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“A Climate Change by Any Name” part 2

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Making our Socially-Responsible Strategy Sustainable

As with most of our eight investment strategies, we custom-built AIP's Socially-Responsible LargeCap Strategy for a large client. We combined the quantitative forecasting and portfolio construction methodology we use in all of our investment strategies with the experience and expertise of KLD Research and Analytics® in socially-responsible screening to build an investment strategy which emulates the characteristics of our long-established LargeCap strategy, while omitting stocks from industries traditionally considered to have a negative impact on society (alcohol, tobacco, firearms, nuclear, and gaming). In late 2007, we added companies doing significant business with the Sudan to our restricted list.

The strategy has adhered to the aforementioned guidelines and has performed to our expectations over the past four-plus years, having outpaced both the S&P 500 Index® and the Domini 400® (please contact AIP for composite results). As we moved through 2008, we believed the time was right to take advantage of vastly improved coverage and data quality of environmental, social, and governance (ESG) research, thereby making our core socially-responsible strategy more robust. Our vision included the introduction of positive ESG scoring and increased diversity and granularity in our strategy offerings. Having incorporated the changes described below, AIP's Socially-Responsible strategy becomes our Sustainable Responsible LargeCap (SRL) strategy.

Introducing Positive Scoring

Since the strategy's inception in 2004, we have relied on KLD to provide us with the aforementioned industry and country screens. As we looked to evolve and improve our offering via the inclusion of positive ESG scores, we established a partnership with ASSET4®, a Swiss firm founded in 2003, which spans the globe with ESG research covering over 2,500 companies. ASSET4®'s database offers hundreds of customizable metrics with the ability to drill into supporting documentation to allow for complete transparency. This allows us to evolve from a “plain-vanilla” socially-responsible strategy (read – simple exclusion of certain industries) to a set of more customized sustainable and responsible investment (SRI) strategies.

The introduction of positive scoring comes with its own issues. ASSET4®'s Equal-Weighted Rating, for instance, derives one quarter of its weight from economic, environmental, social, and governance scores. However, with AIP's underlying forecasting process including fundamental analysis, our research shows the use of ASSET4®'s economic pillar to be redundant and ineffective.¹ Therefore, we have stripped ASSET4®'s economic score out of their Equal-Weighted Rating and re-blended the three remaining components to better complement our proprietary stock forecasts.

ASSET4® - End 2007 Rankings*

Consumer Staples	66.6%
Utilities	64.8%
Industrials	62.3%
Materials	61.8%
Technology	53.8%
Health Care	49.8%
Retail	49.1%
Energy	48.8%
Consumer Discretionary	48.7%
Financials	42.9%
Services	39.7%
AVERAGE	51.7%

*ASSET4® normalizes company ratings from 0 to 100, with 50 the median score. Higher scores are more desirable.
(Source: ASSET4®, AIP Research)

For AIP, building core portfolios necessarily means avoiding systematic biases and focusing instead on pure stock selection as the primary source of active risk. However, we have found that ESG data tends to be systematically biased. For example, the Services sector ranked lowest in ASSET4®’s equal-weighted scoring of environmental, social, and governance metrics, followed by the Financial sector. Conversely, sectors such as Consumer Staples and Utilities rank highest (see table above for a full breakdown).

In order to maintain the core nature of our sustainable strategies, we have normalized ASSET4®’s ESG scores within each economic sector and we have repeated that process for each industry as well. This enables us to implement a “best-in-class, best-of-breed” approach to SRI, wherein the companies with the best ESG ranks in any sector are favored and those in the bottom quintile of a given sector are avoided. Thus, AIP’s sustainable portfolios remove any broad sector bias which might have been introduced via positive ESG scoring.

Removing the Nuclear Restriction

Another change we made to the process is the removal of the nuclear constraint. This legacy constraint traces its roots directly to the Three Mile Island and Chernobyl accidents. These two events were devastating in nature; however, we believe the time to cast aspersions across all companies involved in the production of nuclear energy has passed.

We are removing the nuclear restrictions from our strategy for three reasons. First, while legitimate safety concerns linger, Generation 3 and Generation 4 nuclear power plants offer significantly



increased safety in the form of improved “passive safety systems, longer lifelines, optimized fuel use, reduced construction time, reduced waste, and increased proliferation resistance.”² Second, several companies that are involved in nuclear power generation are at the vanguard of alternative energy. NRG Energy and FPL are notable examples of this trend. Finally, nuclear power is one of Princeton University’s seven “wedges,” or choices, for policymakers to curb greenhouse gas emissions.³ Note that while we have removed this restriction from our strategy, an individual client may still direct AIP to prohibit ownership of nuclear companies in his or her portfolio.

Putting our Experience with Customized Solutions to Good Use

Our new SRL strategy maintains its previous restrictions (minus nuclear), but also ensures the ESG attributes of the portfolio exceed those of the S&P 500[®] benchmark. We have simultaneously developed a more narrowly defined set of value-based strategies to complement the basic SRL strategy.

Our new SRL Green strategy favors companies with strong environmental records as measured by environmentally friendly product innovation, efforts to diminish use of resources, and improved emissions control. Borrowing from techniques used in the SRL strategy, we normalize ASSET4[®]’s environmental score by economic sector. We eliminate any stock whose environmental score ranks in the bottom quintile of its sector and the portfolio’s weighted environmental score is constrained to be higher than the S&P 500[®] Index’s weighted rank.

This strategy follows the same dual-benchmark strategy as the SRL Strategy: the S&P 500[®] as primary benchmark (4-5% ex ante active risk), with a shadowing of our LargeCap portfolio as the secondary benchmark (1.5% ex ante active risk). Again, this allows us to build a truly green core portfolio which emulates our well-established LargeCap strategy. Companies in the alcohol, tobacco, firearms, and gaming industries are not automatically restricted from the SRL Green strategy. Thus, rather than a “green” strategy which is narrowly invested in alternative energy, we offer our clients a strategy which invests across the U.S. large cap spectrum, favoring companies in every sector which are at the vanguard of environmental protection within their respective peer group.

Other value-based strategies we are now able to implement include: a Catholic strategy which not only restricts companies involved in alcohol, tobacco, gaming, abortion, stem-cell research, and pornography, but also encourages investments in companies with strong records of human rights and board diversity; a Methodist strategy which restricts alcohol, tobacco, gaming, pornography, land mines, defense, and nukes, while again encouraging board diversity, human rights, and environmental awareness; and a Sharia-compliant strategy which should be available in short-order (all of these will follow the unique dual-benchmark strategy described above). In fact, as discussed by Bill Gates’ “The Road Ahead” and as seen with the ubiquitous iPhone, we believe our Sustainable and Responsible LargeCap strategy can be customized to meet almost any individual needs (think of animal rights metrics underlying a PETA or Humane Society endowment).



Looking in the Mirror

No company could conduct the amount of research we have and not help but think about what it can do to increase the sustainability and responsibility of its business. We at AIP have taken many steps to improve our awareness of corporate sustainability and responsibility, and we continue to evaluate opportunities to improve. Among the small steps we've taken:

- We have become members of the Social Investment Forum, a group of 500 investment practitioners and institutions who integrate economic, environmental, social, and governance information into our respective investment processes. Learn more at www.socialinvest.org.
- We are one of 226 investment managers across the globe to sign the United Nations' Principles for Responsible Investment, a six-point framework for incorporating ESG issues in investing. The Principles reflect the notion that ESG issues can affect the performance of investment portfolios and that applying the six Principles may better align investors with the broader objectives of society. Learn more at www.unpri.org.
- We are one of 25 global investment managers to sign a request that brokers continue to support and expand ESG research, even as budgets are pared.
- We have signed a letter to urge companies to review their suppliers' possible use of child labor to source cotton in Uzbekistan.

Within our office, we focus on several simple initiatives:

- Shredding and recycling used paper
- Donating dated office furniture, computers, and peripherals
- Curbing printing by using both sides of paper when copying and printing and using an eco-friendly font which reduces printer ink use by 20% (learn more at www.ecofont.eu)
- Turning on only one of two overhead lights in our offices and ensuring lights are turned off when we depart for the evening
- Using blinds to regulate sunlight and modulate heating/cooling needs
- Using fully or partially recycled and/or green office supplies and paper where practical

There are so many simple things we can all do to curb our footprint. Let's remember that these small steps we take are not really going to save the planet. Earth has endured much worse. The history of our planet tells us this is more about improving the quality of our lives.



Disclosure

Since inception performance results shown above represent historical gross composite performance of actual unrestricted program portfolios on the Fiduciary Services Platform that follow Advanced Investment Partners' Socially Responsible LargeCap strategy and do not reflect deduction of investment management or brokerage fees. Composite creation and performance results were calculated by the Smith Barney Consulting Group. Actual returns will be reduced by the expenses that may include investment management fees and cost of transactions. Program fees and expenses are disclosed on Schedule H of ADV, available from the Smith Barney Consulting Group. As fees are deducted quarterly, the compounding effect will be to increase the impact of fees by an amount directly related to the gross performance of the account. For example, on an account with a 2% annual fee, if the gross performance of 10% is earned evenly over a twelve month period, the compounding effect of four mid-quarter fee payments will result in annual net performance of 7.83%.

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The Domini 400 Social Index is a service mark of KLD Research & Analytics, Inc. KLD's Domini 400 SocialSM Index (DS400) is a float-adjusted market capitalization weighted common stock index modeled on the S&P 500® Index. The DS400 is the first benchmark for equity portfolios subject to multiple environmental and social screens. It is a widely recognized benchmark for measuring the impact of social screening on financial returns and the performance of socially screened portfolios.

ASSET4 is a provider of objective, comparable and auditable extra-financial information. ASSET4 provides professional investors and corporate executives access to a database of ESG information and the analysis tools to integrate that information into their everyday decision making. ASSET4 has 220 employees and is headquartered in Zug, Switzerland with locations in London, New York, Paris, Frankfurt, Mauritius and India. ASSET4 is a proud signatory of the UN's Principles for Responsible Investment and a contributing member to organizations and initiatives like: UNEP-FI, Eurosif, UKSIF, USSIF, Nachhaltiges Investment and the Ceres Coalition in the US. For more information, please visit www.asset4.com

Investors cannot invest directly in an index. These indexes are not managed or sold by Advanced Investment Partners.

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The performance information should not be shown without these accompanying notes.
This report is for use in one-on-one client presentations only.
The returns represent past performance and are not predictive of future results.
Past performance is not indicative of future results

Notes

1. We examined the return spread between the highest and lowest rated quintile of stocks for the original ASSET4® Equal-Weighted Rating and our revised ratings. Using a 12-month holding period and annual rebalancing, we found our revised ratings outperformed the ASSET4® Equal-Weighted rating by nearly 3% per annum over the past six and one-half years.
2. Eurosif Nuclear Sector Report, May 2008.
3. S. Pacala and R. Socolow, "Stabilization Wedges: Solving the Climate Problem for the Next 50 Years with Current Technologies," *Science* 305 (2004): 968-72.