mutual funds in the U.S. Today there are close to 500 funds of various types.

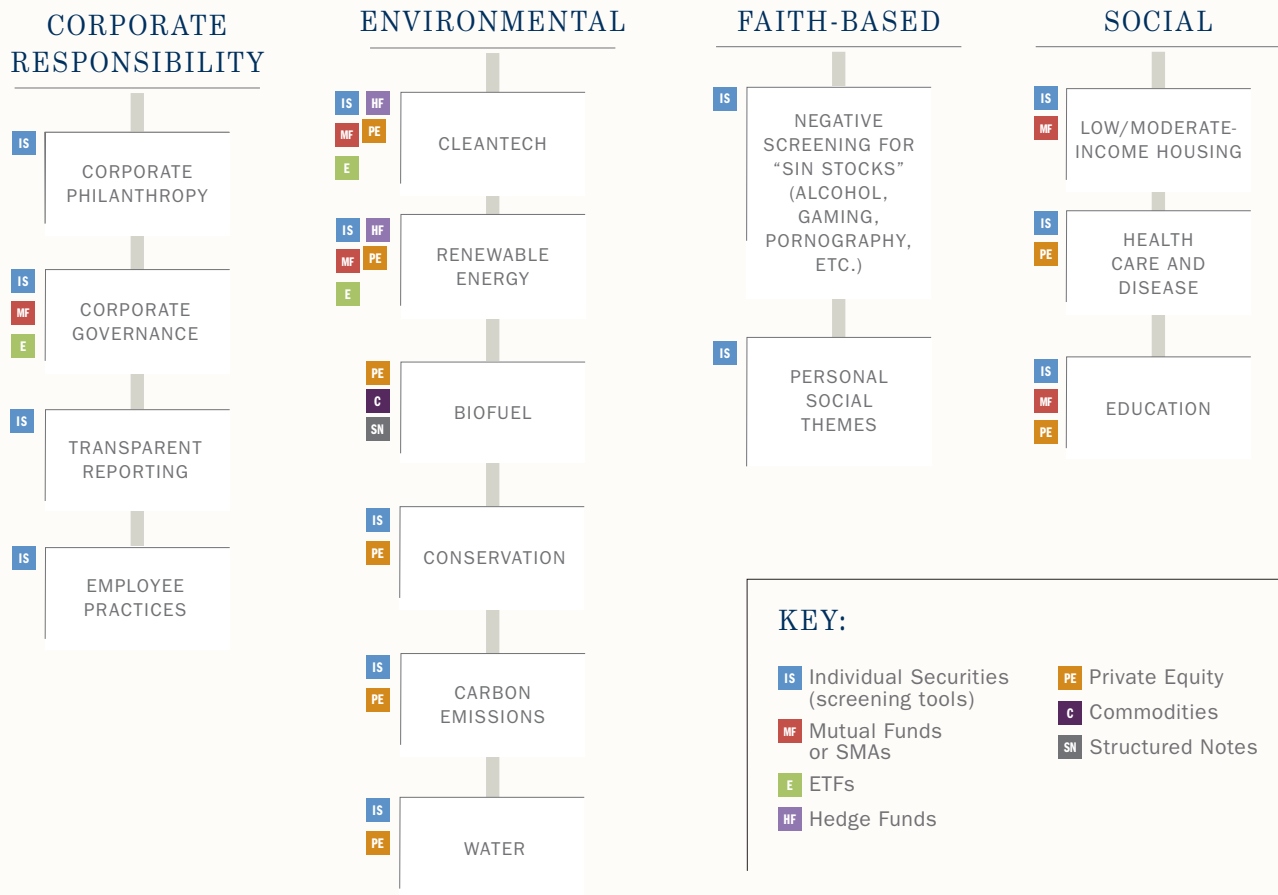
Clients now have access to values-based exchange-traded funds (ETFs), private-equity funds, venture capital funds and closed-end funds. Working with their advisors and outside managers, clients can tailor a managed portfolio to meet their specific values while accounting for their risk profiles and time horizons, all the while selecting alternatives from virtually every asset class and investment category. Increasingly, some are also combining the power of their dollars with the power

of their voices, using shareholder advocacy to make good companies even better or to compel companies whose practices they disapprove of to become responsible global citizens. From 2008 through 2010, more than 200 investors and portfolio managers filed or co-filed resolutions involving VBI issues at U.S. companies.

FIRST, COMPETITIVE RETURNS It’s important to remember that values-based investing is not philanthropy, even if both seek to change the world. In fact, one of the driving forces behind VBI’s popularity is compelling evidence that investing according to one’s principles can generate highly competitive returns. From May 1990 through March 2010, the DS 400², an index of values-based investments, recorded annualized returns of

The Expanding World of Values-Based Investing

While, in one sense, there are as many types of values-based investments as there are types of investors, the field does break down into a relative handful of major values-based-investing categories. Depending on the category, the options available for executing the strategy may change. In general, though, the choices open to investors are multiplying all the time.



9.65% vs. 8.83% for the S&P 500.

There's a growing awareness among investors that when a corporation strives to be a positive force in its community, benefits often reverberate to its bottom line. As Yogeesh Wagle, analyst and portfolio manager with Merrill Lynch Investment Management and Guidance, points out, "companies with good governance tend to be shareholder-friendly, not wasteful, and they don't over-compensate senior management—these are all good things for earnings and stock price."

One 2008 study that compared returns for the DS 400 and the S&P 500 between 1992–2007 found that the stocks of companies with the strongest records on employee relations and community and environmental responsibility performed better than those with the weakest records by three to six percentage points per year on average.³ Even though becoming a better corporate citizen often involves short-term costs, companies that are willing to absorb those costs tend to prosper in the same way they do from other smart, long-term investments, says Meir Statman, author of *What Investors Really Want* and a co-author of the study. Values-based investors increasingly recognize that. "They're willing to bear the costs of their values and reap great benefits later," Statman says.

GETTING STARTED For a phenomenon with wide social implications, the decisions of whether, when and how to become involved in VBI are decidedly personal—reflecting the core values of a person, a couple or a family. While people may think they know where they stand on social or environmental issues, a concerted analysis can yield surprising results, observes Steve Prickett, an institutional consultant and Private Wealth Advisor at Merrill Lynch. "It all starts with a little soul-searching," he says. "In a very short time, people's underlying passions either for or against certain things begin to emerge."

Stacy Allred, director of the Wealth Structuring Group at Merrill Lynch, says she will sometimes kick off a VBI conversation with clients by having families hold a mirror to their personal purchasing preferences. "If you own a hybrid vehicle, you have already made a pretty strong personal declaration about the importance of protecting the environment," she says. "I see families with exceptional wealth driving Priuses." However, she adds, if the same family is not filtering any investments for environmental responsibility, "there's at least an inconsistency there that it may want to consider."

10 Questions to Ask

As with any investment decisions, the more you ask and know about values-based investing, the more comfortable you are likely to feel. Here are some questions, suggested by our VBI experts, that you may wish to raise with your Private Wealth Advisor.

- 1 What is my first step to get started in values-based investing?
- 2 Will VBI change the process in which we manage my portfolio?
- 3 Will you help me sort out and talk through the values most important to me and to my family and how those values might drive our VBI strategy?
- 4 Which of my values can best be translated into an investment strategy?
- 5 How will using VBI in my portfolio impact my approach to philanthropy and vice versa?
- 6 Will there be a cost in terms of fees or the returns we can expect? Or can we make a projected neutral-to-net-positive effect one of our criteria for choosing the particular investments?
- 7 Does VBI mean that we have to redefine our portfolio strategy, or can we keep the same balance and risk level?
- 8 How would you recommend that we make the shift into VBI? Gradually? In percentage increments?
- 9 What have your other clients experienced by implementing VBI strategies?
- 10 Do you personally engage in VBI? If so, can you talk about how it has benefitted you?

James Ryan, a Private Wealth Advisor in New York City, heads a group that consults with religious institutions. Although his clients share many core values, VBI decisions often come only after vigorous debate. Ryan remembers a discussion among the leaders of a Trappist monastery over how to direct investments to advance goals of economic justice and fair pay. One participant argued against investing in any company with operations in the undeveloped or developing world that paid what he considered to be unfairly low wages. But another, born in a developing nation, offered a more complex interpretation. His own family had worked at a factory owned by a multinational firm. And despite what

was by international standards very low pay, without those jobs the family would have been unemployed. In the end, the group settled on a strategy of buying shares in some of those multinational companies, then becoming vocal shareholder advocates for higher pay and better working conditions.

FITTING VBI INTO A PORTFOLIO For affluent investors, the same financial goals of growth, risk management, diversification and principal protection apply with VBI—opening the values door just deepens and broadens the conversation, and places added emphasis on the need for advisors who understand both sides of the equation. “It’s not just values and how we can make a difference but how do we build a strategy, a game plan that accommodates the investors’ financial and social goals,” says Elliot Berger, a Wealth Management Advisor at Merrill Lynch.

Investors who decide to incorporate VBI into their decisions may want to start more methodically to avoid disrupting underlying strategies. This may include repositioning a small percentage of their assets, or even creating a satellite portfolio alongside their core portfolio, as a sort of test run. Values-themed mutual funds and managed accounts provide the simplest and most direct starting point, with outside managers handling all of the investment decisions.

As investors become more sophisticated about VBI, they may opt to become more hands-on, incorporating their personal values into decisions of which investments to make—from individual stocks to private-equity or venture capital funds to even investing directly in the target ventures themselves.

Generally speaking, as the specificity and the risk of a values-based investment rise, so does the potential payoff for society and the portfolio. Vinod Khosla, the Silicon Valley venture capitalist who co-founded Sun Microsystems and backed such companies as Juniper Networks, has described how he is currently committing more than \$1 billion to finding environmental “black swans”—long-shot ideas such as waste-free nuclear reactors or carbon-negative cement that have the potential to radically transform the physical planet in much the same way previous Khosla-backed ventures changed the virtual world. “Any one of these things is improbable,” he said in a recent interview with *The Economist*, “but if you have enough shots on goal, it’s very likely that something improbable will win.”

COMPANIES WITH THE STRONGEST RECORDS ON SOCIAL RESPONSIBILITY PERFORMED BETTER THAN THOSE WITH THE WEAKEST BY THREE TO SIX PERCENTAGE POINTS PER YEAR.

Few clients would be advised to reconstruct their portfolios on the black swan model. Yet Khosla’s basic premise—that enormous shareholder value is likely to accrue to those who figure out solutions to the most pressing issues of our time—is one that guides many VBI themes. BofA Merrill Lynch Global Research’s Sustainability Research team, based in London, is continually looking for areas in which the free market appears poised to reward significant social or environmental leaps forward. Sarbjit Nahal, co-head of the group, notes that although overall volatility in the clean-energy sector remains high, certain private funds in the space have been among the best performers within the past five years. Nahal is also especially bullish on sustainable agriculture (new seed hybrids, low-phosphate fertilizer and other non-resource-depleting technologies for feeding a global population that is growing by 9,000 people an hour)—and, yes, electric cars. “There’s been a lot of skepticism around high-efficiency vehicles, and for good reason,” he says, “but with the global demands on energy, we think they’re finally going to see their day as a solid investment.”

MORE EXACTING METRICS Along with the growth in VBI choices has come increasing sophistication in the metrics by which investors can gauge the value of their values-based investments. By far the best known is Bloomberg’s Environmental, Social and Governance (ESG) data service, which has been available since 2009 as a standard feature to all subscribers to the Bloomberg data terminal. The service rates more than 3,000 companies worldwide on a continually evolving list of 120-plus variables. (For instance, in response to the growing pressure on the world’s freshwater supplies, the service recently added a rating on corporate water-use practices.) Users can generate a composite score on all of the variables, or run weighted analyses, executing a screen to find the 20 companies in the Bloomberg data set with the best track records on minority hiring, for example, or the 10 stocks with the

worst records on pollution controls.

Still, for all of its user-friendliness, Bloomberg ESG essentially remains a measure of the values side of the screen. Another tool, recently introduced by Merrill Lynch, attempts to take the process a step further by actually modeling some of the ways that adherence to good social, political and environment governance is likely to affect a company's financial performance.

Known as Who Does What Where (WDWW), the service is based on the thesis (increasingly underscored by events in the Middle East and elsewhere) that operating in countries or regions with poor records on environmental controls, limited political freedoms or rampant corruption presents inherent risks for companies and shareholders. Nahal's Social Responsibility team has identified 21 of these "long-shelf-life" themes, ranging from resource depletion and security to basic food, health and education needs, each computed from a half-dozen or more indicators drawn from publicly disclosed data. The team scores and ranks every country and then rates each company on a 0-100 scale according to its geographic sales and assets exposure. "It by no means covers everything," Nahal says, "but we think it's a good start at bringing some rigor to predicting the ways these factors actually influence risk and thus returns."

WHEN PEOPLE FEEL GOOD ABOUT THE WAY THEY ARE USING ASSETS TO MAKE A DIFFERENCE IN THE WORLD, WE'VE NOTICED THEIR ANXIETY LEVEL OFTEN DROPS.

CONSIDERING THE RISKS... Notwithstanding all the positives of VBI, investing according to your values entails risks and challenges that need to be considered. When engaging in values screening, the fact remains that you are still limiting your choices, which can always limit performance unless steps are taken to mitigate the risk. Suppose, for example, that you've decided to focus on clean energy. Without careful balancing, there is a good chance you could end up underweighting the portfolio too heavily away from large-cap, stable companies and toward smaller-cap firms that may or may not be profitable. To rebalance you may need to consider more aggressively seeking out large-cap, more established performers that still earn respectable marks for

their environmental policies. Or you may ramp up holdings of large companies in those areas of the portfolio that are not directly related to energy, but which meet your VBI criteria in other respects.

You must also steel yourself against the danger of letting enthusiasm for a specific company or technology obscure fundamental financial realities. For example, you might believe wholeheartedly that an effective AIDS vaccine is around the corner. And biotech companies performing cutting-edge research can indeed make for solid investments. But acting on that faith solely on the basis of the company's noble goals could cause you to overlook other factors, like a poor balance sheet or the fact that similar research being conducted at dozens of other firms and university laboratories makes the chance of financial victory remote. You can always support research with the portion of your assets that you've devoted to philanthropy. But if a prospect can't pass financial and risk/reward scrutiny, it probably doesn't belong in your investment portfolio.

...AND THE POTENTIAL REWARDS Yet clarity about values can bring important practical benefits. Although values evolve, they're far more stable than equity markets, which unanchored investors can be tempted to chase. Particularly in upswings, investors can feel cheated if they don't beat or at least match the market, while downturns can panic them into ill-advised selling. But research and experience show that a steady hand is better than a hot one, and that chasing the market often leads to submarket returns. With VBI, market ups and downs may have less power to distract from sound long-term strategies.

Finally, values-based investing offers special benefits that don't always tally on a balance sheet. "There are some real, personal—you might even say selfish—reasons to go down this path, besides it being the right thing to do," says Merrill Lynch Private Wealth Advisor David Waitrovich. "When people feel good about the way they are using assets to make a difference in the world, I've noticed that their anxiety level often drops. They may feel better about themselves—more productive, more engaged."

Allred adds, "Articulating and following your values creates a framework that provides the clarity and confidence needed to make difficult wealth decisions." She says, "When people have refined focus, it's an absolute joy to help them and be part of their journey."

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¹ Report on Socially Responsible Investing Trends in the U.S. 2010. Social Investment Forum.

² The Domini 400 (DS 400) is a benchmark index constructed using environmental, social and governance factors.

³ *The Wages of Social Responsibility*. 2008. Santa Clara University. The study analyzed hypothetical portfolios composed of companies included in the S&P 500 and DS 400 indices. The companies were rated on the following social responsibility characteristics: community, employee relations, diversity, environment and products. A top overall company

was one that was in the top third of companies by two or more of these characteristics and not in the bottom third by any characteristic.

⁴ The FTSE4 Good Global index has been designed to measure the performance of companies that meet corporate responsibility standards.

⁵ The S&P 500 index includes a representative sample of 500 leading companies in leading industries of the U.S. economy.

⁶ The MSCI AC World is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance.

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