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TRACK:	WMI
SESSION: 979038	THE DEBATE ON SOCIALLY RESPONSIBLE INVESTING: MYTH AND REALITY
	MONDAY, OCTOBER 12, 2009
	8:15 AM - 9:30 AM
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The Debate on Socially Responsible Investing: Myth & Reality

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FPA Anaheim 2009

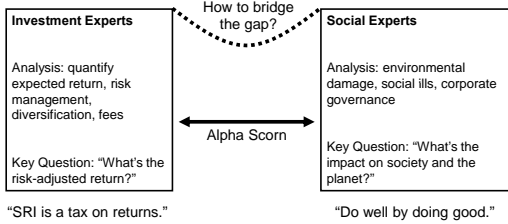
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SRI: Myth and Reality

- Increased interest, especially among younger generations of wealthy families
- Intense debate as to whether SRI is silly
- Implementing SRI across asset classes
- Investment utility vs. "expressive" utility
- New customized approach for public equity strategies
- Case study of wealthy family

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Debate on Socially Responsible Investing: Both High Net Worth and Foundations



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Problems for Advisors Incorporating SRI

- Knee-jerk responses from investment experts
 - It's a mess to figure out the blend between values and investment performance
 - High fees for alpha or screening?
 - SRI a tax on investment return and a waste of time
- Social issue expertise differs from investment expertise
 - SRI practitioners may be social activists first and investment experts second
 - Investment advisors may not understand social issues
 - Values: "one size fits all"

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Problems for Advisors Incorporating SRI

The skeptical advisor with a client interested in SRI faces two unattractive choices:

Rock

Choice #1

"I'll find some expensive fund or manager with high fees and a terrible track record just to placate my client."

Hard Place

Choice #2

"I'll tell my clients what idiots they are for pursuing these silly feel-good values that will be harmful to their wealth."

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Foundations and the SRI Debate

"In contradiction between its grants and its endowment holdings, a Times investigation has found, the [Gates] foundation reaps vast financial gains every year from investments that contravene its good works."

"Dark Cloud Over Good Works of Gates Foundation,"
Charles Piller, *Los Angeles Times*, January 7, 2007

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SRI Across Asset Classes

Asset Class	Challenges & Opportunities
Cash	Community banking
Fixed Income	Screening, microfinance, limited databases
Private Equity	<ul style="list-style-type: none"> • Can be the most mission-driven • Can have highest expressive value
Absolute Return	Most difficult class to address values
Real Assets	<ul style="list-style-type: none"> • Sustainable resource management • Green real estate
Public Equity (Domestic & Foreign)	<ul style="list-style-type: none"> • Easiest asset class to address values • Social research databases • Three levels of interaction <ul style="list-style-type: none"> • Screening, negative and positive • Proxy voting • Activism: proposing resolutions

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Balancing Results and Values

Investment Utility

- Highest return on a risk-adjusted basis
- Quantifying preferences: return versus risk

Expressive Utility¹

- Align portfolio with values/social impact
- Quantifying values: social score versus tracking error

- Can expressive values be incorporated without penalizing performance?
- What new metrics are needed?

¹ "What Do Investors Want?", Meir Statman, *The Journal of Portfolio Management*, Vol. 30, No. 5, 2004.

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Delivering SRI for Public Equities

- Index or active?
- Pre-fabricated or customized values?
- Whose values are reflected?
- Depends on size of portfolio
- Mutual funds
- Separate accounts
- Research on returns: UN summary Oct. 2007
http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf

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Popular SRI Mutual Funds or ETFs

Fund	Ticker	Benchmark
iShares KLD 400	DSI	FTSE KLD 400
iShares KLD Select	KLD	FTSE KLD 400
Calvert Social Equ.	CSIEX	Active
Vanguard FTSE	VFTSX	FTSE4Good U.S.
Domini Social Equ.	DSEFX	Active
TIAA-CREF Social	TICRX	Russell 3000

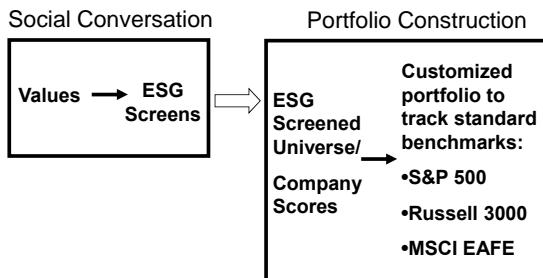
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Index SRI: Have Your Cake and Eat It Too

- Separate accounts allow customization
- Low-cost & transparent indexing to track standard equity benchmarks
- Customized & transparent environmental, social, governance (ESG) screens based on investor-specific values
- Socially responsible proxy voting

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Customized Values Portfolios



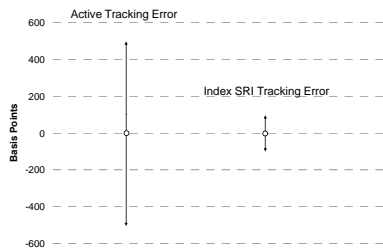
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Tracking Error

Tracking error is a measure of how closely a portfolio follows, or "tracks", its benchmark index. Annual tracking error is a statistical measure that is defined as the standard deviation of the difference in annual returns between a portfolio and its benchmark. It is often described as a measure of "unsystematic" risk.

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Expected Tracking Error



Source for Expected Active Tracking Error: GMO survey of Callan Associates, Inc., Mercer Investment Consulting, Watson Wyatt Worldwide
Source for Expected Index SRI Tracking Error: Aperio Group

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Impact of Tracking Error

Average Active:
 σ_a (T.E.) = 5%

Optimized SRI Index:
 σ_o (T.E.) = 1%

	Variance = (Std Dev) ²	Standard Deviation	Variance = (Std Dev) ²	Standard Deviation
U.S. Equity Market	4.000%	20.000%	4.000%	20.000%
Tracking Error (T.E.)	0.250%	5.000%	0.010%	1.000%
Equity + T.E.	4.250%	20.616%	4.010%	20.025%
Incremental Risk		0.616%		0.025%

Variance terms may be added, but not standard deviations.

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Case Study

- Wealth family with strong ESG views
- Existing manager offered no customized ESG
- In-depth ESG interviews with family
- Combine social scoring, tracking error and tax impact for portfolio recommendation

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Steps to Implement

1. Meet with clients to flesh out belief system
 - Go through questionnaire in detail
 - Determine how to create consensus
2. Create Values Policy Statement
3. Convert client-specific values to a score for every company available

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Steps to Implement

4. Run multiple portfolio optimizations
 - Minimize tracking error
 - Optimize tax impact
 - Maximize custom social score
5. Work with clients to balance optimal trade-off among conflicting goals

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Social & Environmental		Corporate Governance	
Factor	Importance	Factor	Importance
Adult Entertainment	Ignore	Auditing Practices	Ignore
Alcohol	Ignore	Board Accountability	Ignore
Animal Testing	Ignore	Board Composition	Ignore
Bioethics	Ignore	Board Independence	Ignore
Diversity	Med	CEO Compensation	Ignore
Environment	High	Company Ownership	Ignore
Firearms	High	Shareholder Rights	Ignore
Gambling	Ignore	Takeover Defense	Ignore
Human Rights	Med	Corporate Library Grades	High
Labor Relations	Low		
Life/Choice	Ignore		
Military	Low		
Nuclear Power	Ignore		
Recognition	Low		
Sexual Orientation	Low		
Tobacco	Low		

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Investment Goals	Expressive Goals
<ul style="list-style-type: none"> • Expected risk/return benefits of indexing • Tight index tracking • Low fees • Optimal tax management 	<ul style="list-style-type: none"> • Know that investor's values have been heard and implemented in portfolio with minimal impact on investment goals • Follow proxy voting guidelines • Join effort to change corporate behavior

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Summary
<ul style="list-style-type: none"> • Investors may seek to maximize both investment utility and expressive utility • Implementation of values-based investing depends on asset class • For public equities, low-cost custom approaches available to track legitimate market benchmarks • The performance penalty for aligning a stock portfolio with an investor's values is often negligible • If you're going to offer SRI to your clients, offer them the smartest way to capture the best of both worlds

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