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Values

Walden Asset Management a Investing for Social Change Since 1975

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Considering the Options

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The debate over the use and reporting of incentive stock options has gotten so heated, and the arguments made on both sides portrayed as so self-evident, that it makes sense to take a step back and consider the whole subject of stock options as a means of compensation. The controversy frequently pits well-intentioned shareholder advocates against self-interested options advocates¾high tech CEOs, discredited get-rich-at-any-price IPO entrepreneurs, and the usual suspects in the "business is always right" crowd. For once, the opponents of the standard pro-business position seem to have gotten the better of the public debate.

But casting this debate as a conflict between shareholder rights and executive greed is simplistic and misleading and might damage the goal of improving the health and fairness of the market system. For the outcome to be constructive, it is critical that participants distinguish carefully between an appropriate desire to devise a meaningful financial reporting system for options and the unintended result of curtailing option use. It's worth recalling why many social investors have been long-time advocates of options-based compensation. The reason is simple and the mechanism elegant. Incentive stock options are a way for current stockholders to transfer a portion of the ownership of their company to its employees when and if those employees enhance the value of the company, as reflected in the company's stock market value over a specified period of years. In theory, the result should be to align better the interest of shareholders and employees, to diffuse corporate ownership, and to produce a more effective and fair corporate culture.

Bill Apfel is a senior portfolio manager and Director of Securities Research. He serves on USTC's Social Planning and Policy Committee.

Of course, we know what went wrong. An extraordinary market bubble opened the door for avaricious managers to turn this fundamentally positive trend in compensation practices into a vehicle for extracting quick riches from speculative stock prices. Worse, it encouraged the most unscrupulous managers to manipulate stock prices without regard to the long-term health of their companies. And finally, options were too often distributed disproportionately to a narrow group of executives who benefited at the expense of both employees and shareholders. No doubt, the current practice of simply ignoring the cost of options in financial reports encouraged these abuses. But certainly, shareholder advocates and social investors should take care to keep the baby as we drain the bath water.

It is striking how frequently newspapers carry pieces by supposed experts who demand the "expensing" of stock options without ever proposing how this should be done, or as though an option's precise value was readily identifiable. Undertaken without an appreciation for the complexities and benefits of options, the unintended result could be reluctance by progressive managements to use this tool at all. This would be a shame for shareholders and employees alike. A sensible reporting system, however, would avoid misleading investors about a program's true

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About Walden Asset Management

Walden Asset Management is the socially responsive investment division of United States Trust Company of Boston. Walden began offering socially responsive investment services in 1975. We are among the largest and most experienced investment managers specializing in services for individual and institutional investors with social concerns.

About This Newsletter

This newsletter is designed to share our thinking about trends and issues in socially responsive investing and to generate dialogue with our readers. We invite you to comment on any article in the newsletter by calling your portfolio manager (617-726-7250) or by writing Heidi Soumerai or Meredith Benton, co-editors, at the following address: Walden Asset Management, 40 Court St., Boston, MA 02108. FAX: (617) 227-3664.

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The Estate Tax:
A Fiscal Imperative and Fair

Why does Bill Gates Sr. want his estate to be taxed?

For some, the estate tax is "un-American" and "unfair" for allegedly punishing people who, after a lifetime of hard work and paying taxes, aspire to pass something on to their children. Some have questioned the fairness of a tax that singles out less than 2 percent of wealthy households, and that will decline to roughly 6,000 households by the end of the decade. Some feel this is a form of discrimination or is rooted in a politics of resentment, or worse, "class warfare."

For Bill Gates Sr. and other members of Responsible Wealth – a national network of businesspeople, investors and affluent Americans who are concerned about deepening economic inequality – the estate tax is the most fair tax we have. It generates substantial revenue from those most able to pay. Last year it generated $30 billion but its revenue-generating prowess will increase in the decades ahead as an estimated $41 trillion of wealth transfers from one generation to the next. In the next five decades, the estimates are that the estate tax will generate $150 billion to $700 billion per year.

At a time when our country is facing annual budget deficits of over $300 billion per year, it is fiscally reckless to eliminate this tax. Eliminating the estate tax as a source of revenue inevitably shifts the tax burden onto those less able to pay.

The estate tax is also an incentive for charitable giving, the lifeblood of our healthy civic institutions. The evidence suggests that without an estate tax, charitable giving will decline approximately $6 billion to $8 billion a year, with the largest decline coming from estates of more than $20 million.

Chuck Collins is co-founder of Responsible Wealth. He is co-author, with Bill Gates Sr. of the new book "Wealth and Our Commonwealth: Why America Should Tax Accumulated Fortunes" (Beacon 2003).

The estate tax protects our democracy and equality of opportunity by thwarting the build-up of concentrations of wealth and power. U.S. Supreme Court Justice Louis Brandeis said, "We can have concentrated wealth in the hands of a few or we can have democracy, but we cannot have both."

But at the core of the case for preserving the estate tax is an acknowledgement that none of us get to where we are alone. We live in an economy that has enabled a wide variety of people to attain wealth and comfort. And those who accumulate great wealth – $10 million, $20 million, $50 million and up – are families that have benefited disproportionately from the system of public investment that we together, as taxpayers and gift givers, have put in place in our society.

This is not to minimize an individual's effort, the hard work, creativity and sacrifice that has enabled someone to accrue wealth. We should celebrate and reward these efforts. But we should not lose sight of a simple fact in this accounting. The United States has a remarkably fertile soil for the creation of wealth. It is part of the inheritance that many of us receive in the form of public investments that have been made over the centuries. We have a strong economy precisely because we have order, stability, a predictable system of rules for investing and mechanisms to resolve disputes. We have confidence that the rules today will be the same in a year and the year after. And we have a skilled workforce thanks to our substantial investment in public education and infrastructure.

We should strive toward a society where children are

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Cutting Edge Companies
Great Perks in a Poor Economy

This column highlights companies in the business of providing solutions to social and environmental challenges. Featured companies are typically held in the SmallCap Innovations portfolios offered to Walden's clients.

The economic downturn of the past two years has resulted in layoffs, salary caps, and benefits cuts at thousands of companies. For many employees, having a job during a recession is satisfaction enough. Yet leading employers continue to offer benefits packages that retain strong talent, boost productivity, and even make some of us jealous. Smaller-sized companies that Walden has identified as innovators in employment practices are no exception. Here are some of our favorites, with anecdotes from our own files, as well as those of Fortune, Working Mother, and social research firm KLD:

"Spreadsheets and slippers." About one-quarter of employees at Michigan-based **Republic Bancorp** work at home.

"Fries and a Coke, and a towel, please." Computer marketer **CDW** provides employees free meals and, perhaps an appropriate complement, a fitness center. Employees also receive a paid family vacation in the continental United States if three-year targets are met.

"Happy at least 3% of the time." Software firm **Autodesk** offers six-week sabbaticals after four years of service.

"What are my options?" **Advent Software**, **CDW**, bank holding company **First Tennessee**, **Republic Bancorp**, financial service firm **Synovus**, and others offer stock options to all employees. **Synovus** also gives employees a 50 percent discount on company stock.

"Please don't go!" **First Tennessee** guarantees employees at least one year's salary in case of merger-related layoffs. Tech firm **Acxiom** recently gave employees stock options with pay cuts in order to avoid layoffs. Unfortunately, brokerage firm **A.G. Edwards** ended a 100-year streak of no-layoffs in 2002.

"Here's your paycheck, and a rake." **Advent** pays their employees to volunteer. Boot maker **Timberland** pays up to 40 such hours per year. At jam maker **J. M. Smucker**, it's unlimited.

"Lunch at 10 a.m.?" At **Republic**, about 46 percent of employees participate in flextime programs. At **Autodesk**, it's more than 50 percent, at **First Tennessee**, more than 75 percent, and at **Lincoln National**, about 95 percent.

"Have you seen my turtle?" **Advent** and **Autodesk** permit pets at work. –K. Scott

(Estate Tax continued from previous page)

born without vast disparities in access to education, health care and opportunity. Unfortunately, we are moving in the opposite direction. London Observer columnist Will Hutton, a thoughtful commentator on the U.S., made a startling observation last year about the changing nature of American society. "The reality is that U.S. society is polarizing and its social arteries hardening," lamented Hutton. "The sumptuousness and bleakness of the respective lifestyles of rich and poor represent a scale of difference in opportunity and wealth that is almost medieval and a standing offense to the American expectation that everyone has the opportunity for life, liberty and happiness."

We must decide what kind of country we want to become. Do we want our children and grandchildren to grow up in a country with great extremes of wealth and poverty? Do we want to have our own hereditary aristocracy? Do we want to be a society that places more emphasis on preserving inherited wealth rather than strengthening equality of opportunity?

The estate tax should be reformed to raise exemptions and address the few situations when family farms and small businesses get tangled in the estate tax web. But complete repeal would undermine the level playing field that we are striving to create. The estate tax, much maligned, is actually a fair and fundamentally American tax with significant benefits, not least of which is the brake it applies to the build-up of American wealth dynasties and the dispersion of wealth it encourages.–C.Collins

Sources of information for this article include the Brookings Institution, U.S. Treasury Department and Independent Sector/ Council on Foundations. See OMB Watch, "The Estate Tax and Charitable Giving," at http://www.ombwatch.org.

For information about our proposals to reform the estate tax – or to sign the "Call to Preserve the Estate Tax," go to www.responsiblewealth.org.

Social Research and Action

Heidi Soumerai is Director of Walden's Social Research group. She also co-chairs our Social Planning & Policy Committee.

Tim Smith is the Director of Socially Responsive Investing at Walden. Tim provides leadership on corporate governance and corporate social responsibility.

2002 may well be remembered as the year when corporate scandals caused investor confidence to plummet and the stock market to roil. 2003 is shaping up to be the year that investors are stepping up and being counted—using their voices and votes to call for strengthened governance and corporate responsibility. According to the Investor Responsibility Research Center, as of February 1, more than 860 shareholder proposals had been filed, compared to about 800 in all of 2002, ExxonMobil alone received 23 proxy resolutions on global warming, human rights and corporate governance issues. Moreover, proponents of corporate governance and social issue resolutions are increasingly finding common ground in recognizing both areas as fundamental to good management and good performance.

Among these shareholder proponents are Walden clients—whose collective voice is a formidable force for change. Twenty-seven shareholder resolutions have been filed at 25 companies on a breadth of issues, and Walden is a lead proponent in negotiations with 17. (See Walden's 2003 Shareholder Resolutions, below.) Many more companies are actively engaged in dialogues with us. Even before the 2003 annual general meetings occur and the shareholder votes are tabulated, Walden has seen positive movement.

Colgate-Palmolive (CL) has agreed to include a section on the HIV/AIDS pandemic in Africa in its 2003 global sustainability report. The section will describe CL's policy and some of its initiatives to address the devastating human suffering and loss in Africa.

SUPERVALU provided public confirmation that sales of mercury thermometers have been phased out at all of its retail and distribution companies. Walden estimates that 89 percent of all pharmacy chain stores have now phased out such sales.

BJ's Wholesale Club has committed to a Board-level review of its policy to have shareholders elect directors in classes for multiple year terms (a staggered board), rather than the preferred annual election of all di-

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Walden's 2003 Shareholder Resolutions

Environmental Focus

Recycling: Coca-Cola, Coca-Cola Enterprises, PepsiCo
Climate Change: Marsh & McLennan*, Occidental Petroleum*
Mercury Pollution: SUPERVALU*
Sustainability Report: Yum! Brands

International Human Rights Focus

Child Labor: Federated Department Stores
Sweatshop Issue/Vendor Standards: TJX, Wal-Mart
Adopt or Review Human Rights Policies: ExxonMobil, Unocal
Report on HIV/AIDS Pandemic: Colgate-Palmolive*

Equality Focus

Comprehensive Diversity or Glass Ceiling Report: Illinois Tool Works*, Merck*
Inclusive Non-Discrimination Policy: ALLTEL, Dover, Emerson Electric, ExxonMobil, FedEx

Corporate Governance Focus

Adopt Policy Requiring Annual Election of Directors: Avon, BJ's Wholesale*, Gillette, McDonald's, Merck*
Executive Compensation Policy: JPMorgan Chase
Communications with Independent Directors: Autodesk

*** negotiated withdrawal of resolution**

(Social Research continued from previous page)

rectors. Annual election provides for greater accountability to investors.

Illinois Tool Works agreed to develop an employee relations section on its Web site and to provide comprehensive equal employment opportunity (EEO) information to investors upon request. Transparency on diversity goals and statistics is key to continued progress toward eliminating employment barriers faced by women and minorities.

Dell Computer, in response to a dialogue led by the Calvert Group, has agreed to set up a system to measure the recycling rate of computer equipment it sells, and to establish equipment recycling goals by March 2004. Dell will be the first computer company to establish quantitative recycling goals.

These changes in policies and practices resulted directly from shareholder input. But many of the most important company initiatives never enter the shareholder realm. Such is the case for approximately five dozen major corporations filing an *amicus* brief to the U.S. Supreme Court in support of the University of Michigan's fight to maintain race as a factor in the admission process. Standing against the Bush Administration decision to oppose the university, these companies argue that affirmative action in higher education is critical to building a high quality and diverse workforce. Some of the companies offering strong support include Coca-Cola, Fannie Mae, General Motors, Intel, Lucent, Microsoft, Pfizer, Procter & Gamble, Merck, and Johnson & Johnson. Concerned investors can celebrate this positive and significant initiative championed by so many companies. –H. Soumerai

Triumph at the SEC

Timothy Smith is president and chair of the Social Investment Forum, as well as Director of Socially Responsive investing here at Walden. The following is excerpted from his January 23 statement pertaining to new SEC rules on proxy voting.

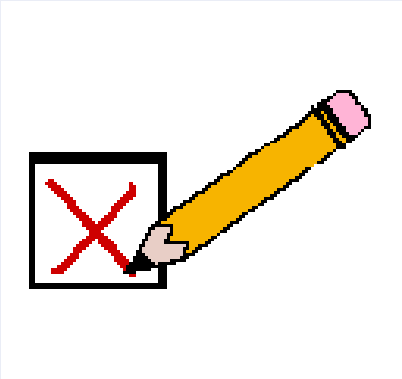
Both socially and environmentally responsible investors hail today's important decision by the Securities and Exchange Commission (SEC) to protect the rights of all investors by requiring meaningful disclosure of proxy voting by mutual funds and investment advisors. In taking this action, the SEC has empowered investors with the right to information that can be used to evaluate the commitment of mutual funds and investment advisors to good corporate governance and long-term shareholder value.

For years now, Social Investment Forum members have called for disclosure of proxy votes and voting guidelines. Forum members were the first firms in the nation to voluntarily make such disclosures. In fact, all of the U.S. mutual fund companies that currently disclose both their guidelines and voting decisions publicly are members of the Forum. Our members have done so voluntarily because they understand that mutual funds have a fiduciary duty to vote proxies in a manner that is consistent with the best interests of their shareholders and clients.

It is important to remember that corporate scandals like Enron, Tyco, and WorldCom were not caused by executive greed alone. Mutual funds were among those that approved Enron's board of directors, supported CEO compensation packages, and voted against numerous corporate governance measures that may well have prevented some of the abuses we've recently witnessed. The SEC's action today tears away the cloak of secrecy that up until now has shielded mutual fund proxy voting from much-needed public scrutiny.

The SEC action is good for investors and it is a good thing for the mutual fund industry, including those companies that do not yet appreciate that fact. There is mounting evidence that attention to shareholder rights, including social and corporate governance issues, is linked to long-term corporate performance. When all mutual funds reveal how they use proxy votes, enabling shareholders to know what is being done in their name, we expect to see a contribution to long-term shareholder value.

More and more investors today understand the importance of good governance, ethics and corporate citizenship in the companies in which they invest through mutual funds. They want to see if mutual funds "get it" and are voting thoughtfully and conscientiously on their behalf. Today's action by the SEC finally makes that possible.



Women's Self-Employment Project:
Taking Social Innovation to Scale

Picture this. Chicago, 1992. Sherry and her three children are living on the South side of the city in a government-subsidized apartment that the landlord doesn't maintain. Unemployed and feeling alone, Sherry wants more for her family than the welfare they are receiving. "I was smart in school; there had to be a way for me to get beyond this," Sherry said in a later interview.

One April morning Sherry is opening her welfare check as she has done for many months and years before. But today is different. This time attached to the check is a notice that reads: *"Do you want to be self-employed? Do you want to learn how to turn your talent into a business? If the answer is yes, then call the Women's Self-Employment Project (WSEP) and find out how you can start your own business and not lose your welfare benefits."*

Fast forward to 1994. Sherry is the proud owner of her own day care business. The business has been operating for a year and caters to young mothers who are very much like Sherry. She earns enough through the business to pay two employees, repay her loan to WSEP and take care of her family.

Picture this. Chicago, 1997. Sherry is now the owner of not one, but two day care facilities. The second facility is a two-story building that has an apartment where Sherry, her mother, and children live. What a great picture!

How did this mother of three go from welfare to owning her own business and her own home? It was through the innovations developed by the Women's Self-Employment Project. With the mission to increase the economic self-sufficiency of low- and moderate-income women through self-employment and asset development, WSEP serves as a financial intermediary connecting low-income women to the mainstream economy. As a certified community development financial institution (CDFI), the Women's Self-Employment Project addresses the barriers to economic independence and wealth creation. Sherry and thousands of women like her since 1986 have used the many services of WSEP. Since its founding, WSEP has committed nearly $3 million to low-income women through micro loans, helped to create over 800 new jobs through self-employment and assisted another 600 existing businesses to grow and develop. Approximately 31 percent of these businesses created additional jobs. The organization provides capital and investments for asset and wealth building, and provides incentives for people to save and invest in their futures.

WSEP committed to expanding its capacity, products and scale as a way to meet growing and changing demands for capital and for its own financial sustainability. In June 2000, it reorganized with three distinct nonprofit operating entities that now make up the WSEP Family of Companies. The original WSEP continues to provide services directly to low-income women and advocates to remove policy barriers as it always has. A second nonprofit, WSEP Ventures Inc., represents a bolder step. It aims to blend and leverage financial and social capital to produce greater social returns and value through businesses that strengthen economic opportunities for people of color and low-income communities. The third, WSEP Futures, acts as a holding company to ensure the philosophical and strategic alignment of all the companies. Together the WSEP Family of Companies provides a wide range of products and services for organizations, emerging businesses and entrepreneurs, and low-income individuals in Chicago and throughout the country. The mission is to build an institution and system that can take small-scale solutions that have been proven to work, such as micro loans and IDAs (Individual Development Accounts), to a greater height and impact. –C. Evans

Connie Evans is President & CEO of WSEP Ventures. For more information on the WSEP Family of Companies, contact them at (312)606-8255.

Through our Community Development Investment Service, Walden clients have invested over $8 million in community development banks, credit unions, and loan funds. We are pleased to have included Women's Self-Employment Project in this service.

(Employee Compensation continued from page 1)

costs, while making plain how managers were allocating shareholder resources to achieve corporate goals.

Why do many proposals to "expense" options fail this test? Options are really "contingent liabilities." That is, they are a commitment by a company and its current shareholders to issue shares to employees at a specified price for a finite number of years. An expense will only be incurred if the stock price rises. If it rises a great deal, the cost of that commitment will be very large. If it falls, the option will have no value and there will be no cost to current shareholders. It would be simple to quantify exactly how big or small the commitment would be if we knew where the stock's price would be at the expiration of the option grant period. But we don't know, so "expensing" some guess of their future value is almost certain to get wrong the true cost to shareholders. Perversely, an accounting system that expenses all options based on a fixed, mathematical guess of their true cost (the essence of most proposals), fails to capture the financial appeal of options issuance from the point of view of current holders: They will only be required to make good on their commitment to transfer part of the ownership of their company if the value of the company's stock rises.

An accounting system that reflects the fundamental uncertainty of options-based compensation would be simple enough to devise.* Each year companies would be required to record an initial estimate of the ultimate cost of newly granted options and this would commensurately reduce earnings. In subsequent reports this estimate would be adjusted to reflect changes in the estimated value of all outstanding options, and this change would also be reflected in earnings. The ultimate cost of option grants would be recorded upon exercise, reducing the incentive for companies to manipulate their estimates along the way. For companies that fared well, the estimated cost of all outstanding option grants from prior years would increase, reducing reported earnings. For those companies that fared poorly, the costs would decline, yielding the opposite effect.

Is this system just too complicated for the investing public? We don't believe so. Accounting principles are normally complex, indeed arcane, because they seek to describe the complex nature of profit and loss. The worst accounting treatments are those that allow for simplistic reports that misrepresent reality and thus run the risk of encouraging behaviors designed to mislead their users, or simply discourage behavior that would be in the best interest of investors and other stakeholders. Let's make sure this is not the outcome of the options debate. –B. Apfel

*Mark Rubinstein has devised such a reporting framework. It was described in *The Economist* of November 9, 2002.

Taking Option Expensing to the Proxy Ballot

As part of their overall campaign for corporate reform, labor union pension funds have placed a strong focus on stock option expensing. The pension fund of the United Brotherhood of Carpenters has been most active on this issue, approaching more than 80 companies with stock option related proposals in 2003. Companies the union is targeting include Ecolab, SUPERVALU, U.S. Bancorp, and Wells Fargo. The Carpenters have made some early headway with other companies. Bear Stearns, DPL, Genuine Parts, Lehman Brothers, Provident Financial, and TXU have all agreed to expense future options. Resolutions were withdrawn at Archstone Smith Trust, AvalonBay Communities, CarrAmerica Realty, Cummins, Mercantile Bankshares, and Simon Property Group because these companies had already begun expensing stock options, or had committed to a January 1, 2003, start date.

Other trade unions have approached approximately 45 more companies. These include the International Brotherhood of Teamsters proposal at Weyerhaeuser and the Communications Workers of America (CWA) resolution at Verizon. CWA announced it would be filing similar proposals at multiple communication and media companies. AFL-CIO, a federation of 65 unions, has also been working on executive compensation issues.

In general, it is Walden's policy to support these proposals.

An increasing generalized pressure on these companies aids the unions' efforts. *The New York Times* published an article by renowned investor Warren Buffet, where he called for companies to expense options. The influential proxy advisory firm, Institutional Shareholder Services, has said that it will support shareholder proposals asking for stock option expensing. Perhaps what is most indicative is that at least 75 other companies have committed to expense options without being formally approached by shareholders. –M. Benton

Walden is pleased to welcome Meredith Benton to the 5-member social research and advocacy team led by Tim Smith and Heidi Soumerai. Before joining us, Meredith worked as a research associate for a policy consulting company, assessing the risks and opportunities of corporate responses to climate change. Meredith will be evaluating, monitoring and communicating with companies on a broad array of corporate responsibility issues, and will work with clients participating in shareholder actions. Along with Ken Scott and Regina Morgan, this team continues Walden's tradition of leadership and innovation in corporate social research and advocacy.

On the financial side, we believe Walden's renewed focus on its actively managed, in-house investment services, as described in the previous edition of *Values*, should continue to yield strong results. Though this past year has been painful in the equity markets, Walden's equity performance in 2002 achieved good results relative to market benchmarks.

Continuity in investment staffing and consistency of our investment approach in these core investment services are Walden's hallmark in a decade of excellent relative performance. Our chief investment officer and our economist have been with Walden/United States Trust Company of Boston since 1980 and 1984 respectively. Portfolio manager Bill Apfel has been with Walden for well over a decade and since 1994 he has been the Director of Securities Research. The senior Walden portfolio manager, Stephen Moody, has been with Walden for twenty-three years. Importantly, the voting membership of the securities research, asset allocation, and portfolio composition committees has not changed in over five years.

Of course, a style that emphasizes quality in equities such as Walden's may underperform in a strong, speculative market that is lifting all boats, and future results will be different. Nonetheless, we are proud that continuity in staff and investment approach, along with our strong social commitment, has served our clients well.

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