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Organic Food: Holding Its Own In Recession

BY ELLEN PFEIFER



IT'S FRIDAY AFTERNOON IN LATE JUNE IN BOSTON'S COPLEY SQUARE. THE SEMI-WEEKLY FARMERS' MARKET IS HOPPING AS SHOPPERS ON THEIR LUNCH HOUR STOCK UP ON LOCAL BERRIES, LETTUCES, SPRING ONIONS, HERBS, CHEESES AND BAKED GOODS. ALTHOUGH BUSINESS IS BRISK AT EVERY STAND, THE LONGEST LINE IS FOR VEGGIES AT CERTIFIED ORGANIC ATLAS FARM. CLEARLY, BOSTON CONSUMERS ON THIS DAY ARE EAGER TO BUY ORGANIC AND TO BUY LOCAL.

That impression is reinforced by visiting Boston-area Whole Foods Market locations, which always seem to have plenty of customers.

Yet, just two days after that Farmers' Market in June, the *Boston Globe* ran a front page story on the woes of Vermont's organic dairy farms during this recession. After peaking at 113.2 million gallons in 2008, sales of organic milk will drop to a projected 96.3 million gallons in 2009, according to the Northeast Organic Dairy Producers Alliance. As a

result, dairy farmers are being asked to cut production and reduce the prices they receive for their milk. After years of double digit growth and healthy profits, some farmers are now finding that they can't earn enough to cover their costs. A few are closing up shop.

These apparently contradictory stories underscore the uneasiness in the organic food market as consumers throughout the world adjust their

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FEATURED COMPANY

UNITED NATURAL FOODS *King Of The Road*

BY ETHAN BERKWITS

For many of us, organic and natural food elicits a strong emotional and idealistic response. Organic



food provides healthy sustenance to our families; it protects our land from the ravages of corporate mega-agriculture; it offers us a deeper connection to the earth. Then there is the taste. Once we have experienced the intense flavors and aromas of natural foods, we never want to go back.

By contrast, the story of United Natural Foods (UNFI) may seem a bit prosaic. Yes, UNFI is a company that makes our enjoyment of organic foods possible, but its seemingly mundane business is wholesale food distribution. As the

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MARKETBEAT PAGE 2

Checking Healthy Living's Vital Signs

Taking a closer look at the Healthy Living Index after a stress-inducing year



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Westport Innovations Under New Hood

LNG and CNG technology fuels new Freightliner trucks introduced by Daimler

AN OBESE AMERICA RECEIVES A FAILING GRADE

Our nation's obesity epidemic is getting worse, according to "F as in Fat: How Obesity Policies Are Failing In America." The Trust for America's Health 2009 report, which is known for its yearly updates to state-by-state obesity rankings, includes a number of other ominous facts and figures as well. Think and chew on these:

- In 31 states, more than 25% of adults are obese. Top billing goes to Mississippi at 32.5%.
- Adult obesity rates exceed 20% in every state except Colorado.
- In 1991, no state had an obesity rate above 20%. In 1980, the national average was 15%.
- Childhood obesity rates have more than tripled since 1980. In 30 states, the percentage of children that are obese or overweight is at or above 30%; again, Mississippi is #1 with an astonishing 45% childhood obesity rate.

Particularly disturbing: in all 50 states, obesity is higher among 55-to-64 year olds — baby boomers — than among those 65 and older. This wave of obese boomers will have a huge impact on Medicare — recent research shows that modern medicine will help them live longer, but they will be much sicker for much longer, and will require expensive treatments like dialysis and knee replacements. Jeff Levi, executive director of the Trust, said that Medicare spends thousands more annually on health care for an obese senior than a non-obese one.

"There isn't a magic bullet. We don't have a pill for it," said Levi. "It's not going to be solved in the doctor's office but in the community."

HEALTHY RETURNS

BY MATTHEW W. PATSKY AND ELIZABETH R. LEVY

No one needs to be reminded that the stock market took investors on a bumpy ride over the past nine months. As green investors, we at Winslow were naturally curious about how the Healthy Living® industry fared during this period. The industry sits at the intersection of two powerful forces: the strong growth of consumer demand for natural and organic products and the shrinking consumer budgets caused by recent economic upheaval. Which force has been stronger, and how did the stocks of Healthy Living companies respond? Can any lessons be learned yet?

What Happened?

Although a somewhat painful exercise, we can gain a few insights by revisiting the past few months of Healthy Living stock performance, as demonstrated by the Canaccord Adams Healthy Living Index ("HLI"). Back in October, when faced with the threat of economic Armageddon, Americans were understandably frightened. With the seemingly daily collapse of iconic American companies, they worried: "Is my company next? Is my paycheck next?" It seemed logical that many consumers of higher-priced organic and natural foods would retreat to less expensive conventional foods. Some investors clearly feared as much: the stock of bellwether organic retailer Whole Foods Market (WFMI) dropped 47% during the month of October 2008 on worries that shoppers would abandon the store in favor of lower priced conventional grocers.

However, the performance of the Healthy Living Index as a whole showed surprising resilience. In October, the HLI fell 18.5%, but the S&P 500 itself,

representing the broader stock market, experienced a similar drop of 16.8%.

The two indices continued to offer similar performance through the fall and winter, as shown in the accompanying chart. In November 2008 — the HLI's worst month of the downturn — the index only underperformed the S&P by 4%. And in January 2009, it bested the S&P by 7%.

The indices diverged in April and May, with the HLI demonstrating a clear advantage. During this period, companies reported their Q1 2009 performance, and signs of economic stabilization were finally visible through the veil of uncertainty. These early positive signals seemed to greatly benefit the HLI, which outperformed the S&P 500 by 9%, 13% and 5% in April, May and June respectively. As of June 30, the HLI had essentially recovered completely from the market crash which began in September 2008.

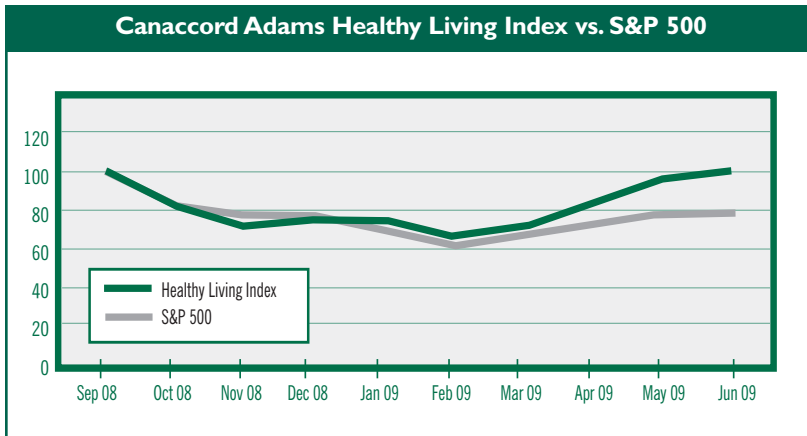
One could conclude that it's back to business as usual for organic and natural products. But what has really happened with the HLI? Have consumers abandoned their organic leanings, or remained loyal? Have investors overreacted to both good and bad news over the past several quarters?

Underlying causes

In our view, much of the activity in the equity markets in October and November was based more on severe concerns about corporate liquidity and solvency, than about real company fundamentals or earnings prospects. And as those fears have diminished over the past few months, most companies' stock prices in the HLI have rebounded strongly. For example, in October Whole Foods'

stock fell much more dramatically than the S&P. In addition to fears about declining sales, Whole Foods also had higher debt and lower cash liquidity than the market demanded at the time. When the company was able to raise \$420 million from an investor in early November, which greatly alleviated balance sheet fears, its stock immediately found its bottom and began to outperform the S&P significantly.

At the same time, fears about falling sales at Whole Foods and across the organic foods industry were justified. For the three months ending January 18th, Whole Foods reported that same store sales (a metric comparing each store's sales to its sales figures from the year prior) had been negative for the first time in its history, a 4% decline. It reported another 5% same store sales decline for its fiscal quarter ended in April.



Growth rates have slowed across the industry. As cited in Ellen Pfeifer's article in this edition of WEN, year-over-year growth in organic food sales in March of 2008

Whole Foods wasn't the only company within the HLI which swung wildly during this period. In November, the HLI was down 12% but there were six companies in the HLI whose stocks fell by more than 40%. Conversely, when the HLI increased by 18% in April, there were 10 companies whose stocks increased by more than 40%. One of the reasons for these big moves is simply that the index is populated with many small, volatile companies. These stocks became even more volatile during the past year, as investors fled initially to higher quality names and then returned after regaining their appetite for risk. As an example, Gaiam, a leader in yoga-related products, has a market cap of \$131 million, and proved to be very sensitive to economic fears. It fell 66% between October 1 and April 1. However, when the company announced during Q2 2009 that it would repurchase 4% of its outstanding shares, its stock shot up 77% during the quarter.

was 24% vs. March of 2007. In March of 2009, growth in sales was only 1% vs. a year earlier.

Looking Forward

So, it seems that, at least in the very short-term, stock valuations in the organic and natural foods segment may have gotten ahead of themselves. It's difficult to come to any other conclusion, with valuations back to pre-crash levels set against a backdrop of fundamentals that have clearly deteriorated in the past 9 months.

However, we are still quite confident in the long-term growth story in this segment. Given our country's huge obesity and diabetes epidemics, we expect consumers to continue their shift to natural foods as part of the solution. And it's important to note that the overall industry kept growing throughout this economic downturn – perhaps the best demonstration of all that this industry is diversifying, maturing, and on solid footing for long-term success.

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All market data provided by Canaccord Adams. Index data as of 7/1/09. Investors cannot invest directly in the S&P 500 or the Canaccord Adams Healthy Living Index. For more information on the Canaccord Adams Healthy Living Index, please see www.canaccordadams.com. **Past performance is not indicative of future results.**

From modest beginnings, United Natural steadily matured, eventually developing a sophisticated, best-of-class national operation, driven by strong technology and a highly trained work force.

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largest organic food distributor in the United States, its day-to-day operations are all about trucks and warehouses, shipping and receiving, and constant attention to the thin operating margins inherent in the industry.

However, the company's successful modus operandi isn't about squeezing suppliers or maintaining a vise-like grip on labor costs. In fact, the company has been guided by a deep-seated environmental and social philosophy since its founding in the 1970s. From its regional origins powered by "vision, entrepreneurial spirit and a shoestring budget," to its ongoing service-driven investments in technology and people, to its pioneering environmental stewardship initiatives, United Natural has demonstrated that a business model based on environmental sustainability can indeed drive profitable growth.

Large "family" gathered under one umbrella

United Natural developed from the many regional organic food distributors that appeared in the 1970s to serve the growing demand for natural foods. Cornucopia Natural Foods and Mountain People's Warehouse, based in New England and Northern California respectively, merged to form United

Natural Foods. As time went on, United Natural acquired additional regional distributors in order to achieve market leadership and national scale.

The organic food business – well before the golden growth era of Whole Foods Market – was relatively unsophisticated and fragmented in those early years, and the primitive operations of some of UNFI's "family members" (its term for acquired businesses) bordered on the surreal. Consider Blooming Prairie, a distributor acquired by United Natural in 2002. According to the company's website, in Blooming Prairie's early years "orders were coordinated by a collective of volunteers and phoned into another distributor in Minneapolis. When the order was ready, a volunteer would hitchhike north to Minneapolis, rent a truck, pick up the order and deliver the goods to stores and the warehouse in Iowa City."

From these modest beginnings, United Natural steadily matured, integrating its various "family members" and eventually developing a sophisticated, best-of-class national operation, driven by strong technology and a highly trained work force. As of year-end 2008, United Natural employed over 6,300 associates to serve more than 17,000 customers in the U.S. and 40 other countries.

CONGRESS HEATS UP ON GLOBAL WARMING

In June, history was quietly made in Washington: for the first time ever, legislation to curb greenhouse gas emissions in the U.S. made it to a floor vote in the House of Representatives. And after a huge amount of drama and compromise, the House voted in favor of the bill. Sweet victory!

While the passage of this bill is certainly an excellent development, we at WEN felt that the final version passed by the House was far from perfect. In our view, far too many credits would be allocated (i.e. given away) to emitters, rather than auctioned, which would eliminate the potential for billions of dollars in funding for renewable energy projects. And significant concessions were required to win key Democratic votes in states with ethanol and coal interests, so those industries (both major carbon emitters) were handled with kid gloves.

Now climate legislation is being debated in the Senate. The kickoff in early July, with overview testimony from the Obama administration, was friendly enough. But look for plenty of sound and fury in coming months, and not just from GOP opponents, some of whom still question the validity of global warming. Agriculture Chair Tom Harkin has already made clear he will demand the same protections for farmers as House Ag Chair Collin Peterson did on the House version. "EPA's got to get over their absolute rejection of ethanol. They've just got to get over it," Harkin said. "And we're going to force them to get over it." Let the games begin again...

Boasting a catalog of over 60,000 products, it operated 20 distribution centers around the country, with an aggregate 5.8 million square feet of warehouse space.

Success through sustainable operations

United Natural's growth strategies have definitely been supported by excellent performance against environmental metrics.

In terms of environmental stewardship, United Natural's accomplishments extend far beyond its commitment to sustainable and organic agriculture. The firm has championed the cause of solar power, and generates over 2 million kWh of electricity annually from two huge solar arrays at its Dayville, CT and Rocklin, CA distribution facilities. Its brand-new Ridgefield, WA distribution center is also 100% powered by renewable energy. Tom Dziki, the firm's VP of Sustainable Development, reports that United Natural's solar projects are providing substantial energy savings and relatively short payback periods. "It's going to take us six to seven years to pay off the investment we have in the system, but after that, we're going to have another 20 years of clean energy. So it's really a win for us."

United Natural's Ridgefield, WA facility, according to *Progressive Grocer*, is the "first refrigerated distribution center to earn LEED Gold certification from the US Green Building Council." The certification was earned partly from its green energy usage, but also from a host of other environmental attributes, from the materials used in construction, to systems designed to greatly reduce water usage.

Even more significantly, United Natural became the first distributor in the country to be certified organic by Quality Assurance International in 2002. According to Ellen Holton of QAI, "The task of choosing to certify its entire distribution network demonstrates UNFI's commitment to preserving organic integrity through the entire supply chain."

New era in management

UNFI's management team will benefit from a

combination of experience and new perspective in the coming years. Founder and Chairman Michael Funk stepped aside as CEO in 2008, and industry veteran Steve Spinner joined the firm as his successor. The expansion in the management team (Mr. Funk remains Chairman and is still active in helping guide the firm's strategy) was seamless. Mr. Funk was actively involved in the search process and was impressed with Mr. Spinner's clear industry bona fides – he was formerly the CEO of the third-largest mainline food distributor in the country – as well as his strong passion for United Natural's environmental mission.

Mr. Spinner took the reins at United Natural just as the economy and the stock market began its tailspin in late 2008, so his early tenure hasn't been easy. But he has shown a steady hand, making solid cost-containment decisions while maintaining the company's commitment to several key strategic initiatives. One of these initiatives was the recent opening of the company's new 675,000 square foot facility in York, PA – it is United Natural's first completely integrated distribution center, which stocks its entire catalog of products and is now effectively serving the entire mid-Atlantic market. Mr. Spinner told *WEN* that the facility is a likely model for future centers elsewhere in the country.

Guided by new management, United Natural achieved record earnings during its most recent fiscal quarter (ended May 2, 2009), defying some of the worst economic conditions in memory while also raising its earnings guidance for fiscal 2009. And investors have responded – as of June 30, United Natural's stock had rebounded to its pre-crash price levels (the S&P 500 has yet to come close to this achievement). "United [Natural] remains in an enviable position with still-favorable fuel prices, market leadership and enhanced management," said Canaccord Adams analyst Scott Van Winkle. "Even exposure to softening consumer spending isn't leading to declines, but rather just moderated growth." And in these times, even moderate growth looks very tasty indeed.

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PORTFOLIO UPDATE

Canadian Hydro Developers Opens Wolfe Island – 2nd Largest Wind Facility in Canada

CALGARY, CANADA – Canadian Hydro Developers, Inc. announced in June that its 197.8 MW Wolfe Island EcoPower® Centre, located near Kingston, Ontario, has commenced commercial operations. The second largest wind facility of its kind in Canada, the Wolfe Island EcoPower® Centre was completed on schedule, with a total anticipated capital cost of approximately \$478 million.

“With the Melancthon EcoPower® Centre and now Wolfe Island, we own and operate the two largest wind installations in the country,” said Kent Brown, Executive Vice-President & Chief Financial Officer.

Wolfe Island is expected to generate approximately 594 MWh of renewable energy annually. Wolfe Island has a 20-year contract with the Ontario Power Authority for the purchase of electricity and Renewable Energy Credits. In addition, the facility will also receive \$10 per megawatt hour in subsidies for 10 years under the Canadian ecoENERGY for Renewable Power program.

Wolfe Island's commercial operation officially pushes Ontario past the 1,000 MW installed threshold of new renewable energy brought online since October 2003. Approximately

40% of this generation is provided by Canadian Hydro.

Canadian Hydro Developers, Inc. is the largest and most diversified developer, owner, and operator of renewable energy facilities in Canada, totaling net 694 MW of capacity in operation, 185 MW under construction, and 1,624 MW in development.

WaterFurnace Visited By Secretary of Energy During Geothermal Tour

FORT WAYNE, IN. – In June, U.S. Energy Secretary Steven Chu toured the world headquarters of WaterFurnace Renewable Energy, a leading manufacturer of geothermal heat pumps. During his visit to Fort Wayne, he announced a \$50 million program that will encourage the installation of geothermal heating and cooling systems like the ones manufactured by WaterFurnace.

The secretary also participated in a roundtable discussion with WaterFurnace employees, executives and dealers, and then toured the WaterFurnace facility with President and CEO Tom Huntington, Chairman of the Board Tim Shields, and Fort Wayne Mayor Tom Henry.

Secretary Chu announced funding for several programs supporting geothermal heating and cooling, including grants for demonstration projects, technology improvement projects, and the creation of a national certification process to increase consumer confidence.

“We are very excited about Secretary Chu's announcement today and the leadership WaterFurnace will continue to play in our country's movement toward clean energy technology,” said Huntington. “The products we build and promote are among the most environmentally friendly heating and cooling products available in the world today.”

Westport Innovations News: Daimler Trucks North America Introduces Vehicle with Cummins Westport LNG Engine

VANCOUVER, BC – Cummins Westport Inc. (CWI) announced in June that Daimler Trucks North America will incorporate its ISL G Natural Gas engine in the Freightliner Business Class M2 112 truck in a total of six LNG (liquid natural gas) and CNG (compressed natural gas) tractor/truck configurations. The ISL G meets 2010 EPA emissions today, reduces greenhouse gas emissions and offers top-level performance and efficiency. Cummins Westport is a joint venture between Cummins Inc. and Westport Innovations Inc., to produce alternative fuel engines.

The rollout began with an LNG tractor for port and regional haul applications. Later in 2009, a CNG version of the tractor is expected to be offered, followed by single axle tractors, 4X2 and 6X2 trucks, and other configurations. The entire line up should be available by the end of 2010.

“Introducing a factory designed and engineered Business Class® M2 112 with natural gas provides our customers with a hard-working truck that features added economic and environmental benefits,” noted Melissa Claussen, Director of Marketing, Freightliner Trucks.

Roe East, President of Cummins Westport, added, “This is a great opportunity for CWI to partner with Freightliner, one of North America's market-leading truck manufacturers. By launching the Cummins Westport ISL G in the M2 112 tractor, Freightliner will be able to provide customers with clean, economic natural gas power for a wide range of applications.”

INTERNATIONAL UPDATE

Vestas Introduces New V60-850 kW Wind Turbine: Made In China, For China

In April, Denmark-based Vestas Wind Systems unveiled a new wind turbine uniquely tailored for the Chinese market, the first market-specific turbine ever developed by Vestas. The V60-850 kW was developed from Vestas' proven and reliable kW technology platform, and features custom designed innovations to make the turbine highly suitable for Chinese wind and weather conditions.

The V60-850 kW was designed to be most effective in low and medium winds, which represent close to 75 per cent of China's unutilized onshore wind resources. It is also specially designed to withstand conditions such as the tough winters in northern Chinese areas such as the Inner Mongolian Autonomous Region (IMAR), home to a significant proportion of China's untapped wind resources.

The V60-850 kW is almost entirely sourced in China; over 90 per cent of its components are Chinese-made, and the turbine will be built in Vestas' new factory in Hohhot, IMAR. Hohhot was chosen because of its proximity to the key wind energy sites in northeast China and the developing wind energy market in IMAR.

“The V60-850 kW turbine is a ground-breaking new product for China, and is the first time Vestas has customized a turbine for a single specific market,” said Vestas CEO Ditlev Engel. “China, as a future global wind energy superpower, is one of the most important markets for us. The development and introduction of the V60 represents the beginning of a new stage in Vestas' 20-year history in China.”

spending habits in the face of a severe economic downturn.

Double Digit Growth for 2008

With increasing numbers of consumers seeking the health benefits touted by producers of organic foods, the market for organics skyrocketed in recent years. In the U.S., sales of organic food and beverages grew from \$1 billion in 1990 to an estimated \$20 billion in 2007, according to the Organic Trade Association, headquartered in Greenfield, MA. In 2008, U.S. sales of organic foods grew by 15.8% to reach \$22.9 billion so that organic food sales accounted for 3.5% of all food product sales in the country."

However, that 15.8% figure concealed a major slowdown in growth in the latter part of the year as the recession took hold. According to market research firm The Nielsen Company, sales in December were up only 5.6% year on year, against a 25.6% rise a year earlier. By March 2009, sales were up only 1%, as compared to a rise of 24% a year earlier.

In Europe, the organic industry held its own in France and Germany, but in Britain it was hit hard, with sales of organic fruit dropping by 4.9% and vegetables by 13.5%, according to the Soil Association, which certifies organic food. Overall, the market dipped to 1.7% growth for the year.

Committed Buyers Staying Loyal

Despite these sobering figures, the industry has continued to grow. Tom Pirovano, director of industry insights at The Nielsen Company, attributes this to the philosophical commitment of people who buy organic. "I'm not convinced that we are going to see big declines in organics any time soon," he said.

The Organic Trade Association backs him up and projects an annual growth rate in the single digits for 2009.

Organic Customers Weigh the Cost/Benefits

Sylvia Tawse, of The Fresh Ideas Group in Boulder, Colorado, believes that while green consumers aren't giving up organics altogether, they have become increasingly choosy about what organics they buy. "The green conscientious mom will deny herself that wonderful organic body lotion but won't deny her kids organic bananas and broccoli." She "may also opt for the private label products of a grocery store rather than brand

names. In a recession, the greater the 'green premium' for an item, the harder it is to sell. Organic meat, which can cost 50% more than alternatives, may be too costly a choice for many customers," Tawse said. Instead, "they may turn to grains or produce."

Indeed, publications from *Forbes* to *Cooking Light* are counseling readers on making the most effective and economical choices in organic products.

For example, Sonya Lunder of the Environmental Working Group recommends getting the most health benefit for your buck by buying organic versions of the "dirty dozen" in produce. These are the fruits and vegetables that absorb more pesticides than others, including peaches, apples, bell peppers, celery, nectarines, strawberries, cherries, kale, lettuce, imported grapes, carrots and pears. For shoppers who selectively buy organic, Lunder suggests splurging on organic meat, cheese, milk and baby food. "Chemicals accumulate in fat," she says. "So products like meat or cheese, which contain large portions of animal fat, may have accumu-

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THE DIRTY DOZEN ~

If you're looking for the biggest health benefit from just a partial shift to organics, try starting with these twelve items, which tend to absorb very large amounts of pesticides when exposed.

- Peaches, apples, bell peppers, celery, nectarines, strawberries, cherries, kale, lettuce, imported grapes, carrots and pears**

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lated antibiotics or pesticides.” She also recommends buying organic baby food because infants eat large amounts of a few types of food.

“Organic-Plus” to

Enhance Customer Appeal

If consumers are going to continue to pay the “green premium” for organic products, many will ask for more than the absence of pesticides and chemical fertilizers, according to some commentators. *The Organic Monitor*, for example, writes that “consumers are demanding more from organic food products; they are increasingly looking at ethical sourcing, traceability, the carbon footprint, sustainability and corporate social responsibility.” Taking heed, some certification agencies like the IMO and Ecocert have introduced fair trade standards into their metrics.

Producers are also stepping up to the plate. Green & Black’s, the U.K. organic chocolate

company, sources ethically from developing countries. Palestine-based Canaan Fair Trade has invested in a war-torn region to produce organic olive oil. Hipp, which uses renewable energy to make organic baby food, is cutting carbon emissions and recycling 97% of its waste.

The local food movement is also generating enthusiasm. Consumers, such as those at the Copley Square Farmers’ Market, like the idea of supporting local farms and reducing the energy wasted to transport food products long distances. They also like the improved flavor and freshness of produce bought the same day it is picked.

Still, the key to boosting sales of organics will boil down to the basics. Finn Cottle of the U.K.’s Organic Trade Board maintains, “Growth will be dependent on communicating simple and effective messages on the benefits of organic produce – organic as a healthy choice, focused on animal welfare and being kinder to the environment in which we live.”



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