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Integrating ESG Analysis to Manage Indeterminate Risk

By Julie Fox Gorte, Ph.D., Senior Vice President for Sustainable Investing and Steve Falci, CFA®, Chief Investment Officer

Until recently, sustainable investing has been regarded, at least in North America, as a niche investment strategy. Mainstream asset managers were often skeptical of it, primarily for perceived performance reasons. Nevertheless a growing body of evidence has shown that taking environmental, social and governance (ESG) factors into account can enhance portfolio management as well as meet the needs of two growing demographics in the market—women and millennials.

Many mainstream asset managers have assumed that ESG factors are detrimental to financial performance, largely due to the conflation of exclusionary practices that may limit an investment opportunity set with ESG integration focused on risks and opportunity. We have been collecting academic and other studies that examine the relationship between various forms of ESG and financial outcomes for years, and have amassed a database of nearly 300 such studies, all of which show that ESG is positively and significantly linked to performance or risk management. Several of these studies are also meta-studies, which statistically evaluate the results of many other studies. One recent example is a paper from the University of Oxford and Arabesque Partners, which found that of the 190 sources analyzed, 88% found that "companies with robust sustainability practices demonstrate better operational performance".[1] Of the studies we have collected, some examine a group of sustainability factors, and some concentrate on just one (e.g., board diversity or environmental compliance). Taken together, this body of literature is a powerful argument for incorporating ESG factors into asset management.

Not every single ESG item is going to matter equally for all companies or at all times as is the case for many intangible assets (brand, patents, etc.) considered by traditional analysts. As with all active management, skill and passionate pursuit of unique insights are keys to long-term success. The skilled investor looks for clues in the numbers to find value or risk before the events actually occur; in short, our business is one of skating to where the puck is going to be. Figuring out where that is depends on the totality of corporate performance and impact, not just those factors that are included in financial reporting. Timing can also be an issue; many investors make the mistake of believing that ESG factors' impact is long-term, and thus less relevant for investment managers who measure the number of years in the investment horizon on the fingers of one hand. In fact, many ESG-related risks are better described as indeterminate-term risks, ones that can occur at any time. A perfect example is that of BP's Deepwater Horizon explosion: the company had an industry-lagging safety record for many years prior to that accident, but the exact timing of the disaster was not predictable. Currently, many investors still see climate change as a long-term risk factor (or set of factors), but the storms, fires, floods, droughts and other incidents that wreak physical as well as financial havoc are already occurring, and will continue to happen at unpredictable intervals.

Integrating ESG also makes good business sense. By 2030, women will manage or control two-thirds of the nation's wealth.[2] And between now and midcentury, approximately $30 trillion in wealth is being transferred to millennials.[3] Women and millennials are, compared with the cohorts who control most of the wealth now, more interested in making the world better, and that sentiment is expected to carry through to their investment choices. Those facts alone should drive a fairly significant overhaul in how traditional asset

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30 Penhallow Street, Suite 400
Portsmouth, NH 03801

Editor & Layout: Dorset Norby Star

General Fund Information:
☎ 800.767.1729

Shareholder Account Information:
☎ 800.372.7827

www.paxworld.com

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Pax World CEO Makes Business Case for Gender Equality at the Women's Empowerment Principles Annual Event

Joe Keefe, Pax World CEO and President seated with the United Nations High Commissioner for Human Rights Mary Robinson, and former Secretary of State, Hillary Clinton. *Photo credit: Women's Empowerment Principles*

At this year's Women's Empowerment Principles (WEPs) event, all in attendance rallied around gender equality as the great economic challenge of our time. Leaders from the United Nations, government, the business sector and civil society came together in New York City to discuss how business can be a force for change in advancing gender equality across the globe.

Joe Keefe, President and CEO of Pax World Management and co-chair of the WEP's Leadership Group, made his business case for gender equality when he spoke during the event.

"As a long-time advocate for women's empowerment, I have always felt that it is both the right thing to do and the smart thing to do, that it is both a moral imperative and an economic imperative. I look to the research and the numbers, and the data is now beyond compelling; it is overwhelming. The key to building a more profitable business and a more equitable and prosperous society is inclusion. The key is equality," stated Keefe.

Keefe was one of the first CEOs in the world to sign onto the Women's Empowerment Principles. The principles are a joint initiative of the United Nations (UN) Global Compact and UN Women, and constitute a set of practical guidelines for companies on how to empower women in the workplace, marketplace and community. At Pax World we have taken steps to integrate these principles into our investment analysis and decision making process. We recently wrote letters to every company in the Pax Ellevate Global Women's Index Fund (PXWEX) that have yet to sign onto the Principles, asking them to do so.

"We use the 7 principles because they provide a unique framework for our company and the private sector globally. They provide an essential vehicle for advancing women's empowerment and improving the global economic climate at the same time," explains Keefe.

Also present at the event as a featured keynote speaker was former Secretary of State, Hillary Clinton, who argued that "full participation of women and girls is the unfinished business of the 21st century and that the only way to achieve significant growth is to build economies and societies that include everyone."

To read more about the role Pax World is playing in supporting women's empowerment and gender diversity visit paxworld.com. Learn more about the Pax Ellevate Global Women's Index Fund (PXWEX) and the importance of investing in women at paxellevate.com.

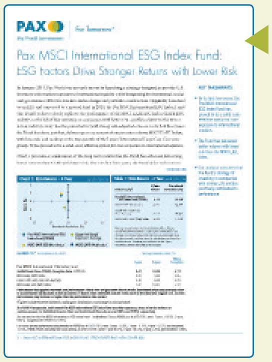
The Pax Ellevate Global Women's Index Fund seeks investment returns that closely correspond to or exceed the price and yield performance, before fees and expenses, of the Pax Global Women's Leadership Index* (the "Women's Index"), while maintaining risk characteristics that Pax Ellevate Management LLC ("PEM") believes are generally similar to those of the Women's Index. For risks, please visit www.paxworld.com

*** A custom index calculated by MSCI. One cannot invest directly in an index.**

What's new on paxworld.com

Have you visited Pax World's website recently? New content ranging from commentary to advocacy to product news may be of interest. A few examples include the following:

In "Male Business Leaders Need to Support Women's Empowerment" Pax World President and CEO Joe Keefe and Elizabeth Broderick, Sex Discrimination Commissioner, Australian Human Rights Commission discuss why advancing gender equality across the globe is the great economic challenge of our time. They believe that unprecedented economic value will be unleashed, and an unprecedented economic boom will occur, if women are afforded the same educational and economic opportunities as men. Learn more by visiting paxworld.com/thoughtleadership.



Read our recent whitepaper "Pax MSCI International ESG Index Fund: ESG Factors Drive Strong Returns with Lower Risk" to learn why our International Index Fund is a cost-effective option for core exposure to international equities. The Fund has reached its four year anniversary and while four years is admittedly a modest time frame, our analysis indicates that the Fund's strategy of investing in companies with strong ESG profiles positively contributed to performance. Learn more by visiting paxworld.com/international.

Pax MSCI International ESG Index Fund: Risk-Efficient International Investing

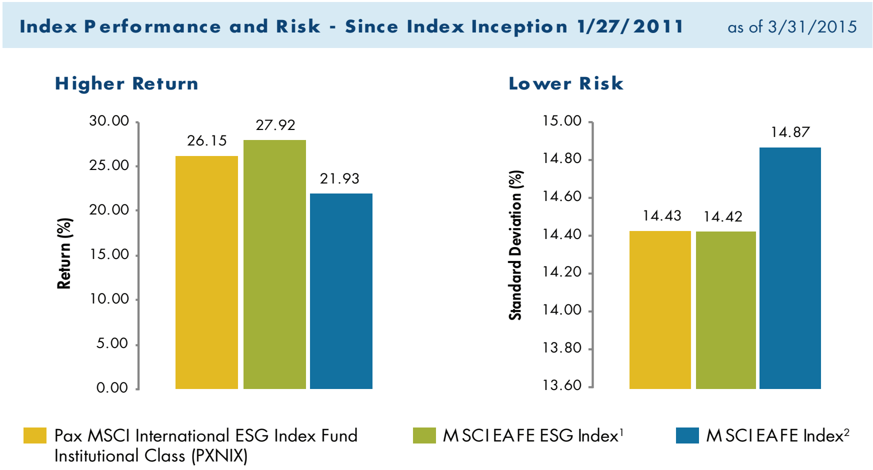
At Pax World, we believe companies with strong environmental, social and governance (ESG) standards are better at mitigating risk and more focused on the long term. In January 2011, Pax World was an early mover in launching a strategy designed to provide U.S. investors with market exposure to international equities while integrating ESG factors into index design and portfolio construction. Originally launched as an ETF and converted to a mutual fund in 2014, the Pax MSCI International ESG Index Fund (the Fund) seeks to closely replicate the performance of the MSCI EAFE ESG Index (EAFE ESG), in the belief that investing in companies with better ESG profiles relative to the MSCI EAFE Index (EAFE) has the potential to yield strong risk-adjusted returns. In its first four years the Fund has done just that, delivering an increment of excess return above EAFE, with less risk. It has proved to be a cost-effective option for core exposure to international equities.

The Fund's management team uses an optimization process to control portfolio risk with the objectives of minimizing tracking error relative to EAFE ESG and managing the total number of holdings in an effort to reduce trading costs and other fund-related expenses. The optimized portfolio is intended to closely replicate EAFE ESG with the goal of delivering returns that are competitive with EAFE. The optimization process has a preference for higher-ranked ESG companies when trying to solve for risk constraints.

The accompanying chart details the Fund's outperformance with lower risk since inception (1/27/2011) relative to EAFE. The Fund has performed in line with its underlying index (EAFE ESG) after a deduction of annual Fund expenses.

Our latest whitepaper called "Pax MSCI International ESG Index Fund: ESG Factors Drive Stronger Returns with Lower Risk" details the long-term risk-adjusted performance benefit that our Fund has produced since its inception, and how ESG factors have contributed to the Fund's long-term relative outperformance vs. EAFE. To download this white paper and learn more about why we believe the Fund is a compelling, cost-effective solution for international equity investing visit paxworld.com/international.

Pax MSCI International ESG Index Fund has outperformed with lower risk relative to the MSCI EAFE Index over time.



The Pax MSCI International ESG Index Fund (PXNIX) has outperformed the MSCI EAFE Index by 4.23% cumulative from 1/31/11 to 3/31/15. Comparable returns since index inception 1/27/11 are shown "net", which includes dividend reinvestments after deduction of foreign withholding tax. Risk statistics are calculated using closest month end date 1/31/11. Standard Deviation measures a Fund's variation around its mean performance; a high standard deviation implies greater volatility.

The returns for the Pax MSCI International ESG Index Fund - Institutional Class (PXNIX) were: 1 year: -0.40%, 3 year: 9.81%, Since Inception (01/27/2011): 5.72%. The returns for the Pax MSCI International ESG Index Fund - Individual Investor Class (PXINX) were: 1 year: -0.67%, 3 year: 9.52%, Since Inception (01/27/2011): 5.43%. The returns for the MSCI EAFE ESG Index were: 1 year: 0.89%, 3 year: 9.97%, Since Inception (01/27/2011): 6.08%. The returns for the MSCI EAFE Index were: 1 year: -0.92%, 3 year: 9.02%, Since Inception (01/27/2011): 4.86%. Returns are as of 3/31/15.

Performance data quoted represents past performance, which does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.

Total annual Pax MSCI International ESG Index Fund operating expenses are *0.55%* for the Institutional Class and *0.80%* for the Individual Investor Class, as of the 5/1/2015 prospectus. The management fee is a unified fee that includes all of the costs and expenses of the Fund (other than taxes, charges of governmental agencies, interest, brokerage commissions incurred in connection with portfolio transactions, distribution and/or service fees payable under a plan pursuant to Rule 12b-1 under the 1940 Act and extraordinary expenses), including accounting expenses, administrator, transfer agent and custodian fees, Fund legal fees and other expenses.

RISK: Equity investments are subject to market fluctuations, the fund's share price can fall because of weakness in the broad market, a particular industry, or specific holdings. Emerging markets and International investments involve risk of capital loss from unfavorable fluctuations in currency values, differences in generally accepted accounting principles, economic or political instability in other nations or increased volatility and lower trading volume. Investments in Asia/Pacific increase the impact of events and developments associated with the region can adversely affect performance.

[1]The MSCI EAFE ESG Index is a free float-adjusted market capitalization weighted index designed to measure the performance of equity securities of issuers in developed countries around the world excluding the U.S. and Canada that have high ESG ratings relative to their sector and industry peers, as rated by MSCI ESG Research. Performance for the MSCI EAFE ESG Index is shown "net", which includes dividend reinvestments after deduction of foreign withholding tax. One cannot invest directly in an index.

[2]The MSCI EAFE (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI EAFE Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. Performance for the MSCI EAFE Index is shown "net", which includes dividend reinvestments after deduction of foreign withholding tax. One cannot invest directly in an index.

Shareholder Corner:

Benefits of Automatic Investment Plans

Keep your savings on track year-round with an Automatic Investment Plan (AIP). An AIP allows you to invest a designated dollar amount on regular intervals. An AIP also allows you to take advantage of important benefits without having to remember to make your investments when life gets busy.

- Pay yourself first rather than using that money for other things. This may be an effective strategy to help you save for the future - faster.
- You may reduce your average cost basis over time because you buy more shares when the price is low and fewer shares when the price is high, a concept known as dollar cost averaging.
- Save time, energy, and effort. You'll spend less time analyzing or worrying about the "right time" when you invest automatically on a regular schedule.

The amount that you designate will automatically be taken from your bank account and invested into your Pax World account on a monthly or quarterly basis.

To establish a Pax World AIP online using a bank account previously provided, log in to your account from paxworld.com. If you prefer to send written instructions, or need to add a bank account, download and complete our Shareholder Service Form. If you have any questions or to have a Shareholder Service Form mailed to you, please contact an Investor Service Representative.

Automatic investment plans do not assure a profit and do not protect against loss in declining markets. Please note that the information contained in this article does not constitute investment or tax advice. Always consult your tax advisor before making any tax-related or investment decision.

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Your quarterly Pax World Investor Statement automatically combines all accounts registered under the same Tax ID number and exact address (including Zip code extension). To combine accounts in your household that are not listed under the same Tax ID, please call an Investor Service Representative to determine what is needed. If all accounts you wish to combine are controlled by the same individual, you may be able to request a combined statement by telephone. If there is more than one authorized individual across the accounts to combine, please download and complete the Shareholder Mailing Form available at paxworld.com.

Please note: any combinations made to your quarterly account statements will also combine the accounts under your Online Account Access User ID.

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If you have any questions, or if you would like a paper copy of a document you are receiving electronically please contact an Investor Service Representative.

If you have any questions, please contact an Investor Service Representative at 800.372.7827 Monday – Friday 8am – 6pm ET.

INTEGRATING ESG ANALYSIS TO MANAGE INDETERMINATE RISK CONTINUED from FRONT PAGE

managers think. Combine that with the rapidly-increasing evidence showing the financial impact of environmental, social and governance in affecting corporate financial performance, and there are few reasons left not to think about sustainable or impact investing unless, like the fiddler on the roof, you're more interested in tradition than anything else.

[1]Gordon L. Clark, Andreas Feiner and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance," University of Oxford and Arabesque Partners, September 2014.

[2]"Why a Man Is Not a Financial Plan," by Lori Livingstone, 4/3/2012, iVillage.

[3]The "Greater" Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth, Accenture, 2012.

PAX

Pax World Investments

Pax World Investments
30 Penhallow Street, Suite 400
Portsmouth, NH 03801
800.372.7827
info@paxworld.com
www.paxworld.com

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. For this and other important information, please obtain a fund prospectus by calling 800.767.1729 or visiting www.paxworld.com. Please read it carefully before investing.

An investment in the Pax World Funds involves risk, including loss of principal. Past performance is no guarantee of future results.