

# A PRIMER ON PORTFOLIO CONSTRUCTION AND MANAGEMENT

Chief Investment Office • MAY 1, 2018

## Overview

The Global Wealth & Investment Management Chief Investment Office (GWIM CIO) created the Merrill Lynch Impact Portfolios (ML Impact Portfolios) to meet investors' desires to align their investments with the issues and causes important to them. In recent years, investor demand for impact investments has expanded significantly. U.S. Trust's 2017 Insights on Wealth and Worth® Survey found that 45% of high-net-worth investors either own or are interested in owning impact investments (up from 32% in 2015) and 55% say that the social, political or environmental impact of an investment affects their decision to invest.<sup>1</sup>

The interest and the dramatic increase in the breadth and depth of environmental, social and governance (ESG) data has driven an expansion of products. At the end of 2016, there were 25 ESG ETFs as compared to 8 ESG ETFs in 2007, when the US SIF (Forum for Sustainable and Responsible Investment) started tracking such ETF products. Moreover, asset managers responding to a 2017 survey said that they plan to increase the number of funds incorporating ESG or responsible investing over the next two years.<sup>2</sup>

Lastly, research from BofA Merrill Lynch Global Research concluded that ESG attributes may be too costly for investors to ignore. The research found that ESG factors have been strong indicators of future volatility of earnings, and incorporate information which may help avoid severe price declines and bankruptcies of companies.<sup>3</sup>

## Summary of Portfolio Offerings

Merrill Lynch offers a suite of 5 Core Impact (primarily ETFs) and 5 Hybrid (MF/ETF) Sustainable Impact Portfolios. Consistent with other centrally managed portfolios offered through the Merrill Lynch Investment Advisory Program (IAP):

1. They adhere to Strategic Asset Allocation (SAA) guidelines.<sup>4</sup>
2. They are measured against the same benchmarks as Traditional (Non-impact) CIO total portfolios in the IAP program.
3. They pursue return characteristics appropriate for each investor risk profile.
4. They incorporate the CIO's tactical views.<sup>5</sup>

### Footnotes:

<sup>1</sup> U.S. Trust Insights on Wealth and Worth, 2017.

<sup>2</sup> BNP Paribas, Great Expectations: ESG, 2017.

<sup>3</sup> Bank of America Merrill Lynch, Equity Strategy Focus Point, "ESG Part II: a deeper dive," 01 June 2017

<sup>4</sup> Strategic asset allocation (SAA) is an asset allocation developed with a 20—30 year time horizon in mind that systematically diversifies portfolio allocations across multiple asset classes, which can then be used as part of a disciplined investment approach. The SAA targets are intended to control exposure to market volatility and assists clients in achieving their investment goals within their defined risk capacity and tolerance.

<sup>5</sup> "Tactical" refers to the current GWIM CIO asset allocation recommendations for this investor profile type based on its views of current market conditions, risks and opportunities, deviating from the Strategic asset allocation targets.

Investment products:

|                      |                         |                |
|----------------------|-------------------------|----------------|
| Are Not FDIC Insured | Are Not Bank Guaranteed | May Lose Value |
|----------------------|-------------------------|----------------|

## KEY FACTS

### OVERVIEW

- The Merrill Lynch Impact Portfolios are portfolios of mutual funds and/or exchange traded funds constructed by the Global Portfolio Solutions team.
- The ML Impact Portfolios adhere to the CIO's Strategic Asset Allocation (SAA) framework.
- The portfolios are classified as Total Portfolios, hence they pursue growth plus income.
- The ML Impact Portfolios are available through the Merrill Lynch Investment Advisory Program.

### ML IMPACT PORTFOLIOS ARE CONSTRUCTED WITH THE FOLLOWING DUAL OBJECTIVES:

- Maximize the ESG impact of the portfolio.
- Meet or exceed benchmark returns, while controlling tracking error to the benchmark.

# Asset Allocation

ML Impact Portfolios follow the tactical allocation guidelines of the GWIM Investment Strategy Committee (ISC). These recommendations are based on a 12-month outlook, but use long-term Strategic Asset Allocation guidelines as a foundational building block. In practice, the ISC makes between three to four tactical adjustments per year. At times, the Portfolio Construction team may depart from the ISC recommended asset allocations to meet its dual objectives of impact and risk adjusted return.

## Exhibit 1: Contributors to Allocations and Investment Selections

| Team                                     | Allocation Input  |
|--|---|
| CIO Due Diligence                        | Identification and coverage of impact investing Mutual Funds and/or ETFs available for inclusion  |
| CIO Global Portfolio Solutions           | Mutual Fund and/or ETF selection from covered funds, and determining the weight for each fund   |
| GWIM Investment Strategy Committee (ISC) | <ul style="list-style-type: none"> <li>Asset allocation between equity, fixed income and cash</li> <li>Geographical allocation within equities</li> <li>Equity size and style allocations</li> <li>Fixed income guidelines for duration, quality and other characteristics</li> </ul> |

However, unlike other CIO centrally managed portfolios which solely focus on risk adjusted return as their primary goal, these portfolios pursue a second equally important objective, impact. The ML Impact Portfolios utilize funds and/or ETFs (whenever possible) that include positive impact as one of their objectives and that integrate ESG into their investment philosophy.

It is important to note that positive impact differs from negative screening. When a manager does negative screening, they may exclude some names from the portfolio which have exposure to certain industries (typically excluded industries may be tobacco, coal industry, manufacturers of mass weapons, etc.). However, the ML Impact Portfolios seek to invest in funds with a positive influence on environment, social or governance issues. Companies in such funds are typically those seeking to improve the environment (e.g. by cleaning water, reducing carbon footprint, etc.), have a positive social impact (e.g. improving working conditions in companies, investing in projects which may benefit lower income families, etc.) or affect companies' governance (e.g. by engaging the board of directors).

The ten ML Impact Portfolios, all incorporate allocations between equity and fixed income funds, along with a potential cash component:

- **Conservative:** Investors in this risk profile seek to protect principal and provide protection against the risk of inflation.
- **Moderately Conservative:** The primary objective of an investor in this risk profile is to obtain sustainable income from dependable sources with an emphasis on capital protection.
- **Moderate:** Investors in this risk profile balance priorities between current income and growth, and are willing to sacrifice some capital appreciation for reduced risk and income.
- **Moderately Aggressive:** This risk profile highlights the accumulation of wealth with less concern for income, but with less tolerance for risk than the Aggressive risk profile.
- **Aggressive:** The risk profile emphasizes above-average capital growth with comparatively less concern for income.

# Due Diligence Investment Selection Process

The ML Impact portfolios seek to emphasize funds that are classified by the CIO due diligence team as sustainable. To make this designation, the CIO due diligence team conducts two reviews.

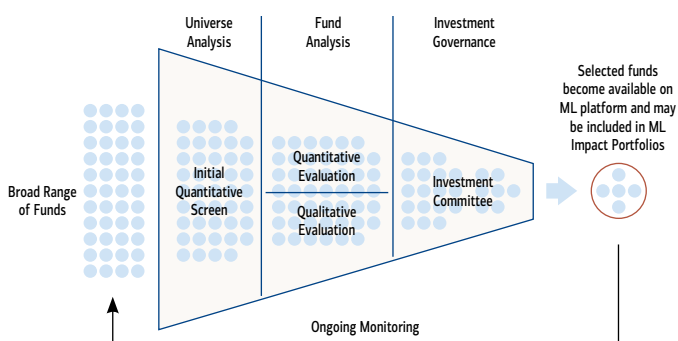
First, the team performs a review similar to the review of traditional funds. This process is a quantitative and qualitative evaluation to establish a forward looking view of whether the strategy will meet or exceed its investment objective for a given level of risk. It is important to note that for any sustainable strategy, the CIO due diligence team evaluates the strategy against the full universe of comparable strategies (not just those that identify themselves as sustainable) and against widely used investment benchmarks. For example, the investment merits of a sustainable U.S. large-cap strategy would be evaluated against the full large-cap universe and against the S&P 500, not just against other sustainable large-cap strategies. This allows the ML Impact Portfolios access to strategies on par with any high conviction traditional (non-impact) strategies.

Once a strategy has passed the investment evaluation, the due diligence team conducts the second part of the review, which ensures that the manager intentionally and consistently uses environmental, social and governance factors in security selection, portfolio construction and/or risk management. A strategy can only be considered sustainable when the CIO due diligence team determines that it is constructed and managed with the intent of creating positive impact.

# Portfolio Investment Selection Process

The Global Portfolio Solutions (GPS) team selects from the list of funds which have been classified as high conviction impact funds by the CIO due diligence team. The GPS team evaluates each fund based on the weighted average ESG rating of its underlying holdings, as well as based on the fund's risk and return profile. Currently, the GPS team uses MSCI's ESG rating to measure the ESG score of the portfolios and benchmarks. The GPS team chose MSCI because of the depth and breadth of its ESG coverage. MSCI uses approximately 100 measures to determine various aspects of environmental, social and governance attributes of companies that they cover. They combine these measures into three aggregate scores that represent E, S and G for that company. Finally, the scores are aggregated once again at fund level to determine the ESG score for a given fund.

Our investment selection process is typically iterative and uses quantitative tools to assess risk and expected returns. In cases when there aren't any available impact funds to meet a specific ISC tactical allocation requirements, the GPS team may use other non-ESG funds to fill the gaps. If such traditional funds are included in the portfolio, it is done in a manner that such inclusion would attempt not to undermine the overall impact orientation of the portfolio. While the GPS team seeks to maximize risk adjusted return, they regularly measure the ESG rating of the portfolios against the ESG rating of the market benchmarks. Lastly, in the selection process, the GPS team considers the liquidity and fees of the funds.



For illustrative purposes only.

## RETURN



- Exposure to attractive asset classes
- Fund potential for outperformance compared to the relevant benchmark

## IMPACT



- Portfolio's potential for positive impact
- Ratings based on MSCI ESG Research assessment

## RISK



- Controlled active risk vs. benchmark

# Portfolio Rebalancing and Other Considerations

The portfolios are designed to achieve their investment objectives over a market cycle. The GPS team monitors the portfolios continuously and, if needed, may rebalance the portfolios at least once a year.

During the year, the GPS team may trade the portfolios in order to realign them with ISC tactical views. As more high conviction Impact strategies become available in the market and on our investment platform, the GPS team will review these funds regularly to determine their eligibility for inclusion in the portfolios.

## Important Information

**Investing involves risk, including the possible loss of principal.** No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT).

**Past performance is no guarantee of future results.**

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