WHAT IS SOCIALLY INNOVATIVE INVESTING?

The search for companies that do good *and* do well.

by Jason Baron

The Socially Innovative Investing Strategy (S2I), a proprietary strategy developed by U.S. Trust, is based on a growing awareness that strong corporate financial performance and social responsibility are not mutually exclusive; rather, they are mutually beneficial qualities.

For investors, S2I seeks to answer yes to an age-old question: is it possible to do good and do well at the same time?

BACKGROUND

The idea of investing according to personal values and beliefs is hardly new. At least since the mid-18th century, when Quakers banned followers from participating in the slave trade, individuals and groups have periodically chosen to avoid investments that conflict with moral, religious, environmental or other values.

This approach to investing, now often referred to as socially responsible investing, or SRI, is viewed largely in terms of what it doesn't do. Investors choose what not to invest in — such as tobacco, weapons manufacturers and alcohol. And, because SRI entails limiting the universe of potentially profitable investments, the implication is that though this might be a noble endeavor, the investor is doomed to lower returns.

During the 1980s, *Fortune* magazine famously described SRI as "feel good investing" and "politically correct investing." But as interest in SRI has continued to grow, a new, more active and demanding approach to social investing has emerged based on the idea that social responsibility and corporate earnings should naturally go hand in hand. Dr. Michael Porter, of the Institute for Strategy and Competitiveness at Harvard Business School, summed up this new idea: "Corporate Social Responsibility can be much more than a cost, a constraint or a charitable deed — it can be a source of opportunity, innovation and competitive advantage."

Inspired by those words, U.S. Trust has created Socially Innovative Investing, which takes traditional socially responsible investing a step further. S2I incorporates an active, proprietary method for reviewing U.S. securities across a wide spectrum of criteria that weight both social responsibility and financial fundamentals. To be considered for inclusion, companies must be attractive fundamentally, as well as fit global macro investment themes established by U.S. Trust's thought leadership team. During the portfolio construction process, sector weights adhere to U.S. Trust's recommendation.

ABOUT THE AUTHOR

Jason Baron is a senior vice president, portfolio manager at U.S. Trust.

See last page for important information.

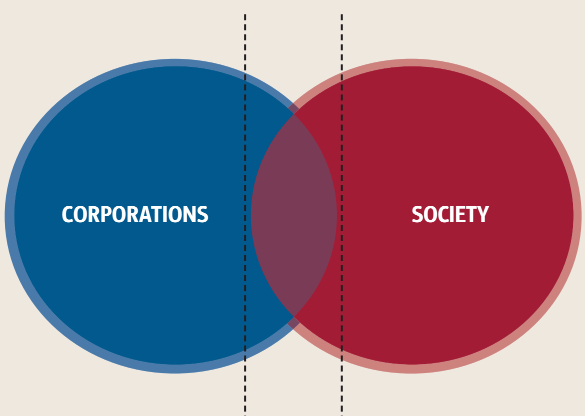
THE PRINCIPLE OF SHARED VALUE

S2I stands on the idea that corporations and society don't (indeed, can't) thrive as wholly separate, unrelated entities.

Corporations need vibrant communities in order to create demand for their products and to provide a supportive environment in which to operate.

Society needs healthy, competitive companies able to create jobs, buy local goods from the community and pay taxes. Where these needs intersect, in a zone of shared values, is the sweet spot of S2I. It is our conviction that companies that demonstrate and remain committed to policies and practices that enhance their own competitiveness while simultaneously advancing economic and social convictions in their communities not only meet the ethical criteria of socially minded investors but stand best poised to prosper in a pure business sense.

Shared Value



SHARED VALUE: Policies and practices that enhance the competitiveness of a company while simultaneously advancing economic and social conditions in the communities in which it operates.

Corporations need vibrant communities to create demand for their products and to provide a supportive business environment.

Society needs healthy, competitive companies to create jobs, buy local goods and pay taxes.

THE FRAMEWORK

Our framework for assessing a company's commitment to social innovation rests on three pillars:

- **Human capital engagement.** How does the company treat all of its stakeholders (employees, shareholders, customers, suppliers and the community)?

  Considerations include such issues as the pay gap between management and employees, employee ownership, health and wellness, diversity and product quality, among others.

- **Environmental stewardship.** What policies does the company employ for interacting with the environment?

  Considerations include greenhouse gas reduction, renewable energy use, emissions, effluents and wastes, recycling and others.

- **Corporate philanthropy.** What are the standards and procedures regarding its role as a corporate citizen?

  Considerations include community engagement, community investment, corporate giving, employee volunteerism and community impact policies.

Measuring a company's actual commitment to these pillars involves a two-part review of stated policies and performance accountability.

- **Policy review.** We review, benchmark and score policies, based on our analysis that good policies indicate good management and are indicators of long-term value creation.
- **Performance accountability review.** Because good intentions don't always result in positive results, we assess companies by how effectively a corporation has implemented its policies. And, crucially, we consider whether it has capitalized on external incentives for good corporate behavior, and avoided costly fines and penalties.

However, it is our belief that while quantifying intent and peer-to-peer benchmarking is important, the direct tangible results of the policies must be measured in order to determine their absolute or relative success.

MONITORING AND MAINTAINING THE PORTFOLIO

Continual attention, monitoring and adjustment are required to keep the S2I properly balanced to achieve its goals. We review changes in U.S. Trust's recommended sector allocations and periodically rebalance the portfolio. We monitor position sizes to make sure the maximums are not violated. Whenever a stock price moves significantly, or our analysts change a rating to "sell," we initiate an intensive review of company fundamentals.

Similar assessments help ensure that our companies remain consistent with social goals. For example, all companies are set up for news alerts. Egregious violations of practices trigger an immediate review. In addition, we review all holdings quarterly by refreshing our model data, and we seek potential new investments by reviewing all eligible stocks biannually.

Stocks are sold if they fall from the S&P 500, if their position exceeds the 5% limit, if an analyst rating changes dramatically and a review indicates selling is advised, or if a company's Social Innovation Score dramatically shifts.

Portfolio Balancing Process

To learn more about investment opportunities and U.S. Trust's Socially Innovative Investing Strategy, please contact Jason Baron at either 617.434.1073 or jason.baron@ustrust.com.

Four myths about social investing debunked

MYTH #1:

Corporate social responsibility comes at the expense of profit.

- S2I was designed to identify companies that address social issues as part of their strategies to be more competitive in the marketplace — in keeping with the theory of Shared Value.
- Shared Value proposes that companies can improve their long-run position by looking for sustainable competitive advantages, including methods of engaging stakeholders on social issues.

MYTH #2:

Reliable and consistent data are not available.

- The Socially Innovative Investing Model addresses transparency and data manipulation by relying predominantly on third-party verified data. The quality of the data and the proprietary weighting of the model form the central value proposition of the strategy.

MYTH #3:

Interpretation of social metrics is extremely subjective.

- In our model, 46 independent data points divided into 32 criteria are collected and scored, and compared with their peers, sector by sector.
- Whenever possible, we set metrics and ranges as quantifiable targets. For example, 11 of the 32 criteria have definitive numerical targets that must be achieved for a company to receive a positive ranking.
- Our model to determine each company's composite social innovation score is applied uniformly. Companies must meet a minimum rated score, regardless of their sector.

MYTH #4:

Social investing underperforms the broad market.

- The S2I methodology was designed both to identify long-term value creators and to mitigate risk.
- When SRI strategies underperform, usually they do so because of poor portfolio construction, not social screening. To address this shortcoming, we:
  - Utilize U.S. Trust® thought leadership for sector overweights and underweights.
  - Require positive ratings from non-SRI analysts on each eligible security.
  - Maintain a rigorous buy, sell and rebalance discipline.

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Other Important Information

All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments.

Global investing poses special risks, including foreign taxation, currency fluctuation, risk associated with possible differences in financial standards and other monetary and political risks.

Investing in securities involves risks, and there is always the potential of losing money when you invest in securities.

S&P 500 Index: S&P 500 Index is a capitalization-weighted index of 500 stocks.

Unlike mutual funds, indices are not managed and do not incur fees or expenses. It is not possible to invest directly in an index.