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— Christopher J. Wolfe,
Chief Investment Officer,
Private Banking and Investment
Group at Merrill Lynch

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Values-Based Investing

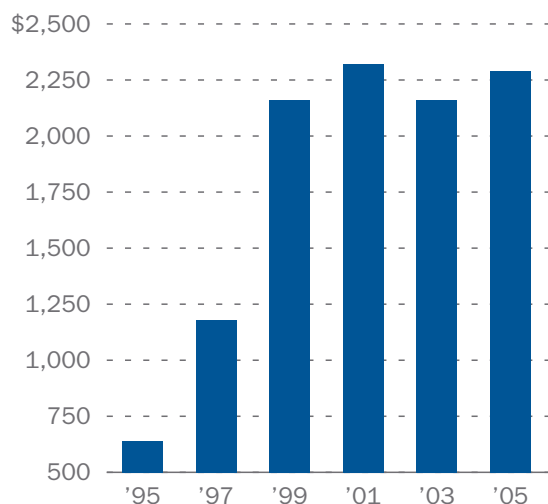
Investors are using social values to guide investment choices. Today’s newest options offer an opportunity to do good, while doing well.

The line that has separated the building of wealth from accomplishing social goals has been one of the most enduring features of capitalism. The industrialists of the Gilded Age amassed fortunes in manufacturing, railroads and banking, and only then did they turn their attention to erecting the museums, symphony halls and philanthropies that bear their names. As the markets grew during the 20th century, socially minded investments were, as *Fortune* magazine put it, nothing more than “feel good” investments. For years, they were largely confined to socially responsible investment (SRI) funds that screened out companies deemed inappropriate according to social or ethical guidelines—even if that meant sacrificing the potential for competitive returns. Today, not only are such funds increasingly sophisticated and competitive, but a whole new world of opportunities beyond mutual funds has emerged as well for individuals eager to align their investments with their personal values. This burgeoning global phenomenon demands a much broader and more comprehensive name than SRI: values-based investing.

In 2005, American individuals and institutions invested \$2.3 trillion—one in every 10 investment dollars—by taking environmental, social and governance factors into account in their investment decisions, according to the Social Investment Forum. That’s a 360% increase from the \$639 billion put into “socially responsible” companies in 1995.¹ Values-based investing has also gained currency around the world. The 2007 Merrill Lynch/Capgemini World Wealth Report found strong interest in values-based

The Rise in Values-Based Investing

Tremendous growth in socially responsible investing reflects the appeal of values-based investing, of which SRI is the cornerstone.



U.S. Dollars Directed into Traditional "Socially Responsible Investing" (Dollars in billions)

Source: Social Investment Forum Foundation

investing from Asia to the Middle East; and in Europe, such investments rose from \$381 billion in 2003 to \$1.29 trillion in 2005.²

That individuals can choose among hundreds of values-based investments accounts for only part of their popularity, however. Today, investors are far less likely to accept the "conscience penalty" of lower returns that was not unusual for the handful of mutual funds that vetted companies for their socially redeeming practices a decade ago. Values-based investments are now designed to fit seamlessly into portfolios by meeting specific financial objectives, such as protecting assets, seeking growth or hedging against market risk. "Individuals who want to integrate their values into their investing can seek, and expect, a competitive return," says Tim Smith, chairman of the Social Investment Forum.

A growth-minded investor concerned about the environmental impact of fossil fuels, for example,

can opt to provide startup capital to companies converting corn or soy into bio-fuels. A more conservative investor might purchase bonds from an organization building low-cost housing in expensive cities. Still another might select a mutual fund investing in companies whose practices don't conflict with particular religious convictions, or pool money with like-minded investors to make microloans to small business owners in sub-Saharan Africa. The choice is always deeply individual, says Christopher J. Wolfe, Chief Investment Officer for the Private Banking and Investment Group at Merrill Lynch: "Some people's values are governed by the environment. Others are focused on modifying corporate behavior or oriented toward social change."

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CHANGING THE WORLD, ONE INVESTOR AT A TIME

Heightened awareness of such issues as global warming and income inequity is one of the forces behind the growth in values-based investing. Another is entrepreneurs who view their personal wealth and success as closely integrated with their values. At their own companies, they've established environmentally friendly practices or taken steps to ensure that their suppliers treat workers fairly—and they want to invest in companies making similar efforts. "People are stepping back and asking themselves how successful they've been, not just in terms of money and traditional business

success, but in their lives overall,” says Jed Emerson, a senior fellow at London’s Generation Foundation and a leader in the values-based investing movement. “More than just a big bank account, they want to leave their kids a legacy of having done positive things with their wealth and talents.”

Merrill Lynch Private Wealth Advisor Hilary Giles says that her team’s clients, many of whom are young, ambitious entrepreneurs who have made their wealth in tech startups, ask about ways to structure their personal finances according to their values. “They have tremendous optimism about their ability to change the world,” she says. Adds Elliot Berger, Director of Foundations and Strategic Philanthropy at the Merrill Lynch Center for Philanthropy & Nonprofit Management: “Clients increasingly expect to work with their advisors to build investment strategies that reflect the full set of their goals, including the intersection of financial, social and environmental values.”

SELECTING THE RIGHT VALUES-BASED INVESTMENTS

As with any investment, the return rates and risks of values-based investments vary widely, “so they must be carefully selected to complement a balanced portfolio,” Wolfe says. Merrill Lynch clients work with Merrill Lynch advisors to determine what percentage of overall assets to devote to values-based investments, what returns to expect and which types of investments offer the necessary diversification. “This is a form of portfolio customization that isn’t radically different from other ways of investing,” Wolfe says. “Your portfolio must continue to manage risk and growth to cover inflation and taxes and still allow the assets to appreciate.”

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Shares in individual companies, of course, hold the potential for high returns (along with elevated risk, if the company founders). Besides evaluating a prospective company’s track record, potential for growth and other indicators of financial health, a values-based investor should also seek information on how the company stacks up against a variety of environmental or social criteria. A growing number of research firms, among them ASSET4 AG, which announced a strategic alliance with Merrill Lynch in September 2007, offer details on major companies’ economic, environmental, social and corporate governance performance. Investors can customize these reports to give priority to the issues most important to them.

In Europe, where climate change and environmental conservation top the list of concerns for values-based investors, the newly launched Carbon Leaders Europe Index assesses European companies based on the size of their carbon footprint (the environmental friendliness of their practices) as well as their price/earnings ratios. “Just because a company is ethical or environmentally friendly doesn’t automatically make it a good investment,” says Zoe Knight, Senior Director of Socially Responsible Investing for Merrill Lynch. “Ethical investors apply as much rigor to financial analysis as any other investor. The index offers exposure to companies that have low

VBI: A Wider Range of Choices

LOOK FOR VALUES-BASED INVESTMENTS THAT MATCH YOUR GOALS, RISK TOLERANCE AND PERSONAL TIMELINE — AND OFFER COMPETITIVE RETURNS.

Individual stocks. With the help of research firms, investors can choose companies based on how well they conform to the ethical, governance and product standards investors consider most important, in addition to evaluating their financial performance.

Private-equity or venture capital funds. Investments in startups that are attempting to improve the environment or benefit society offer the opportunity for high returns—and high risks.

Socially responsible investment (SRI) funds. The most popular form of values-based investing, SRIs hold shares in profitable companies that rank high on social, environmental and corporate governance screens. They are available in a variety of asset classes, including domestic and international equities, hedge funds and exchange traded funds.

Real estate. This category includes equity funds aimed at conservation and responsible forestry and environmentally friendly real estate investment trusts.

CDs. Many community development banks offer certificates of deposit (CDs) for housing and development projects benefiting low-income communities.

Pooled portfolios and loan funds. If high financial performance isn't a consideration but using investments to increase philanthropic contributions or ensuring that nonprofits put the money to use as intended is appealing, consider these portfolios and funds. Products such as Calvert Community Investment Notes pool assets of like-minded investors to work toward solving specific social problems. Investors choose the length of the loan and the return rate, usually between 0% and 3%.

carbon footprints within their sectors and are favorably valued.”

An increasing number of venture capital and private-equity funds are financing startup companies engaged in solving social and environmental problems. Bio-fuels and other alternative energy sources, an area of strong interest for values-based investors, attracted more than \$70 billion in investments in 2006, a 43% increase over the previous year.³ “You can certainly hit a home run when your personal values dovetail with a strong market interest,” Wolfe says. Yet timing the market with values-based investments is as difficult as with traditional investments. Because of the risks,

“you wouldn't want to put all of your money into this space,” Jed Emerson says. “You have to think like any other investor in terms of your risk tolerance, the returns you are seeking, and your investment horizon.”

SRI funds, among the earliest and still the most prevalent type of values-based investing, now seek out companies whose practices they admire rather than simply filtering out those regarded as social pariahs. In 2005, investments in SRI funds totaled \$179 billion, an 18.5% increase over 2003 and a fifteenfold increase from the \$12 billion invested in 1995, according to the Social Investment Forum.⁴

The rapid expansion of interest in SRI funds and other types of values-based investing owes itself not just to increasing social awareness on the part of investors, but also to the realization that such investments can produce competitive returns. A growing body of academic research supports that view—with some caveats. For example, a 2005 Wharton School study found that SRI-focused index funds, which seek to match the overall performance of the market or a market segment, fare about as well as index funds as a whole. Yet Robert F. Stambaugh, a Wharton School finance professor and co-author of the study, warns that investors who drift from indexing in search of higher-performing funds are likely to be disappointed: “If you are not a market index investor, the cost of imposing a social investing screen can be significant.”⁵

And a 2002 study by the Netherlands’ University of Maastricht found that more than 100 U.S. and European SRI funds performed just as well as their non-SRI counterparts from 1990 to 2001. The study also found, however, that newer, less time-tested SRI funds don’t perform as well as older, more established ones.⁶

Still, both these and other studies suggest that values-based investing, once widely viewed as an automatic money loser, has come of age as a means for investors to manage risk and bolster their own financial portfolios, even as they do good things for the world.

DIVERSIFYING YOUR PORTFOLIO

Less traditional investment areas, such as real estate, have also joined the values-based investing movement, providing investors with opportunities to own alternative asset classes that help

diversify their portfolios. In 2006, Merrill Lynch participated in a conservation forestry fund that partnered with The Nature Conservancy to protect thousands of acres of land from unrestrained development. Capital raised from individual investors purchased the land, which was then used for controlled timber production. Because timber is not correlated to the performance of stocks or bonds, it offered investors an attractive diversification strategy.

Some real estate advisory firms have launched equity funds that generate returns for investors while furthering such causes as conservation, affordable housing and urban redevelopment. For example, MMA Sustainable Land Investments, started in 2006, invests in properties such as large tracts of forest and farmland. Income is derived from sustainable forestry or crops raised using green techniques. Among the company’s stated goals are minimizing urban sprawl, protecting wildlife habitats, reducing soil erosion—and producing competitive returns for investors. Even real estate investment trusts (REITs) are going green. “Some publicly traded REITs are working to improve energy efficiency, lessen the carbon footprint and develop green buildings,” says Gary Pivo, a professor of urban planning and natural resources at the University of Arizona.

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— Zoe Knight, Senior Director, Socially Responsible Investing for Merrill Lynch

HOW DOES PHILANTHROPY FIT IN WITH VBI?

Investors committed to serving a cause may even be willing to sacrifice some financial gain from a values-based investment, such as purchasing a below-market-rate CD from a community development bank as a way to support community and local projects. But knowingly forfeiting returns for a good cause is difficult to justify if the investment is part of a personal portfolio in which maintaining income or protecting assets is a consideration. If

“Many entrepreneurs and other investors want to make sure the money they give actually is put to work and has an impact.”

— David Waitrovich, Merrill Lynch Private Wealth Advisor, Private Banking and Investment Group at Merrill Lynch

the investors do not seek at least a competitive market return, Merrill Lynch’s Wolfe says, it’s possible that they could lose ground to taxes and inflation, risk diminishing the value of the portfolio, or even force the investor to compensate with much riskier investments elsewhere.

On the other hand, accepting low returns to benefit society may be an acceptable strategy for an investor who has excess capital. But if financial gain is not an imperative, why not just give away the money in the form of an outright gift?

One reason, says Merrill Lynch Private Wealth Advisor David Waitrovich of San Francisco, is “many entrepreneurs and other investors want to make sure the money they give actually is put to work and has an impact.” An investment implies

an obligation on the part of the recipient to produce value—whether societal, financial or both, he says.

Another advantage values-based investing has over philanthropy is that it provides people with an opportunity to direct much more money toward funding their social entrepreneurship. Someone with \$1 million in cash might decide that she can comfortably donate 5%, or \$50,000, to charity.

Yet by investing in an organization providing loans to disadvantaged small business owners, she can put the entire \$1 million to work for a particular cause. When the loan term ends and the principal is returned, the investor can commit the same \$1 million once again to another worthy organization. Likewise, if she operates a private philanthropic foundation, she can use program-related investments, which support charitable activities and anticipate a certain return within a set amount of time.

To fulfill a philanthropic goal of promoting understanding and ending violence in the Middle East, the founder of a popular e-commerce Web site had been donating money directly to various nonprofit agencies. But short of increasing his charitable gifts, he wondered how his dollars could have an even greater impact. Hilary Giles, his Private Wealth Advisor at Merrill Lynch, suggested the Calvert Foundation, which sells Community Investment Notes to fund such initiatives as building affordable housing or providing small loans to business owners in impoverished areas—a process known as microfinancing.

Owning an investment that delivers returns as it fosters economic development in the Middle East appealed to the entrepreneur. “I realized that helping people create jobs is an effective tool in fighting terrorism,” he says. “And I can afford

to loan a lot more money than I can afford to give away, so the Calvert Foundation is a way for me to get a lot of cash to people who need it. It's a sustainable model."

When investors buy Community Investment Notes from the Calvert Foundation, they choose a return rate of 0% to 3%. The lower the rate of return, the more money goes toward the cause the investor wants to support. Of the foundation's 2,500 investors, some 350 have elected zero returns, says Shari Berenbach, the foundation's executive director.

After a quarter-century, there is little doubt that values-based investing is more than just a passing trend. Though the field will undoubtedly continue to evolve with new products—and with causes to invest in, as world events thrust new issues to the fore—more and more portfolios are including investments that contribute to an individual's notion of an ideal world as well as to his or her bottom line. And the feel-good factor is a bonus. Says Merrill Lynch Private Wealth Advisor Waitrovich, "There's an afterglow from knowing your values and your investments are in the same place." ■

Companies Invested in Causes

MORE AND MORE CORPORATIONS LOOK TO MAKE A DIFFERENCE, SOCIALLY AND FINANCIALLY.

Companies, like individuals, are increasingly devoting a portion of their investment dollars to causes that can generate a financial return while furthering social goals. Since 2001, Merrill Lynch has invested more than \$1 billion in loans and investments to disadvantaged communities through the Merrill Lynch Community Development Company (CDC). Some 400 loans and investments have resulted in construction of 18,000 affordable housing units, 300,000 square feet of community facilities ranging from child care centers to schools to medical facilities, and created almost 28,000 jobs, according to Merrill Lynch CDC Director Dan Letendre.

But even as its loans serve a social cause, the Merrill Lynch CDC is built on a model of making financially viable investments rather than grants. Indeed, the company has been profitable since its first year of operation, and has lost no loans through default.

Letendre attributes that success to choosing partners with a record of financial responsibility and success. "We partner with experienced community development intermediaries," he says. "These are nonprofit, local organizations that specialize in financing education, health care, housing or small businesses. They have a high sensitivity to the local needs of the community."

The CDC has also begun investing through such organizations as the Calvert Foundation, which makes loans both in the United States and internationally for community-based projects. The CDC invests its own capital and does not currently process investments for private individuals. However, it has consulted with co-investors interested in investing \$500,000 or more about possible ways to get involved in community-based investments. "We welcome the opportunity to work with like-minded investors on projects with solid financials and strong community impact," says Letendre.

Merrill Lynch understands the responsibilities that come with substantial wealth. Your Merrill Lynch advisor is singularly positioned to discuss values-based investing with you and to help you implement solutions.

For more complete information on any mutual fund, please request a prospectus from your Financial Advisor, and read it carefully. Before investing, carefully consider the investment objectives, risks, and charges and expenses of the fund. This and other information can be found in the fund's prospectus.

- ¹ "What Is Socially Responsible Investing?" Social Investment Forum, <http://www.socialinvest.org/resources/sriguide/>.
- ² 2007 Merrill Lynch/Capgemini World Wealth Report, <http://www.ml.com/media/79882.pdf>, p. 19,
- ³ World Wealth Report, <http://www.ml.com/media/79882.pdf>, p. 20.
- ⁴ "2005 Report on Socially Responsible Investing Trends in the United States," Social Investment Forum, <http://www.socialinvest.org/pdf/research/Trends/2005%20Trends%20Report.pdf>, p. 6.
- ⁵ Christopher Charles Geczy, Robert F. Stambaugh and David Levin, "Investing in Socially Responsible Mutual Funds" (October 2005). Available at Social Science Research Network: <http://ssrn.com/abstract=416380>.
- ⁶ Rogér Otten, Rob Bauer and Kees C. G. Koedijk, "International Evidence on Ethical Mutual Fund Performance and Investment Style," LIFE Working Paper No. 02.59, Social Science Research Network (March 7, 2002), papers.ssrn.com/sol3/papers.cfm?abstract_id=325702

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