Socially Responsible Investing

By:

Katie Stuyvenberg
Abstract

Socially responsible investing (SRI) is an investment strategy that combines the maximization of both financial return and social good. Its principles are rooted in Judeo-Christian and Islamic tradition, which support peace and avoid business with harmful practices. Over the years, SRI has experienced changes and adaptations since its creation hundreds of years ago. The main strategy employed by socially responsible investors is screening, by which companies are included or excluded based on either positive or negative criteria. The performance of SRI funds can be measured with the use of two different SRI benchmarks, the Domini 400 Social Index and the Dow Jones Sustainability Index. Two main thought processes are involved with socially responsible investing. The first is that by investing socially, one forgoes the financial return. The other is that it is possible to make competitive returns to, or better returns than, the S&P 500 by participating in SRI. There is no proof that either of these beliefs is exclusively true. Despite this, the popularity of SRI has increased significantly over the past ten years. While nobody can be certain of what the future holds for socially responsible investing, it is safe to say that it’s not disappearing anytime soon.
Social responsibility is becoming a popular topic in the corporate world. Businesses are increasingly looking for ways to incorporate sustainability and social responsibility into their business strategies. Socially responsible investing (SRI) has also become popular, especially in recent years with growing environmental concerns. SRI can be thought of as an investment strategy that combines the maximization of both financial return and social good.

Socially responsible investing is a rather broad idea with many different definitions that are based on an individual’s beliefs. The Social Investment Forum, a U.S. national nonprofit membership association for those who are dedicated to promoting the practice and growth of socially responsible investing, provides a clear, comprehensive definition: SRI is “the process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis” (Chieffe & Lahey, 2009). Basically, SRI investors avoid companies associated with undesirable businesses, such as alcohol, and/or invest in companies that are engaged in more desirable businesses, such as green technology (Leahy, 2008). The concept of socially responsible investing is not new, and its origins are, perhaps surprisingly, rooted in religious tradition.

The idea of SRI has existed for hundreds of years, and it was mainly practiced by religious and philanthropic groups for much of its history, only recently becoming mainstream. The principles of SRI are fixed in Judeo-Christian and Islamic tradition, which support peace and avoid business with harmful practices. The Quakers were the first group to adopt the practice of SRI in the 17th century by prohibiting members from taking part in the slave trade. The Quakers
followed strategies that matched their principles of non-violence and human equality. Early Methodist investment strategies also incorporated SRI by avoiding companies involved with alcohol and gambling, which became the first investment screens ever created. In more recent times, such as during the Vietnam War, some investors screened their investments to avoid companies that supported the war (Blowfield & Murray, 2008).

In 1971, the Pax World Fund was established in the U.S. in response to the investor demand for the exclusion of companies benefiting from the Vietnam War (Blowfield & Murray, 2008). The Pax World Fund was the first SRI mutual fund, which had $101,000 in assets and was the first to use social and financial criteria in its investment decisions (Chieffe & Lahey, 2009). The fund was started by two Methodist ministers, whose motivations included providing a fund that allows people to invest in companies that share their values and setting standards of environmental and social responsibility that businesses should be challenged to live up to (Chieffe & Lahey, 2009).

Socially responsible investing has experienced changes and adaptations since its creation. SRI first began as a “values-based” approach to investing, meaning it was aimed at aligning investors’ beliefs and values to the greatest extent possible with their portfolio holdings (Rubin, 2008). Values-based investing constructs portfolios using personal values and disregards the financial impact of those decisions. Investors using a values-based approach look to achieve social objectives while at the same time creating returns. During the 1990s the “value-seeking” approach was developed as an alternative SRI strategy. Value-seeking investing examines how social and environmental performance affects a company’s share value. These investors are more concerned with making profits, and therefore they rely on non-financial screens (environmental and social impacts) as factors that influence stock performance. The newest
approach to SRI is called the “value-enhancing” approach. It is used by investors who don’t typically consider themselves to be socially responsible, such as pension fund managers. These investors try to increase the value of the companies in which they invest by using shareholder activism to force companies to engage in good corporate governance.

Socially responsible investing is typically based on three key strategies. These strategies include screening, shareholder advocacy, and community investments (Chieffe & Lahey, 2009). Screening, which will be discussed in detail later, is a common approach to SRI that includes or excludes companies using positive or negative screens. Shareholder advocacy is used to promote superior social and environmental performance in companies. These social and environmental changes are brought about based on how the shareholders vote at the annual meetings of companies in which they invest. Lastly, community investing relates to allocating a portion of a fund’s assets for investment in disadvantaged areas. It is the least used strategy of SRI, but it is also the fastest growing area, increasing by 540% in the past 10 years. The Social Investment Forum is currently encouraging all investors to invest at least 1% in community investment. (Goldberg, Goldberg, & Ratliff-Miller, 2008).

Besides the 3 key strategies described above, there are two important methodologies used by SRI fund managers in assessing investments. The first is screening and the second is best-in-class approach (Leahy, 2008). Screening, as mentioned above, is setting standards that each potential investment must meet. There are qualitative and exclusionary screens. Qualitative screening evaluates a company based on its performance in areas such as environmental practices, employee diversity, and work conditions. Exclusionary screens set standards for company investment in certain inappropriate business practices, and those that don’t meet the standards are excluded. The most common exclusionary screens are for tobacco, alcohol,
gambling, arms and nuclear power (Leahy, 2008). The best-in-class methodology evaluates companies from the same industries to identify those with the best social and environmental performance. For example, a screened bond fund might exclude all mining companies due to environmental concerns. However, a best-in-class fund invests in the mining company with the best environmental record (Leahy, 2008). The Dow Jones Sustainability Index, which will be discussed soon, uses the best-in-class method in creating its funds.

As mentioned above, screening is most often the main strategy for SRI mutual funds. The use of screens as a common strategy began during the Vietnam War, as Americans were fighting for civil rights, women’s rights, and environmental policies. This led to screens for animal testing, products and services, and the environment. Today, there are eleven frequently used screens, which are alcohol, tobacco, gambling, defensive weapons, animal testing, products and services, environment, human rights, labor relations, employment equity, and community investments. Most funds will screen for multiple criteria, which is likely in an attempt to appeal to more investors (Chieffe & Lahey, 2009). This list of screens has changed and evolved over time, and will continue to do so as different social concerns develop.

For most of SRI’s history, people “screened out” investments, meaning they invested based on negative screens. Today, more and more investors are “screening in” companies that have good environmental and management records (Mincer, 2008). Negative screening removes companies that take part in negative business and environmental practices. The Social Investment Forum surveyed 201 socially screened US funds and found that tobacco is the most commonly used social screen, affecting over 88% of the total assets in socially screened funds. Alcohol came in second with 75% of the total assets and gambling in third place with 23% (Blowfield & Murray, 2008). Employing negative screening as an investment strategy can be
risky, because it can cause diversification issues by limiting the companies in which one can invest (Blowfield & Murray, 2008). Using solely negative screens can also result in missed alpha opportunities. It is essential to balance the use of negative screens with both fundamental analysis and positive screens to ensure the maximization of alpha (Rominger & Bamford, 2008). Positive screening is investing in companies that are the best at corporate governance, social, environmental, or ethical criteria, and that support sustainability. Positive screening is related to a triple bottom line investment approach, which ensures that a company performs well economically, socially, and environmentally (Blowfield & Murray, 2008).

Within the last 20 years or so, socially responsible indices have come into existence to act as benchmarks for SRI funds’ performances. The two main indices are the Domini 400 Social Index (DS400) and the US portion of the Dow Jones Sustainability Index (DJSI) (Blowfield & Murray, 2008).

The DS400 was started in May 1990 and was the first SRI index of its kind. Back in 1990 the index was created by removing 200 stocks from the S&P 500 with the use of social screens and then adding 100 stocks to balance out the index by sector. The goal then was to set a benchmark for SRI fund managers that was subject to social and environmental screens. Today, the DS400 is comprised of 250 companies (mainly large cap) in the S&P 500, 100 additional large and mid cap companies chosen for sector diversification, and 50 smaller companies with exceptional environmental, social, and corporate governance records (Blowfield & Murray, 2008). This index was produced by KLD Research and Analysis, Inc., and it excludes firms that earn revenue from manufacturing alcohol or tobacco products, gambling products and services, electric utilities that own parts of nuclear power plants, and firms that make over 2% of its sales from producing military weapons. It also excludes companies with a negative record on
environment, diversity, and employee relations (Chieffe & Lahey, 2009). Since its inception on May 1, 1990 through March 31, 2009, the DS400’s annualized performance is 7.74% compared to the S&P 500’s annualized performance of 7.01% over the same time period. Over the past year, from March 31, 2008 to March 31, 2009 the DS400 has outperformed the S&P 500 by 3.05% (KLD, 2009). Further, a study in 2000 found that the DS400 is riskier than the S&P 500 and outperformed the S&P 500 from 1990-1998 in actual returns and risk-adjusted returns (Chieffe & Lahey, 2009). Some might find these facts surprising, as many believe that by participating in socially responsible investing one must give up on the possibility of competitive returns. These performance results prove quite the opposite.

The Dow Jones Sustainability Index is another commonly used socially responsible index. It was established in 1999 and was the first index to track the financial performance of the leading sustainability-driven companies on a world-wide basis (Blowfield & Murray, 2008). The DJSI focuses on a best-in-class approach, which was described earlier. The index’s assessment criteria include corporate governance, labor practices, risk and crisis management, and human capital development among others (Blowfield & Murray, 2008). Before becoming a member of the DJSI, companies are closely examined based on a variety of criteria, such as their economic, environmental, and social behaviors, that are then quantified and weighted (McPeak & Tooley, 2008). Being a member of this index has its benefits. Companies are publicly recognized for being an industry leader and their performance results are highly visible (McPeak & Tooley, 2008). Since its establishment on August 31, 1999, the DJSI has an annualized performance of -24.15% compared to the MSCI World Index’s performance of -23.55% over the same period. The DJSI one year performance from March 31, 2008 to March 31, 2009 is -45.17% compared to MSCI World Index’s performance of -42.58% (Dow Jones, 2009). DJSI has outperformed
MSCI World in several different years, but it seems that the two indices realize very similar results year after year.

Constructing an SRI portfolio is done in the same manner as building a traditional portfolio. An SRI portfolio can contain mutual funds, ETFs, bonds, and stocks just as a conventional portfolio might contain (Mincer, 2008). There are a number of other ways to invest in SRI as well, such as venture capital, hedge funds, and international funds (Goldberg, Goldberg, & Ratliff-Miller, 2008). In 2007, 11% of assets under professional management in the US were invested in companies based on their environmental or social records (Leahy, 2008). The Social Investment Forum 2007 Report stated that nearly 1 in 9 dollars of professionally managed assets was invested in SRI; and, between 2005 and 2007 these investments increased by over 18%, compared to 3% for other professionally managed assets (Goldberg, Goldberg, & Ratliff-Miller, 2008). The Social Investment Forum also reported that in 1995 there were 55 SRI funds worth $639 billion, and in 2007 there were 260 funds worth $2.71 trillion. This shows a 324% growth over 12 years, and indicates the huge potential for growth into the future as well (Chieffe & Lahey, 2009).

Two main thought processes are involved with socially responsible investing. The first is that by investing socially, one forgoes the financial return. The other is that it is possible to make competitive returns to, or better returns than, the S&P 500 by participating in SRI. There have been many academic studies comparing ethical and non-ethical funds and have found, in fact, that there is no difference in financial performance (Blowfield & Murray, 2008). David Vogel, Professor at the Haas School of Business at Berkeley, believes that investing in social responsibility pays sometimes, and sometimes it doesn’t. He notes that some companies have gained competitive advantages by being responsible, while other responsible companies have
actually performed poorly financially. It completely depends on the company. Vogel says that if there is a positive relationship between social responsibility and financial performance, it could likely be due to the fact that profitable companies usually have more resources to engage in socially responsible activities. Yet, there are many socially irresponsible companies that have done quite well financially, such as Philip Morris and Exxon Mobil. In the end, Vogel maintains that there is neither a positive nor a negative relationship between social responsibility and financial performance; rather, there is little or no relationship at all (The Market for Virtue, 2006).

While there might not be a relationship between social responsibility and financial performance, people have experienced competitive returns with SRI. A study by Goldman Sachs Group in 2008 found that stocks of companies with solid social responsibility policies outperformed their peers by 70% over the past two years (Goldberg, Goldberg, & Ratliff-Miller, 2008). The Winslow Green Growth Fund is the best performing no-load SRI, with 3 year annualized returns of 35%. It has nearly $300 million in assets and screens for companies with positive environmental records. Another SRI fund performing well is the Ariel Fund, with $5 billion in assets. Its 3 year annualized return is 19%, compared to the S&P 500’s 15% return. It is often the case that SRI funds are better at maintaining capital in bear markets than making profits in a bull market, which is important to realize at this time in the US. Some believe that SRI funds might lag behind the market because they are not invested in oil companies, which are some of the best performers in recent times (McPeak & Tooley, 2008).

Still, there are others that believe that one cannot expect competitive returns with SRI. A Morningstar study in 2008 found that socially responsible funds returned 7% less than conventional funds over the last 5 years (Goldberg, Goldberg, & Ratliff-Miller, 2008). Lipper
data also shows that for the four years leading up to the peak in US equities in 2007, the median SRI equity underperformed its conventional peer by about 2%. One possible reason for this is that it might pay to invest in “sinful” stocks in a downturn (Anonymous, 2008). Merrill Lynch analysts researched this idea and found that during the six recessions since 1970, alcohol, tobacco, and casino stocks have returned 11% on average compared to a loss of 1.5% for the S&P 500. Merrill Lynch also reported that these “sinful” companies are outperforming the broader market now by about 10% (Anonymous, 2008).

The Global Reporting Initiative was incorporated in Amsterdam in 2002 as an independent nonprofit and has developed standardized sustainability reporting guidelines. The GRI guidelines are the most commonly-used framework in the world for sustainability reporting. Today, over 1,000 organizations from over 60 countries use these guidelines to produce their reports. The GRI created “the world’s de facto standard in sustainability reporting guidelines, which organizations follow to publicly communicate their economic, environmental, and social performance” (Rubin, 2008). Because companies disclose their information in the public domain, sustainability reporting promotes transparency and accountability, in addition to helping these companies manage their impact. Reporting often leads to improved sustainable development outcomes, because it allows organizations to measure, track, and improve their performance on specific issues. Organizations are more likely to effectively manage an issue that they can measure. From an investor standpoint, sustainability reports provide them with criteria beyond financial statements with which to evaluate an investment. Socially responsible investors are urging companies to issue sustainability reports; those companies that provide them could earn a competitive advantage in attracting and retaining a growing share of investors. The
ultimate goal of the GRI is to make sustainability reporting by all organizations as routine and comparable as financial reporting (Rubin, 2008).

While no one can be certain of what the future holds for socially responsible investing, it is safe to say that it’s not disappearing anytime soon. Its popularity has increased significantly over the past ten years. Companies and investors alike are beginning to realize the importance of social responsibility and the connection between profitability and social behavior. Lately it’s become “chic” to be socially responsible, whether by going green or by excluding tobacco from one’s portfolio, and I believe that this trend will continue on for years to come.
Works Cited


The following pages are a collection of diary entries from my Portfolio Management class this past year. These diaries are intended to show what I learned in class and how it can be applied to practical purposes.
Today’s class time focused mainly on teams presenting their preliminary recommendations to buy, sell, or hold their stocks. We also had two guest speakers, Harry Papp and his wife Rosellen Papp. In the last few minutes of the class, the portfolio committee presented its reports on asset allocation and sector weightings. Unfortunately, we ran out of time and could the committee could not finish their presentation.

This is the second Friday that teams had been presenting their initial recommendations, and overall the material in the presentations were well researched and thought out. The presentations were quite detailed and rather time consuming, which often left little time for discussion. Yet, I sometimes felt like I needed a little more information about the company and our holdings to feel really confident in making a decision when teams recommended buying more of the stock. My team was supposed to present today as well, but the class ran short on time so we are now scheduled for next week.

The two guest speakers were very interesting, and I enjoyed listening to them speak. Mr. and Mrs. Papp are with L. Roy Papp & Associates, LLP. The two mainly spoke to us about their firm and their investment process. Among other qualities, this company looks to invest in growth companies who are highly leveraged, established market leaders. They also talked to us about their Buy/Sell discipline and 20 of their largest equity holdings managed by L. Roy Papp & Associates, LLP. Their investment strategies were very logical, and I think that I will consider them when I begin to invest my own money.

Finally, at the end of class, the portfolio committee was given a chance to present their recommendations on sector weightings. As they only had about 15 minutes to present and answer questions, the process was a little stressful. The class did not feel prepared to make such an important decision, so the voting was postponed until the following week. The honor’s students requested that the portfolio committee post their presentation to Blackboard so the rest of the class could look it over and be prepared to vote next week.
I felt as though this week’s class was the most productive class we have had yet this year. We finally had the chance to make decisions that will affect the performance of our portfolio. Dr. Seeley canceled our guest speaker for the day in order for us to have enough time to finish preliminary recommendation presentations and the sector weighting presentation. Also, the class was informed of the many holdings that were stop-lossed in the past week.

My team presented our preliminary recommendations to buy, sell, or hold our equity holdings in the Healthcare sector. Despite 3 of our 4 holdings being stop-lossed, we still presented on each of our companies. As a team, we had initially decided to hold everything but 200 shares of Medtronic. However, after St. Jude, Medtronic, and Johnson and Johnson being stop-lossed, we made the decision to buy back in total St. Jude and Johnson and Johnson and 300 of the 500 Medtronic shares. Baxter was the only company not stop-lossed. Our presentation went very well, and I think Dr. Seeley and the class were pleased with our decision.

The portfolio committee had enough time this week to finish their sector weighting presentation and the class voted on their suggestions. Because so many of our equity holdings had been stop-lossed, most of our portfolio was held in cash, and therefore quite risky. The class had to make quick decisions in the last few minutes on which of the stop-lossed holdings we wanted to buy back in order to increase the percentage of equity in our portfolio. This is when my team made our decisions to buy back the equities mentioned in the previous paragraph.

Also, during the week the Honors Students contacted the portfolio committee to try to work together in improving communication between the graduate students and the seniors. We thought it was important for everybody in the class to be on the same page, so as to avoid pressures of making decisions on the portfolio when not fully informed (as we had to do last week). The portfolio committee will begin to post their presentations on Blackboard before class, so that the other students can take a look at them and be prepared to discuss the ideas and make informed decisions. The portfolio committee also invited the class to attend their meetings and become even more involved in the class.
As I was not in class on October 17 due to being in Phoenix for an interview, I was not able to write a diary entry for last week.

Group Meeting

The purpose of Monday’s meeting was basically to inform the group of any new companies that might be of interest to invest in. Guillem has been researching Telefonica (an international telecommunications company out of Spain) and is contemplating presenting his information to the class. We currently have no telecommunications holdings; we need to take action soon in order to fulfill the required weighting of that sector, and in turn boost the overall equity weighting.

The group is also looking into other healthcare companies in which to invest. This has proven to be somewhat difficult, as many of the healthcare companies do not appear to be to attractive. There is often a lot of debt and small dividends. We have found one company, Abbott, which looks interesting. However, there is still much research to be done before coming to a decision regarding buying stock in this company. We are also considering buying more stock in a company that we already own, such as Baxter. I am sure that we will continue this discussion next week in our meeting.

Class Discussion

Friday’s class was busy as usual. Mr. Seeley reported to us that we beat the benchmark again, despite experiencing a loss of 12%. The S&P 500 was down 22% so far this month and the Lehman Aggregate was down 5%, resulting in a loss of about 15% in the blended benchmark. We also briefly reviewed money markets and the different types of money market funds one could invest in. There are tax-exempt money markets and taxable ones that included Treasury, Federal, and Prime money markets.

The Portfolio Committee also presented on Friday with a recommendation for Fixed Income weightings. The class agreed upon their suggestions. We will now be over-weighted in US Treasuries, under-weighted in Agencies, equally weighted in corporate, and over-weighted in international government bonds.

Our overall goal is to increase our equities to a weighting of 55% and our fixed income to a weighting of 40% (cash at 5%).

Finally, two groups presented with recommendations to buy 600 shares of Meritage Homes and 1,000 shares of Microsoft. Buying Meritage Homes was voted down, but the class would reconsider if the group comes back with requested information next week. Buying Microsoft was approved in an overwhelming majority.
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Group Meeting

During this week’s group meeting, we discussed more possible companies in which to invest in the healthcare and telecommunications sector. The six of us really like Telefonica (telecom sector) and Guillem is planned on presenting the recommendation to the class on Friday. Also, Phuong had been researching Gilead (healthcare sector), and she is ready to present as well on Friday. I am still in the process of researching Aetna; however, I am not sure that we will need to invest in another healthcare company if the class agrees to buy Gilead.

Class Discussion

The portfolio committee presented a recommendation to change the asset allocation for our portfolio. The class voted to increase the equity holdings to 60% from 55%. At this point the class has only about 43% equities, so we have a lot of work to do. This new increase in equities, will decrease the amount of bonds to 35% and cash will remain at 5%.

The portfolio committee also recommended to get rid of OIBYX, due to its investment in emerging markets and non-investment grade funds. The class voted to replace it with American Century International Board (BEGBX). It has a high total return by investing in high-quality, non-dollar-denominated government and corporate debt securities outside of the US. There are no emerging markets in the fund and it is made up entirely of AAA rated securities. The expense ratio in 0.82%, and it outperformed OIBYX over the past year.

There were several buy presentations this week. The first was to buy as many shares of Telefonica (TEF) that will help us meet our telecommunications sector weighting. The class voted to buy these shares.

The second presentation was to buy 820 shares of Hudson City Bancorp, Inc (HCBK), and the class agreed with the recommendation again.

The third presentation was to buy 900 shares of Morgan Stanley (MS) at $15.39. The class voted to buy this stock as well.

And lastly, the consumer staples group recommended to buy 800 shares of PriceSmart (PSMT). PriceSmart is a membership shopping warehouse in Central America and the Caribbean. The class agreed with the recommendation and voted to buy the shares of PriceSmart.
Katie Stuyvenberg  
Fin 423a  
Diary Entry #4  
November 14, 2008

**Group Meeting**

Our group did not hold a group meeting this week.

**Class Discussion**

Our month-to-date portfolio performance again beat our benchmark. Our portfolio return is 0%, while our blended benchmark return is (3.6%).

Three men from Edward Jones came into class to discuss Fixed Income trading with the class. Two of them were former students of this class. EJ typically trades CDs, corporate bonds, etc., and deals mainly individual investors. The class learned that the Fixed Income market is roughly twice the size of the equity market, nearly $15T. They also discussed the advantages to holding bonds, such as they provide income and security/diversification. Also, since the 1970s, every time the stock market has been down, the Fixed Income market has been up. Lastly, the men made some recommendations about fixed income, saying that corporate bonds offer attractive rates and utilities and industrial issuers are good areas to research. Also, there are a lot of opportunities in municipal bonds, due to their being tax-free.

The day was mostly spent listening to recommendation presentations and voting on whether or not to hold these suggested stocks. The first presenters recommended buying 400 shares of Peabody for the energy sector. Peabody is the largest private-sector coal company. The class, however, voted not to purchase this company. There wasn’t much feedback from those who voted no, but a couple people said they wanted more information on why coal is going to be important to the world in the future. The second presentation was about buying 400 shares of Honeywell for the industrials sector. One person who worked at Honeywell over the summer noted that the company does really well in war times and tends to struggle otherwise, but it has a lot of contracts for this war and will continue to do well for the next few years. This recommendation passed. The third recommendation was to buy 350 shares of Gilead for the healthcare sector. The class voted yes. The fourth group to present wanted to buy 400 shares of Research in Motion (RIM), the makers of the Blackberry, for the information technology sector. The class voted yes on this buy, because it was confident that RIM was undervalued and would continue to do very well in the next few years with their new product line. The fifth and final recommendation was to buy 500 shares of Boardwalk Pipeline LP for the energy sector. This company provides the capacity for oil pipelines. The class voted yes on this recommendation as well.

With four out of the five recommendations passing, this will help the portfolio increase its equities and get closer to reaching our weighting goal of 60%.
Katie Stuyvenberg  
Fin 423a  
Diary Entry  
November 21, 2008

*Group Meeting*

Our group met briefly this week to review our holdings and share our findings on new companies. We agreed to make weekly updates to our fellow group members on recent news findings about our respective companies. We realized that we were getting very caught up in researching new companies that we weren’t paying much attention to our current holdings.

*Class Discussion*

Our portfolio’s month-to-date return as of November 20th was (11.1%). This once again beat the blended benchmark return of (15%).

We spoke about the upcoming Investment Committee Meeting, which takes place on December 12th. The class has completed the book of investment information and the portfolio committee is prepared to present. Also, a few newly purchased companies will also be presented by those who recommended the buy.

Several stocks were stop-lossed this week, including PSMT, PX, XTO, DCI, MDT, and RIM. The class decided to buy back all of these except for MDT. The class agreed that nothing had fundamentally changed with the other companies that were stop-lossed. Also, Clint, who recommended the Morgan Stanley buy, gave the class an update on the company. It has declined about 40% in the two weeks we’ve owned the stock. His presentation was aimed at reassuring the class that MS is still a good company to buy. The class did decide, though, to put in a stop loss at 30% of the closing price today. MS previously had no stop loss. This stop loss amount relates to its 52-week low of $6.71.

There were two recommendation presentations as well today. The first was to buy 1000 shares of Mack-Cali Realty Corporation (CLI) for the financial sector. CLI is a REIT, real estate investment trust. The class voted yes on this recommendation to help diversify the financial sector.

The second presentation was to buy 400 shares of Peabody (BTU). This was presented last week and was voted down. This time around, the girls presenting concentrated on why coal is important and how coal will help diversify the energy sector. The class voted yes this time around.
This week’s guest speaker was Ben Armstrong from FAMCO, Fiduciary Asset Management. He had a few words of wisdom throughout his talk. The first is that the history of finance is full of “crises”, and this most likely will never change. We always get through them and are able to move on. Mr. Armstrong also said that to be a good investor, you really only need to be right 60% of the time. If you know when to cut your losses the other 40% of the time, you can be successful as an investor. One of Mr. Armstrong last points involved how to compensate portfolio managers. He asked us if we thought that compensation based on performance is fair. The class decided that compensation should be based on risk, performance, and consistency of performance. Mr. Armstrong agreed, saying that people can’t control outcomes, but they can control the process of choosing investments.

We talked in class about our portfolio performance and the market’s performance last week. Mr. Seeley wondered if we might have missed a rally, because we were underweighted in our equities. Our portfolio last week had 60% equities, despite the class voting to increase the weighting to 65% weeks ago. Our benchmark is 70% equities, so we might have missed out on some of last week’s market rally compared to our benchmark. During the economic review this week, NASDAQ’s (composed of tech and small cap) returns revealed a tech rally. Its YTD returns were far ahead of the other indices. We knew that the rally was due to tech stocks rather than small cap companies because the Russell 2000 (composed of small caps) was down about 11% YTD.

The Portfolio Committee also presented this week with their attribution analysis of our portfolio. The committee calculated alphas for our portfolio and for our equities since inception in 2002. The alpha for our portfolio is 1.92% and the alpha for our equities is 1.16%. This shows that our class is adding some insight and knowledge into our portfolio to perform above and beyond our benchmark.
This week, Bob Kuberek spoke to our class about Manager Selection for portfolios. He said the first thing to do is to determine the investor’s objectives and then identify his or her constraints, such as time horizon or risk tolerance. Next, you’d screen your database and create a short list of candidates for managers. Then, a great deal of research is necessary, including both quantitative and qualitative evaluations of the possible managers. Once this is complete, you should be confident that you can select a manager that will result in the best possible returns within the objectives of the investor and his certain constraints.

Later in the class, part of the Portfolio Committee presented their project on Portfolio Attribution Analysis. They were able to determine why we got the returns we did and what helped us to beat our benchmark each month. We learned that underweighting Financials was the best decision we made weighting-wise. In the Industrials sector, the specific stocks we chose helped us outperform our benchmark. Furthermore, most of our excess return is a result of our asset allocation. It accounted for about 77% of our excess return. Stock selection accounted for about 30% of our excess return, and bond selection decreased our excess return by about 2.5%.

There were three stock recommendations and three buys this week. The first was LDK, a solar company. Many in the class were concerned because we already hold a solar company in our energy sector. What would be the point of buying into another solar company? Further, our energy sector is now very heavily invested in alternate energy, and not everyone was certain this was the right direction in which to go. The next company was Becton, Dickinson and Company (BDX) to go into our healthcare sector. This buy was intended to replace JNJ, which has been underperforming lately. JNJ is also a very diverse company, and isn’t necessarily a strictly healthcare company. That group wanted to concentrate on solely healthcare companies and BDX is a medical supply company, which fits their criteria. The final buy for the week was DPS, Dr Pepper Snapple Group, on which I presented. We bought a full position to replace our ETF in the staples sector. We liked DPS over its competitors because we felt it was less followed by analysts due to its size and its recent spin off from Cadbury Schweppes plc last year.
This week in class one of the students presented on writing covered calls. The consumer staples group was considering the possibility of writing a call for Proctor & Gamble, so Jena researched this idea and discussed her findings with the class. Originally we believed PG was a good security to write a call for due to its low price volatility. However, upon examination of PG’s price charts, we learned that PG has experienced quite a bit of price volatility over the past year. Writing a call is basically betting on little to no volatility, and this surprisingly was a risky bet to take for PG. Jena presented this topic to the class and we decided that the risk was too great for such a small return. It looks as though we will most likely keep PG in our portfolio for the time being.

The portfolio committee also made a presentation on stop losses today. The class currently uses a simple method for determining a stop loss price for our stocks. We set a stop loss at 20% below the average purchase price. However, there has been discussion lately as to whether this is really the best method. The portfolio committee thought perhaps it was beneficial to incorporate volatility into the determination of the stop loss. They developed a new method to do so. The newly proposed stop loss would be calculated as follows:

\[
= \text{Average purchase price} - \left((0.10\beta + 0.10) \times \text{average purchase price}\right)
\]

The portfolio committee is still looking into other methods of calculating a stop loss, but this was a great start.

Lastly, the fixed income committee presented a recommendation to the class concerning the cash in our portfolio. They want to decrease our cash holding from just over 10% of our fixed income to about 8%. In order to decrease our cash, we must obviously invest in something. The committee recommended increasing our T Rowe Price High Yield bond holding. The class agreed to this suggestion, because our cash only earns about 2%, whereas the high yield bond earns much more.

There weren’t any stock recommendations this week since we have basically met our target equity weighting.
This week was our last week of regular class. We definitely have lost a significant amount of money since August, yet we are still up 9.5%. It has been a very eventful semester, and the recent economic environment created many learning opportunities. This past year has been a great time to be a finance student, as there are infinitely more topics to learn in a down market than when everything is going well.

At the end of class, we discussed some lessons we learned as a class throughout the past nine months as money managers. The following is a list of those lessons:

- Beware of bubbles, markets can and do go to excess
- Leverage can be both a good thing and a very bad thing
- Is there no more normal distribution? We’ve seen many instances of “fat tails”.
- The market can be highly volatile; if you miss a day, you miss a lot.
- There exist intermediaries with “no skin in the game”
  - They solely perform transactions and are paid on transactions/volume
- Compensation drives human behavior
- There is complexity in the markets which hinders transparency
- Financial press/media magnified many issues
- There is a world imbalance of savings
- There is/was too high of a reliance on rating agencies
  - Rating agencies had poor incentives and therefore often rated companies too highly
- Low interest environments create mischief
  - Everyone reaches for yield and mis-prices risk
- Regulatory lapses
  - New and complex products/securities
  - Mark to market accounting
  - Allowance of leverage
  - Believe that free markets self-correct
  - Political environment pushed for deregulation