Briefly give us a little bit of a sense of where you think the Pax High Yield Bond Fund fits in the world of funds, but also maybe in the world of these types of bond funds?

Mr. Schwab: This fund could be used in many ways, as a fixed income allocation specifically on the higher-risk spectrum or for investors needing income. It could also be used as an alternative to one’s equity exposure. High yield bonds, in general, are highly correlated with equities, but with less risk in general than the stock market. Within the fixed income asset class and relative to other high yield bond funds, the primary differentiator for this fund is that we have full integration of ESG — environmental, social and governance — factors into portfolio security selection. We have a four-member team here at Pax that focuses exclusively on sustainability, and every company in this fund is subject to meeting our ESG research criteria.

TWST: I am looking at an article today in The Wall Street Journal called “The Vanishing Reward for Buying High Yield Bonds.” Do you have any response to that? It suggests they may not be the safest of investments.

Mr. Schwab: Each company that we are contemplating as an investment in this fund needs to meet the criteria that the sustainability team here sets for environmental, social and governance performance. The high yield universe does have a heightened number of companies and some industry concentration that could introduce more than average ESG-related risk, mainly on the environmental side. Energy is a very large component of our index, as are basic materials and utility companies. Within these sectors, and others, the team here at Pax is looking for companies that are doing well managing these issues. We compare them relative to each other within the index, and look for companies that disclose more information and proactively manage these issues.

The idea here is to use ESG research as an incremental risk management tool as well as identify and avoid the laggards. It does provide us with more nonfinancial information than you might otherwise have time to gather. Everything in the portfolio does not necessarily have a clean history in these areas, but they are more likely to be managing ESG risks proactively and responding to us in a manner that we think is appropriate when we interact with them.

TWST: With energy being such a big part of the portfolio, and I’m looking at the statement that was issued on June 30, 2017 that has energy at 14.3%, can you help us understand how you might evaluate holdings on ESG? What are the most important metrics that you would use?

Mr. Schwab: On the energy sector exposure itself, it is the largest subsector in the index, so we had a modest overweight at that point in time. In general, our portfolio management approach is not tied...
to a strong view on the price of commodities, particularly for oil and natural gas companies. What we are trying to do is to pick companies that we think will outperform in any environment, up or down. That drives us to the sector weighting that we have. But the actual selection really depends on the subsector within energy.

We have three subsectors, and they are each about a third of that total. We have exploration and production (E&P) companies, gas distribution or midstream companies, and the last third is split between services and refining. We approach each subsector differently. The most sensitive names are the E&P companies that are more extractive in nature. We scrutinize their workers’ safety and environmental track records. The Pax sustainability team will consider what basin they are operating in and what the risks might be within those basins, whether it is water issues or other local sensitivities. We are working through all of those nuances and judging these companies relative to each other in an attempt to identify companies that we think are the best financial investment and also ones that meet our ESG criteria.

**TWST:** You don’t have to name names, but could just give us an instance of a holding with perhaps a decent financial profile, but you felt they disqualified themselves on the basis of ESG? Would there be a specific example of why you felt it would be a disqualification?

**Mr. Schwab:** Chesapeake Energy (NYSE:CHK) is a good example, which is a very large issuer in the high yield market more broadly. We were interested in the company from a financial standpoint as the sector started to recover, but its track record was not only filled with environmental challenges, but also actually had some pretty severe governance problems. The decision to not invest in the company on the basis of ESG criteria was probably equally weighted between the environmental challenges and lack of responsiveness and proactive management to recurring governance issues. It just was too overwhelming, and so they ranked very poorly on an ESG perspective relative to competitors.

**TWST:** On that June 30, 2017 statement, you have that the number of holdings is 257. Is that typical for a fund like this to have so many holdings?

**Mr. Schwab:** The number of companies was approximately 170. Sometimes we have issuers with two or three bonds. It is pretty typical for a high yield bond fund to be very diversified. There are a number of our competitors that have much more than that, but very few good-sized high yield funds would have less than about 100 names.

**TWST:** Your current assets under management are?

**Mr. Schwab:** It is at about $420 million.

**TWST:** Can you explain a little bit about the composition of the portfolio? I’m looking again as of June 30, and the way you have it broken down into stocks and then the rest primarily in bonds including foreign bonds. Can you explain the composition as it stands today?

**Mr. Schwab:** We have less than 1% in stocks and roughly the high teens for foreign bonds. Just for clarification, these are foreign-domiciled companies, a mix of financial, telecom and industrial companies in Western Europe, a few Canadian resource companies and a handful of Latin American companies that issue bonds in dollars.

**TWST:** I am looking at what is listed in the statement under the top 10 holdings for fixed income, and there are companies like HCA Inc., Charlotte Russe Inc. and ION Geophysical Corporation. Can you discuss one of those holdings and describe why it was selected in some more detail?

**Mr. Schwab:** HCA (NYSE:HCA) is one of our largest, most liquid and longest-held high yield issuers. It is a large hospital company that is strong and BB rated. This is what I would call a classically safe name that shows up in most high yield managers’ portfolios. We believe it is a well-run company, and it is well-respected. It is a large index constituent, and so many people like to have at least some exposure to it and, for us, one of the changes that I have made since I arrived at Pax a year and a half ago was to add to our health care exposure.

The company is conservatively managed, and its issuance is likely to migrate to investment grade over time. I would not call it the most exciting holding in the world, but it is a very good example of a well-run company where I believe it is unlikely to have material price degradation. There is little default risk in a name like that, so it offers a good opportunity to collect a good coupon income from a company that is not going to be very volatile.

**TWST:** Is there one that is not as obvious in your mind to this type of fund?

**Mr. Schwab:** A little more off-the-run is the ION Geophysical (NYSE:IO) that you mentioned, which is an oil service name. It is a longstanding holding for us. They provide seismic data to energy companies, so it is an interesting way for us to play in that sector. It is not nearly as impactful in terms of its environmental footprint; rather it is more of a service provider. They have a very valuable set of geologic data that they sell to companies that are exploring in more difficult basins.

It is a public company, but has a very small market capitalization. They got into trouble as did many smaller energy high yield issuers with the oil volatility in the last couple of years. They went through a partial, yet consensual, bond exchange to term out their maturities. We did participate in that and exchanged some of our bonds into a longer-dated maturity. ION is one of our higher-risk positions but is providing an
awful lot of coupon income at the moment, and it is not a very long-dated bond as it matures in about four years.

**TWST:** Is there anyone else you would want to mention?

**Mr. Schwab:** Our largest holding is in Sprint Communications (NYSE:S), which is again one of the largest issuers in the high yield market. It was a very volatile name for a number of years, as they are quite indebted, and there is a perception that they are not going to be able to retain their market share. Not only have they been able to maintain market share, they have also been able to deliver a number of cost savings and access the capital markets in very creative ways. They ended up securing some of the spectrum that they own.

Sprint is a very asset-rich company in terms of spectrum holdings, and that has provided a very important source of funding for them to help manage near-term maturities, which are very large and continue to be heavy for the next couple of years. The bonds have performed quite well in the last year or so. It is also a topical name in terms of the potential merger and acquisition surrounding telecom, including cable. Sprint is thought to be a name that might merge with somebody else in the industry, possibly even T-Mobile (NASDAQ: TMUS), or maybe team up with a cable operator at some point. The bonds are trading very well with a fair amount of speculation, so it is a little tricky at the moment to be honest, but it has performed well for us.

**TWST:** Can you discuss, and you can choose whatever you’d like, but any rules that you think are important for a potential investor to understand about how you govern the fund, whether it’s the turnover ratio or anything about the fund as a whole?

**Mr. Schwab:** First and foremost, we are taking less risk in this high yield bond fund relative to many of our competitors. The index that we have chosen to measure our performance against does not include CCC rated bonds and is called the Bank of America Merrill Lynch U.S. High Yield Cash Pay BB-B Index. CCC bonds represent approximately 15% of the overall high yield market, so we are nowhere near that. We will invest in CCCs; however, we cap it no more than 10%, and historically the allocation has been around 6% or 7%.

Regarding turnover, we try to minimize trading activity, but that is quite hard to do in high yield. The market itself turns over a lot naturally, and so you could easily see turnover in this portfolio at 50% to 70%, but approximately 25% turnover comes from the market itself just going through the various calls, tenders, refinancings, M&A and defaults. Transaction costs are relatively high in this market. We do have systematic sector and position sizing disciplines that we follow closely, including no more than 5% sector over or underweights relative to the index.

In terms of position-size weights, any holding above 1.5% or 2% of the portfolio is going to have to be a much larger and safer name, like HCA, which is perceived to be relatively liquid. As we go down in quality and liquidity, we shrink the position size systematically. Most of the riskier and smaller positions we have are likely to be 50 basis points or less. That is a strict discipline that we have been able to implement.

**TWST:** Is there anything about the ESG rule that you might apply that would be a surprise to somebody? What do you think are some of the more important issues in ESG?

**Mr. Schwab:** We tend to get questions about how a high yield company can be included in an ESG portfolio. The assumption is that high yield companies just by the nature of their credit ratings are poor performers from an ESG perspective, which is generally not true. High yield companies are indebted and often smaller in nature, so the rating agencies can have a bias against size. We have a lot of leveraged buyouts — LBOs — in our index, and they are clearly not going to get an investment-grade rating. There may or may not be any connection between a company’s credit rating, its debt load and its performance on ESG issues.

Having said that, I did mention that we do have a number of more sensitive sectors that make up this index, so we do feel as though we need to scrutinize those companies as carefully as we would otherwise. That’s why we spend a lot of time on the energy sector and the mining sector and certain financial companies that are lending to consumers. Financials are an area often overlooked from an ESG perspective because they generally don’t run into ESG problems. More

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1. Chart provided by www.BigCharts.com

**“This fund is for those who are interested in these issues and want to know the portfolio that they are investing in, despite being high yield companies, are performing well in these areas or at least proactively managing them.”**
aggressive consumer lenders in the high yield index may not have very clear and appropriate guidelines when disclosing information to their customers. So some financial companies are excluded from our investable universe based on ESG criteria. That tends to surprise people.

TWST: Lastly, can you offer some parting words as to how this fund differs from others in its peer group, aside from the fact that you don’t pick the CCC rated bonds? Can you offer that picture as to why an investor would want to choose your fund over another?

Mr. Schwab: First, there are very few of what we would define as fully integrated ESG high yield funds available. This fund is for those who are interested in these issues and want to know the portfolio that they are investing in, despite being high yield companies, is performing well in these areas or at least proactively managing them. The team here at Pax examines different ESG issues depending on the sector and adjust their focus based on sensitivities within the sector. A lot of people who integrate ESG scores are typically backward looking, and we often don’t agree with the scores that they might get from a third party. We think we are doing a better job of integrating ESG information on a forward-looking and dynamic basis.

The fund itself, as I mentioned, does have a more conservative bent to it, and we think it will likely perform well especially in a down market. We don’t have a material duration difference versus the benchmark, and that is intentional. We don’t want to make a directional bet on interest rates and would rather focus on outperforming the index over a full cycle by picking the good performing names with manageable downside risk.

TWST: Thank you. (KJL)

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1 The 10% cap in fund allocation to CCC rated bonds is an internal guideline and is subject to change.

Pax High Yield Bond Fund Top Ten Holdings as of 7/31/2017: HCA, Inc., 5.875% (coupon rate), 2/15/26 (date of maturity) 1.30% (percentage of fund assets); Ion Geophysical Corp., 9.125%, 12/15/21 0.80%; Care Capital Properties LP, 5.125%, 8/15/26 0.80%; Mednax, Inc., 5.250%, 12/1/23 0.80%, Charlotte Russe, Inc., 6.750%, 05/21/19 0.80%; Ard Finance SA, 7.125%, 9/15/23 0.80%; Fly Leasing, Ltd., 6.375%, 10/15/21 0.80%; Sirius XM Radio, Inc., 5.375%, 4/15/25 0.80%; Cott Holdings, Inc., 5.500%, 4/1/25 0.70%; SFR Group SA, 6.250%, 5/15/24 0.70%. Holdings are subject to change.

The Pax High Yield Bond Fund’s primary investment objective is to seek high current income. As a secondary investment objective the Pax High Yield Bond Fund seeks capital appreciation.

RISK: The Fund can invest in “junk bonds” which are considered predominately speculative with respect to the issuer’s continuing ability to make principal and interest payments when due. Yield and share price will vary with changes in interest rates and market conditions. Investors should note that if interest rates rise significantly from current levels, bond fund total returns will decline and may even turn negative in the short term. There is also a chance that some of the fund’s holdings may have their credit rating downgraded or may default.

Credit ratings apply the underlying holdings of the fund, and not to the fund itself. S&P and Moody’s study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency’s opinion of the holdings financial condition and histories. The ratings shown are all considered investment grade and are listed by highest to lowest in percentage of what the fund holds.

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Diversification does not eliminate the risk of experiencing investment losses.

The BofA Merrill Lynch U.S. High Yield - Cash Pay - BB-B (Constrained 2%) Index tracks the performance of BB- and B-rated fixed income securities publicly issued in the major domestic or eurobond markets, with total index allocation to an individual issuer limited to 2%. One cannot invest directly in an index.

You should consider a fund’s investment objectives, risks, and charges and expenses carefully before investing. For this and other information, call 800.767.1729 or visit www.paxworld.com for a fund prospectus and read it carefully before investing.

An investment in the Pax World Funds involves risk, including loss of principal.

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