REGISTERED INVESTMENT ADVISORS
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Diversification And Socially Responsible Investing

In the old days of socially responsible investing (SRI), following your conscience tended to come at the cost of at least a few percentage points in lost returns. SRI funds were few in number, and they tended to focus on avoiding broad swaths of the investing universe. Staying away from companies that slaughtered animals for food or provided feed for slaughterhouses, for example, would mean not investing in many large multinational firms—and in the large-cap mutual funds that hold those companies. Or objections to Asian labor practices would rule out putting money in many promising international stock funds that invested in that region. If you wanted to have a broadly diversified portfolio, you could pretty much forget about SRI.

Recently, though, several changes in socially responsible investing are making it much easier to diversify. Many SRI funds have shifted their emphasis from passively avoiding objectionable investments to an approach that actively seeks investment in profit-driving fundamentals—and that leads the funds to previously unexplored corners of the corporate world. Rather than simply shunning companies that profit from tobacco, polluting industries, child labor, or other frowned-upon products or behaviors, today's SRI funds invest in companies that embrace socially positive behaviors that may also boost the bottom line. Many SRI investment managers look for companies that focus on environmental sustainability and responsible governance, which they believe will foster success and reward investors.

This trend has led to a new acronym, "ESG," for "environmental, social, and governance." Today's SRI investors believe companies that focus on these three characteristics will perform better in the long term, partly by reducing their potential liability amid rising tensions in these areas.

Another factor in SRI's evolution is a rapid growth in the number of SRI funds. Increasing concerns about the environment and moral issues ranging from abortion to gun violence are prompting more fund managers to offer SRI-focused choices that may specialize in a particular area. Having more mutual funds and exchange-traded funds built around SRI principles makes it easier to tailor investments to your concerns and helps you to diversify. And whereas in the past most SRI funds concentrated on large-cap stocks—and usually considered only a narrow range of those big companies—now investors can also choose from among small-cap and mid-cap SRI funds.

One widely cited study, the Social Investment Forum's 2007 Report on Socially Responsible Investing Trends, showed that between 2005 and 2007, the amount of money committed to SRI funds rose at an 18% annual rate. More than 10% of all investment dollars under professional management in the United States, or $2.7 trillion, was invested in SRI funds in 2007, the report said, and more than 260 socially screened mutual funds were available in the United States, up from just 55 in 1995. A number of

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Could The Flash Crash Strike The Markets Twice?

We still don't know what scrambled U.S. equity prices for a few minutes last May. A few stocks soared to $100,000 a share, while others plunged to a penny, instantaneously vaporizing roughly $1 trillion in market capitalization. A few minutes later, everything was back to normal...except investor confidence.

Regulators will try to build circuit breakers that will stop trading in individual stocks that jump or plunge too far during a 30-second period. But critics argue that until we know exactly what caused the problem, there's no way to guarantee this solution will keep the market from crashing again. In fact, there has already been another incident in India, in which a single bad trade knocked the Bombay benchmark down 3.6%.

Computerized trading programs have evolved to where they can buy and sell countless times before the circuit breakers kick in. Another flash crash could crush flesh-and-blood traders caught between the programs and the circuit breakers.

For now, at least, it's best to leave split-second trading to the hedge funds. As your advisors, we provide a longer-term view on financial markets, looking at how they may affect you over the course of a lifetime. We recognize the difference between a computer glitch and a real shift in fundamentals.

We are not infallible, but the trading programs have proved that they're not, either.

Not All ETFs Are Tax-Efficient Anymore

It used to be simple. One reason to consider investing in exchange-traded funds (ETFs) was that you would make out better at tax time than if you put your money into standard index mutual funds. But as ETFs have thrived, with exponential growth since their debut two decades ago, they've branched out from stocks to bonds and now to commodities and currencies. While those more esoteric ETFs provide a convenient way for ordinary investors to participate in hard-to-tap markets, they also bring tax complications that can hit you hard even if you hold on to your shares.

Standard equity ETFs resemble index mutual funds, in that both may be designed to track a stock benchmark. But when investors redeem mutual fund shares, the fund manager may need to sell holdings to come up with the cash, and that can generate taxable capital gains that the fund passes on to shareholders. ETFs, in contrast, are more like stocks; they're traded on exchanges, and most transactions involve existing shares. So, there's less selling of the assets in the fund and fewer immediately taxable gains, though you'll still owe taxes if you sell your shares at a profit.

Many newer ETFs, however, are tied to the value of commodities or currencies, and those may be taxed in many entirely different ways. Such funds are often organized as trusts or limited partnerships, complicated structures that may generate several kinds of taxes. And these ETFs can own a very wide range of assets, from actual currencies and commodities to all kinds of derivatives—futures, forward contracts, options—that may be subject to various levels and timing of taxes. In many cases, you end up paying more than the 15% rate that applies to long-term capital gains of stock ETFs and mutual funds.

Sometimes, you'll even be taxed on gains the fund hasn't realized. The IRS may require a commodities fund that holds futures contracts, for example, to "mark to market" its positions in those contracts at year's end— and you may be responsible for gains that don't yet exist. You could also be on the hook if you own shares in a gold ETF that holds bullion or gold coins. Shareholders of those funds are subject to a tax on "collectibles"—at a 28% rate for long-term gains. The earnings of currency funds, meanwhile, may be taxed as interest, at ordinary income rates of as much as 35%.

In most cases, potential tax liability shouldn't be a deal-breaker when considering an investment. Yet it is a consideration, and it's a factor we look at when working with clients to construct investment portfolios that fit their financial goals, investing timetable, and investment risk-tolerance. If you wonder whether ETFs belong in your investment mix—and what kind of taxation you might face—please make an appointment so we can discuss these issues. ●

You should consider an exchange traded fund's investment objectives, risks, charges, and expenses carefully before you invest. The fund's prospectus contains this and other information about the fund and can be obtained from our office or from the fund company directly.

It's NOT The Economy, Stupid!

In 1992, then-candidate Bill Clinton used the slogan "It's the economy, stupid" to help him stay on message and pound President George H.W. Bush for his failure to pull the country out of a recession. The point was that jobs and other economic issues were what mattered most to voters. Yet while that may still be true as far as elections go, it oversimplifies things when it comes to investments. Your results ultimately have more to do with the choices you make in responding to economic conditions, rather than the actual state of the economy itself.

This is an important distinction that underscores the limits of a pure "buy and hold" strategy that just sticks with investments to wait for them to match their average past performance. While stocks do tend to track the general economy over very long periods of time—and stocks, like the economy, have always ultimately prospered—few investors can afford to wait several decades for beaten down investments to bounce back. Instead, it makes sense to take steps to mitigate the risk of sharp losses.

The events of the past few years have forcibly illustrated the fact that equities can be extremely volatile in the short term. And even if you're still 20 or 30 years from retirement, market ups and downs have a real impact on your returns. It's only at the 40-year mark that returns tend to fall in line dependably with economic progress, according to a recent study by economist Richard W. Kopcke and researcher Dan Muldoon at the Center for Retirement Research at Boston College.

Their study—"Why Are Stocks So Risky?"—shows that investor behavior has a far stronger influence over returns than do the gyrations of the economy, especially over periods of 20 years or less. The authors define investor behavior as "the way shareholders react to their uncertainty

Understanding The Realities Of Charity

For charities, the economic downturn has posed extraordinary challenges. Social services organizations, in particular, have faced mushrooming demand as unemployment, family problems, homelessness, and other human symptoms of the downturn all have increased sharply. At the same time, corporations, foundations, and individual donors, feeling the economic pinch, have cut back on their support.

According to the Giving USA Foundation, donations fell 3.6% in 2009 to $303.75 billion, down from $315 billion in 2008. This is the steepest decline in current dollar terms since Giving USA began its annual reports in 1956.

You may have been compelled to limit your own philanthropic contributions, and even if you've found a way to continue giving, it's more important than ever to make sure your dollars are having maximum impact. You need to know about the organizations you support—how they're using your money, how efficiently they're run, and whether they're living up to their missions.

In order to get a tax deduction for your gifts, you also need to have a proper acknowledgement from the charity and adhere to the IRS's recently toughened requirements. These are the new realities of charitable giving.

The internet has greatly simplified the process of finding a charity, learning about its mission, and doing due diligence before you contribute. Guidestar.org, for example, maintains a directory with information about almost two million charities recognized by the IRS. You can search the database for a particular organization or use keywords, location, and other criteria to look for groups with a specific mission. Type in "homeless" and click Arizona, for instance, and you'll get a list of 210 organizations.

Guidestar and other sites provide comprehensive information about a charity's activities. Charity Navigator (charitynavigator.org) evaluates the financial health of more than 5,400 of America's largest charities, while the Better Business Bureau (bbb.org/us/charity) offers a wealth of resources for both charities and consumers. Its "Wise Giving Guide" summarizes the results of recent evaluations of charitable organizations and provides tips on gift-giving and charitable accountability issues. The American Institute of Philanthropy operates a website (charitywatch.org) that grades more than 500 public charities and focuses on special issues such as compensation for charity executives, top-ranked groups, and "hot topics."

With all of this information literally at your fingertips, it's easy to dig deeper. Find out how much of a group's budget goes to its programs and how much is earmarked for fundraising, other administrative costs, and overhead. (Most organizations should allocate at least three-quarters of their spending to programs.) Look at a charity's annual reports to evaluate its finances and its commitment to its mission. Be wary of those that have consistently operated at a loss.

You can read more financial details in the Form 990 every charitable organization must file with the IRS. Look for a copy on the group's website or call to request one.

Most major charities have adopted a "Donor Bill of Rights" that several philanthropic associations jointly created. Available at Charity Navigator and other internet sites, the document lists 10 things you should expect from any reputable group. This includes information about the group's board, whether it uses paid solicitors to ask for donations, and a promise to treat donors with respect. These guidelines give you one more tool for taking stock of an organization you're considering.

Once you've selected a charity and made a donation, you need to make sure that you have the documentation needed to claim an income tax deduction. The Pension Protection Act of 2006 tightened the rules for substantiating monetary gifts, and you now must have a written record of any contribution. If the IRS asks, you need to be able to show a bank statement or a written communication from the charity verifying your gift. This should show the organization's name, the date of the contribution, and its amount. This requirement now applies to all monetary contributions, even small gifts given in cash.

Charities need your help now more than ever. If you understand the realities of charitable giving, you can deliver your money to deserving groups that will put your generosity to good use. ●

about economic conditions, form opinions about the future, and manage their portfolios."

The good news is that of the two factors—economic conditions and investor behavior—that influence investment returns, the one that exerts the greater influence is the one you control. What really matters are the decisions you make in setting up and operating your investment portfolio.

Those choices include everything from defining your risk tolerance and setting life goals to diversifying your portfolio and reallocating assets in response to shifting short- and long-term trends. Maintaining broad diversification spreads your risk across and within multiple asset classes, and making regular, strategic reallocations helps you stay diversified even as conditions change.

Now, as the economy embarks on what could be a long, uncertain recovery, we can help you make sure that your portfolio is positioned to reflect who you are and what you want to accomplish.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Responsible Investing

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recent studies have shown that funds screened for social concerns have performed comparably to non-SRI funds in terms of average annual growth.

If you are interested in SRI, or ESG, what do you need to know? Here are some questions to explore, courtesy of Morningstar:

- **What issues are most important to me?**
  Are you interested in a religious or a secular fund? What issues are driving your decision—the environment, workplace diversity, weapons proliferation?
- **How does a fund screen its investments?**
  Do the fund managers screen out all involvement in your issue, or do they take the approach of investing only in those firms with "best practices" in the industry involved in your issue?
- **Is this fund involved in shareholder activism and community investment?**
  Look at the fund's website or call the fund company to find out whether managers actively push for change among companies they invest in, and determine whether this matters to you.
- **Is this a good investment?**
  You must do your homework as you would with any fund, and also be aware that many SRI funds charge higher fees to pay the cost of added research.
- **How do these funds work within my overall portfolio?**
  Any fund you invest in should be seen as part of a rational investing strategy that is properly diversified, including SRI funds.

We can help you consider these and other questions related to social responsible investing and work with you to create a portfolio that addresses your priorities, financial and otherwise. ●

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Mutual funds are offered by prospectus. Please consider the charges, risks, expenses, and investment objectives carefully before investing. The prospectus contains this and other information and may be obtained from our office or from the fund company directly.

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