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TRILLIUM'S APPROACH TO INVESTING IN THE DIVERSIFIED FINANCIALS SECTOR

BY KEITH A. MILLS, CFA, DIRECTOR OF RESEARCH

In late 2014, six large, globally focused banks were fined more than $4.3 billion by American, British, and Swiss regulators for their attempted manipulation of foreign exchange rates from 2009 through 2012. These settlements follow other civil and criminal settlements related to alleged residential mortgage foreclosure processing abuses, sales of residential mortgage securities, conspiring to aid tax evasion, and not maintaining proper anti-money-laundering controls.

As our firm works to ensure that clients are invested in the best companies and investment opportunities, Trillium requires our research analysts to regularly complete thoroughly integrated environmental, social, and governance (ESG) reviews of the industries in their sector coverage areas.

We recently completed an ESG review of the Diversified Financials sub-industry, which represents about one-third of the market capitalization of the entire Financials sector, and is roughly 6% of the S&P 1500; making it a meaningful part of the sector and investment universe.

In these reviews, analysts identify the ESG areas that we believe are material to future company performance and investment returns, determine what we believe "best practices" behavior should be, and evaluate the selected companies' performance in these areas. We also work to ensure that our internal Buy List includes industry leaders or improving performers.

Our industry analyses go well beyond ESG analysis to include company strategies, business models, management performance, growth opportunities, the regulatory environment, financial management, returns on invested capital,

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Thinking Capital℠

MATT PATSKY, CFA, CEO

You may have seen the recent announcement that Portfolio 21 has merged with Trillium. Both of our firms have been looking for a business partner with shared values. Like Trillium, Portfolio 21 was founded in 1982 and is a pioneer of Sustainable and Responsible Investing.

Over the years, Portfolio 21 and Trillium have collaborated on many issues. Sharing a deep concern about the proposed Pebble Mine in Bristol Bay, Alaska, we jointly brought the investor perspective to the EPA and the White House in filings urging the Obama administration to protect vital salmon resources. Similarly, we have led investors in urging the administration to adopt robust methane regulations. And in Oregon, we are working with our good friends at Ceres to urge Oregon legislators to remove the Clean Fuel Program sunset provisions.

Trillium has assumed responsibility for the Portfolio 21 brand and the management of the Portfolio 21 Global Equity Fund. We couldn't be happier that the Global Equity Fund

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"EXTRACTING FOSSIL FUELS" GUIDE UPDATED

350.org, Green Century Capital Management and Trillium Asset Management have recently published an updated edition of *Extracting Fossil Fuels from Your Portfolio℠: A Guide to Personal Divestment and Reinvestment,* which is available to download for free on Trillium's website.

The frequency and severity of extreme weather systems continue to impact the lives of people around the globe and increasingly in our own communities. Many investors are becoming acutely aware of the presence of fossil fuel companies in their own portfolios and want to transition their investments away from the industry that is principally responsible for causing a changing climate.

"If it's wrong to wreck the climate, then it's wrong to profit from that wreckage." said Bill McKibben, co-founder of 350.org. "Investors have an important and special role to play in the climate change movement. I hope this guide will help you find yours."

The guide, which aims to help individuals better understand fossil fuel divestment, provides clear steps to move your money out of coal, oil, and gas companies, and give tips on how to proactively invest in sustainable companies and investment vehicles.

"Once divested, funds can then be reinvested in companies that are identifying new market opportunities related to clean energy and the move to a more sustainable economy. These companies will be the beneficiaries as the incentives change to support a low-carbon future." said Matthew W. Patsky, CEO of Trillium.

We hope this guide and the resources in the appendix are used by investors to educate themselves, their family and friends, or their financial planner to go fossil fuel free.

EBAY DECLINES TO RENEW MEMBERSHIP IN ALEC

Trillium Asset Management (Trillium) is pleased to commend eBay, Inc. (NASDAQ:EBAY) for not renewing its membership in the American Legislative Exchange Council (ALEC).

ALEC has been on the forefront of attacks on state renewable energy programs and other legislative efforts to address climate change.

Trillium began engaging eBay on its membership in this organization in January 2014 and is delighted eBay has joined the growing ranks of companies that have dropped their membership in ALEC. Since August alone, Microsoft, Google, Facebook, Yelp, AOL, and Yahoo have abandoned ALEC.

As an investment firm that integrates environmental and social factors into the investment process, Trillium feels strongly that public policy and the markets must take an aggressive strategy to address climate change. This means ambitious greenhouse gas reduction policies, not only by states and the federal government, but also by corporations. American companies have many opportunities to adopt climate change strategies that are good for the climate and good for their bottom line. ALEC continues to be a barrier to public policy and market based.

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will be Trillium's flagship mutual fund and members of the investment team—including Jim Madden, Tony Tursich, Beth Williamson, and Emily Lethenstrom—are now Trillium employees. The Fund will continue to follow the same investment process and will continue to have the same office in Portland, Ore., working closely with Trillium's headquarters in Boston and our offices in Larkspur, Calif., and Durham, N.C. Current Trillium clients should notice very little change in their portfolio management team, service, or investment strategy.

The merger of our two companies will strengthen the depth of our current research capacity, while significantly broadening the investment products that we can offer to our clients.

For all of these reasons, our new partnership is a natural fit.

NEW INITIATIVE TRACKS IMPACT OF SHAREHOLDER ENGAGEMENT

Investors and stakeholders present new reporting framework for the impact of equity engagement

The multi-stakeholder Impact of Equity Engagement (IE2) initiative released a new report revealing the positive outcomes of investor engagement on the environmental, social, and corporate governance practices of publicly traded companies.

Investors often engage with public companies through the proxy process, dialogue, public policy advocacy, and assertive action. However, the report found that no standard method exists to date for demonstrating the impact of these activities. The report, which proposes a new reporting framework to track the impact of shareholder engagement, is available for download from http://croataninstitute.org/total-portfolio/publication/impact-of-equity-engagement

Eleven investors have already committed to alpha-testing IE2's reporting framework by using it to track their engagements during the 2015 proxy season: As You Sow, Boston Common Asset Management, Calvert Investments, Clean Yield Asset Management, Green Century Funds, Investor Voice, Newground Social Investment, NorthStar Asset Management, Pax World Management, Trillium Asset Management, and Walden Asset Management.

"We're excited to test and help further develop this new framework," said Shelley Alpern, Director of Social Research and Advocacy at Clean Yield Asset Management. "Practitioners of sustainable and responsible investing have known for decades that our engagements with companies have produced hundreds of positive outcomes, but much of it has gone unrecorded. This project will begin to capture the scale and depth of this activity so it is no longer lost to history or inadequately conveyed through mere anecdotes."

Early findings of the IE2 initiative were presented at the SRI Conference in Colorado Springs by Joshua Humphreys, President and Senior Fellow of Croatan Institute. Humphreys spoke on a panel entitled "Understanding the Impact of Engagement."

"Investors are increasingly interested in generating social and environmental impact in addition to financial returns, but many simply don't think you can have much impact by investing in publicly traded companies," said Humphreys. "Our analysis highlights the multiple ways that investors can make a difference by engaging with corporations, and the new reporting framework that the IE2 initiative has developed will provide an important foundation for documenting this impact."

> "We see the importance of understanding and articulating the impact of shareholder advocacy in public equities," said Matthew Patsky, CEO of Trillium Asset Management. "Public equities are often the largest part of an investment allocation. We need to provide greater clarity in explaining how the impact from this asset class can be so significant."

"Whether it is getting more women and minorities on corporate boards, securing commitments from companies to slash greenhouse gas emissions, or helping to establish human rights and labor standards for entire sectors, we know that our shareholder engagement has an impact," said Bennett Freeman, Senior Vice President for Sustainability Research and Policy at Calvert Investments.

IE2 builds on an important 2012 study on "Total Portfolio Activation," which explored how impact can be maximized across all asset classes in an investor's portfolio.

Investors using this reporting framework will be able to track and demonstrate the positive social, environmental, and governance impact of their own shareholder activities. By aggregating anonymized data from multiple investors, the reporting framework can also identify what factors lead to successful shareholder engagements.

STRONG PUBLIC POLICY ON METHANE EMISSIONS FROM NATURAL GAS IS VITAL

BY JONAS D. KRON, ESQ., DIRECTOR OF SHAREHOLDER ADVOCACY

It is well established that methane emissions are a serious climate problem. Methane is a highly potent greenhouse gas—as much as 84 times more powerful than carbon dioxide over a 20-year time period. The Intergovernmental Panel on Climate Change, the leading international body for the assessment of climate change, estimates that about 30% of the warming we will experience over the next two decades as a result of this year's greenhouse gas emissions will come from methane.

The entire oil and gas supply chain (from production through downstream uses) is the largest industrial source of methane emissions in the U.S., and recent studies have concluded that methane emissions from the U.S. natural gas supply chain are nearly double the official estimates.[1] As the Obama administration noted in its March 2014 Strategy to Reduce Methane Emissions, emission measurement and estimates entail considerably uncertainty.

What this means is that both carbon dioxide and methane emissions pose imminent risk to the climate and in turn economic stability and investment opportunities. This is particularly true as market forces and the Obama administration's Clean Power Plan position natural gas as a low-greenhouse gas alternative to coal. But methane emission rates put that premise into question. It is therefore critical for us to adopt rigorous regulation to address methane emissions so natural gas has the opportunity live up to its climate potential.

Over the past few years, Trillium, along with other concerned investors, has engaged oil and gas companies on this issue by urging them to set goals for reducing methane and to improve disclosures significantly. In October, Trillium and the NYC Comptroller's Office opened a new avenue of advocacy by organizing investors with more than $300 billion in assets under management to write a letter to Gina McCarthy, Administrator of the U.S. Environmental Protection Agency, urging the agency to move forward with a robust effort to regulate methane emissions from the oil and gas industry, both upstream and midstream. In the letter, which is posted on Trillium's website, we described how investors in the oil and gas industry are deeply concerned that methane emissions pose a serious threat to climate stability, accelerating the rate of warming in the near term and threatening infrastructure and economic harm, which are bad for the country and bad for investors.

The policy we call for in the letter is a comprehensive policy that will: (1) minimize harmful methane and associated emissions, (2) build investor confidence that natural gas is appropriately regulated so that it can help the economy transition to a clean energy economy, and (3) keep more natural gas working for the economy as America migrates towards a more sustainable energy mix.

We also emphasize that there are proven, cost-effective solutions to this problem that will dramatically cut emissions now. A recent report prepared by ICF International, drawing on industry input, identified proven control strategies that can slash oil and gas methane emissions by 40% at an average annual cost of less than one cent per thousand cubic feet of produced natural gas. These strategies, such as vigilant leak detection and repair programs and retrofits of valves originally designed to leak methane, are commonsense ways to cut emissions. In addition, some of these strategies will have a positive economic payback, as the value of captured gas more than offsets the cost of control. Furthermore, addressing methane emissions will benefit regional air quality and public health. The attainable 40% methane reduction brings with it—for no additional cost—a 44% decrease in volatile organic compounds (VOCs) and hazardous air pollutants (HAPs), which are significant contributors to diminished air quality and public health issues such as asthma and other respiratory conditions.

We also argue that it is insufficient to rely solely on voluntary initiatives and state-level action. While voluntary industry action and state-level regulation are meaningful steps in the right direction, they are insufficient to address the magnitude and urgency of the problem. With thousands of industry operators in the upstream segment alone, uniform rules are the only way to level the playing field and ensure high performance across the board. As the industry is highly dispersed, a national framework, in collaboration with states, is the right approach to ensure simplicity, consistency, and certainty. Further, policy is needed to overcome externalities that keep companies from investing in emission reduction. The good news is that the EPA can draw on the Colorado model, where the recent development of sweeping new methane control rules was accomplished through a cooperative process that included political and policy leaders, industry, and environmentalists.

Finally, we pointed out that a rigorous methane policy can reduce risk and create value for investors and the economy. For example, a June 2014 Goldman Sachs report shows that America is losing out 15:1 on certain industrial downstream reinvestment, in part because the methane policy vacuum and associated public environmental concerns create uncertainty in industrial investment. We believe the establishment of a comprehensive methane policy that reduces emissions and ensures a real climate benefit from natural gas as we transition to a renewable-energy economy can have positive economic and environmental benefits. The Goldman Sachs report argues that as many as 1 million additional jobs in the U.S. may be created in the next decade if we address a number of key policy priorities, including methane. Moreover, getting methane emissions under control will help manage the rate of climate change, thereby limiting the damaging economic costs associated with droughts, storms, floods, and other disruptions.

In the year to come we expect this group of investors to grow significantly. We will be continuing to engage policy makers as the policy process proceeds—not only with additional letters, but with in-person meetings and discussions. We firmly believe that investors have the opportunity and responsibility to address climate change at the company and policy level. We feel that this policy initiative is one of the most impactful ways for us to do this.

[1]Brandt, A. R., et al., "Methane Leaks from North American Natural Gas Systems," Science Magazine (February 2014)

TRILLIUM (ONCE AGAIN!) FILES NON-DISCRIMINATION SHAREHOLDER PROPOSAL WITH EXXONMOBIL

Trillium has filed a shareholder proposal with ExxonMobil* (XOM) asking the company to amend its written equal employment opportunity policy to explicitly prohibit discrimination based on sexual orientation and gender identity and to substantially implement the policy. The proposal was co-filed with the New York State Comptroller's office.

Exxon merged with Mobil in 1999 and stripped away the LGBT non-discrimination policies that had been in place at Mobil. Trillium filed its first shareholder proposal with ExxonMobil on the issue in 2001.

In 1995, Trillium was the first investment firm to sponsor a shareholder proposal asking a company to add sexual orientation to its nondiscrimination policy.

"We believe that companies and workers benefit from consistent, corporate-wide efforts to prevent discrimination, ensuring a respectful and supportive atmosphere for all employees," said Brianna Murphy, Trillium's Vice President Shareholder Advocacy and Corporate Engagement.

"ExxonMobil stands out among Fortune 500 companies for its refusal to explicitly prohibit discrimination based on sexual orientation and gender identity," said New York State Comptroller Thomas P. DiNapoli. "Companies that fail to enact equal rights policies risk limiting their ability to attract and retain the best and brightest employees, thus potentially damaging their bottom line."

With the recent evolution in favor of allowing same-sex marriage in the U.S., it may be difficult to believe that in more than two dozen states people can still be legally denied a job, or fired, simply because of their sexual orientation. In more than 30 states, employment discrimination based on gender identity is still legal. U.S. Attorney General Eric Holder recently announced that the Department of Justice will take the position in litigation that the protection of Title VII of the Civil Rights Act of 1964 extends to claims of discrimination based on an individual's gender identity, including transgender status.

** In addition to engaging with our core portfolio companies, Trillium also conducts advocacy on selected companies (identified with an "*") that are not in our core portfolios but are held as legacy positions in client portfolios. These are companies that may not meet our minimum social and environmental criteria, but that we still seek to improve. The information provided in this material should not be considered a recommendation to buy or sell any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable.*

Trillium's Approach to Diversified Financials Sector, *continued from page 1*

return of capital to shareholders, and other benchmarks. Trillium prefers to invest in Diversified Banks that identify and pursue higher growth/return opportunities, manage their businesses efficiently and responsibly, respect and treat their employees and customers well, and consider environmental and social risks and opportunities in their strategies and operations.

While Diversified Banks remain in many of the same businesses (Consumer Banking, Commercial Banking, Investment Banking, and Asset Management) that they were in a decade ago, companies have worked to focus on areas of strength that generate the highest returns on a risk-adjusted basis and require less earned income or capital to be reserved for regulatory purposes. Many banks have been required to scale back their operations in some areas due to regulatory changes. This has resulted in the sale of fewer products and services, no longer doing business with or reducing services to less profitable customer groups, and scaling down the geographies they sell in.

> One of the most problematic consumer product areas for banks is checking account overdraft fees. To maximize fees, many banks post account debits or withdrawals in order of high-to-low amounts. When a customer's account balance moves below zero, a bank can charge more fees due to more transactions hitting the account when it has a negative balance. This methodology is unfair to the customer and is a bad business practice.

CHANGING REGULATORY ENVIRONMENT

New regulations require the largest global banks to ramp up their internal risk monitoring and control processes, which has resulted in the hiring of thousands of new employees and the spending of hundreds of millions of dollars on new technology and systems. We view these new requirements as positive, particularly because they address the regulators' investigation findings.

Some companies have gone beyond the required changes in their business models. For example, HSBC Holdings (NYSE: HSBC) implemented a new incentive compensation program beginning in 2013 for its Retail Banking and Wealth Management division customer-facing staff, whereby they are no longer incentivized by product-sale volumes but instead on meeting customers' needs. We believe this signals that customer feedback has become a material input in employee reviews and compensation at HSBC and removes a past performance metric that supports a short-term, not long-term, profit focus.

Another area where bank business models are changing is in how they do business with their retail bank customers, primarily due to technological innovation, new regulations, and low interest rates.

Specifically, banks—large and small—are rolling out new technology to support more mobile banking services. Fewer traditional teller-type transactions (e.g. deposits) are occurring in the branch, and banks are shifting the purpose of one's bank branch visit to establishing and building relationships in their home mortgage and financial advisory businesses. This is due to banks searching for new fee revenues after new regulations limited areas in which they could generate revenues as well as the current low-interest environment. Overall, we expect that mobile banking will help reduce operating costs and bank branches should generate higher returns on investment with more stable revenue sources due to their transition to fee income.

The evolving regulatory environment has influenced Diversified Banks in other ways, too. For example, new regulations require the largest banks (assets of $250 billion or more) to hold more equity capital or retained earnings on their balance sheet, have less and more stable sources of financial leverage, and hold a sufficient amount of liquid assets to fund short-term operations—all with the goal of working to ensure that these banks are able to withstand a future financial crisis.

Another significant regulatory change is the U.S. Federal Reserve Banks' Comprehensive Capital Analysis and Review (CCAR), which is the Fed's qualitative and quantitative assessment of the larger banks and which then provides authorization related to banks' request to return income and/or excess capital held to their shareholders. Failing the CCAR process is viewed negatively by the financial markets and is particularly concerning if it is for qualitative reasons, as it suggests that the Federal Reserve may be less confident in how they are managing their operations. Citigroup (NYSE: C) failed its CCAR application in 2014 and is now intently focused on addressing the Fed's concerns in creating what its CEO refers to as an "industrial strength" CCAR process.

CONSUMER SAFETY

Our analysis focuses on consumer product/service, as this is a significant income generation area for the companies in this sector as well as an area with significant brand/reputation risk. There is nothing wrong or irresponsible about lending to low-income borrowers. Best practice in making subprime loans is that lenders address additional risks by more closely evaluating the borrower, setting higher standards for collateral, and charging interest rates that are commensurate with the increased risk.

Leading up to the 2008-2009 financial crisis, poor underwriting practices and declining standards for mortgages, coupled with incentives for underwriters, increased the volume of transactions and encouraged a disregard for credit quality. Our analysts attempt to identify potential future problem areas for the companies they review and evaluate internal governance, processes, and other factors that may result in outcomes detrimental to their retail customers.

Responsible lenders offer consumer product/services that are fairly structured, priced, offered, and transparent. Many Diversified Banks have established governance oversight in this area as most banks—not just the large Diversified Banks—have become more aggressive and less customer friendly in their consumer products as they seek to boost fee revenues during this environment of low-interest rates. However, the establishment of internal committees does not always translate into ideal business practices.

Following negative press and class-action litigation, one of the most visible and well-publicized problematic consumer product areas for banks in recent years has been checking account overdraft fees. To maximize fees, many banks post account debits or withdrawals in order of high-to-low amounts. As a result, when a customer's account balance moves below zero, a bank can charge more fees due to more transactions hitting the account when it has a negative balance. This bad business practice is unfair to the customer, and is counterintuitive to building long-term customer relationships. A number of banks have moved entirely away from high-to-low to either chronological or low-to-high amount posting order, which we believe is best practice.

Among the Diversified Banks we researched, we believe HSBC (NYSE: HSBC) and Wells Fargo (NYSE: WFC) adhere to best practices in this area, as they post entirely in low-to-high order on all transactions. Citigroup posts in chronological order, but it lacks adequate transparency in its customer documents. While Bank of America (NASDAQ: BAC) and JPMorgan Chase (NYSE: JPM) both have comprehensive account disclosure documents, they fall short as they still post some debits in high-to-low order.

RISK OVERSIGHT

Most Diversified Banks have established Environmental and Social Risk Committees. As best practice, we believe this committee should include senior executives, business unit heads, and experts from outside the firm working to ensure that the company identifies, minimizes, and manages client environmental and social (E&S) risks and opportunities across the company's lending, investment, underwriting, and asset management business areas. In addition, the committee should also help the company pursue business opportunities and set goals in environmental and social impact areas, including mitigating climate change, water scarcity, biodiversity, and community lending. To ensure proper governance, we also believe this committee should report to the company's Board of Directors. These steps should help a company build a corporate culture that instills the importance of superior E&S performance.

This doesn't mean that banks aren't lending or investing in areas that some might view as controversial, such as the Energy sector. Investors should be aware if the bank audits its internal processes to ensure that its bankers are complying with its environmental and social risk due diligence requirements.

CONCLUSION

It is important to understand banks' internal due diligence process, including how employees who have environmental or social issue expertise are included in the investment approval process. Our analysts work to identify companies that are actively considering environmental and socials risks and opportunities and how companies are considering these risks in their business models

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TRILLIUM FILES TWO DOZEN SHAREHOLDER PROPOSALS FOR 2015

Trillium's shareholder advocacy team has filed or co-filed 24 proposals for the 2015 shareholder season. Proposals were filed on issues including climate change, political spending, diversity, Internet privacy, sustainable agriculture and Native American rights. One of the proposals, a greenhouse gas proposal filed with Costco, has already been successfully withdrawn.

Shareholder proposals provide a vehicle for shareholders of a company to express concerns about material environmental and social issues is vital for encouraging corporate sustainability that is in the best interest of the public, shareholders and the companies themselves. A list of shareholder proposals that Trillium has filed or co-filed over the past 15 years can be found on our website.

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Randy Rice, *Editor*

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