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Pax World Investment Outlook: First Quarter 2017

Eye on Valuation and Climate Progress in 2017

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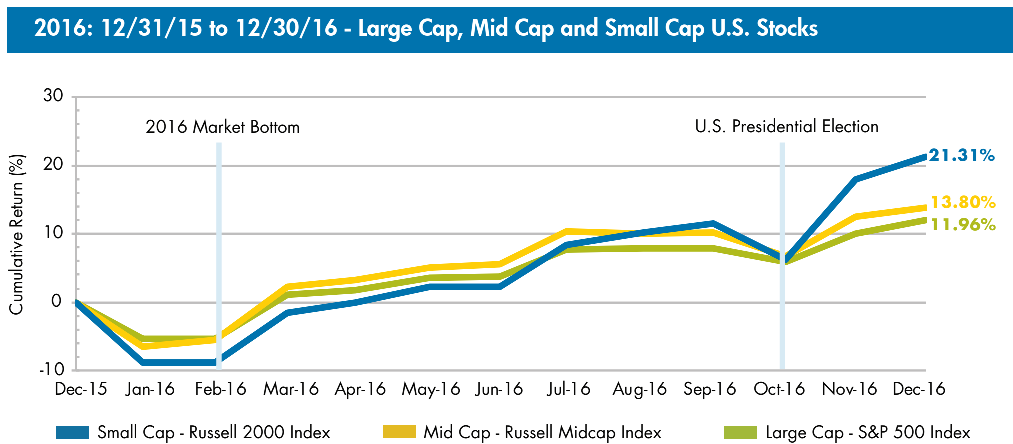
In this quarter's commentary, we'll consider valuation risk in the wake of equity markets reaching near record highs in 2016 and take a closer look at what a Trump presidency may or may not mean for investors in cleaner energy and low-carbon technologies. First though, it's constructive to take a brief look back at how we got here, with a recap of 2016 investment highlights.

U.S. stock markets, in general, posted solid gains in 2016 as evidenced by the following chart and table. Small caps were the big winner and value handily beat growth. Developed equity markets as represented by MSCI EAFE Index did not fare as well, mainly due to a strong dollar negatively impacting returns. Bonds were generally lackluster, with the exception of the high yield market, which delivered very strong returns on the back of an improved economic backdrop.

In many ways, 2016 was an extraordinary year. The markets sold off significantly for the first six weeks of the year, registering negative double digit returns. Equity markets rallied substantially off their February lows, delivering returns on the remainder of the year ranging from outstanding to spectacular depending on the market segment. These returns were boosted by the post-election rally fueled by speculation about the impact of pro-growth policy expectations of a Trump presidency.

2016: 12/31/15 to 12/30/16 - Large Cap, Mid Cap and Small Cap U.S. Stocks



Source: Factset.
Past performance does not guarantee future results.

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KEY TAKEAWAYS

- Solid equity gains in 2016, supported in the fourth quarter by a beta-driven rally following the presidential election, have resulted in extremely rich valuations at year-end.
- The U.S. market remains vulnerable to any disappointment on current policy, economic and corporate earnings expectations, which increases the potential for near-term volatility.
- Policy infrastructure that can accelerate or impede the progress of investments in more sustainable areas is expected to be much more difficult in the Trump administration than in the Obama administration.
- The transition to cleaner energy and low-carbon technologies is driven far more by economics and technology than by policy.

For index definitions, please see page 5.

	Full Year 2016	Since Market Bottom 2/11/16 - 12/31/16	Since Election 11/8/16 - 12/31/16
U.S. Large Cap — S&P 500 Index	11.96%	24.78%	4.98%
U.S. Mid Cap — Russell Midcap Index	13.80%	30.25%	6.09%
U.S. Small Cap — Russell 2000 Index	21.31%	44.29%	13.86%
Developed Markets — MSCI EAFE Index	1.00%	15.80%	2.11%
U.S. Fixed Income —Bloomberg Barclays U.S. Aggregate Index	2.65%	0.39%	-2.10%
U.S. High Yield — BofA Merrill Lynch High Yield Index	14.76%	23.70%	1.89%

Past performance does not guarantee future results.

Looking Forward: Beware Valuations, Volatility and Policy Uncertainty

What happened is fact. What will happen ranges from speculation to informed judgement, but no matter how well-informed a forecast is, it can still be wrong. Late last year, the New York Times ran a story whose theme was summed up at the beginning with this: "Every December as the holidays approach, Wall Street gurus examine the stock market, and nearly all declare that stocks will rise in the forthcoming calendar year." But since 2000, according to the source[1] the Times story cites, those forecasts have been stubbornly rosy, and far rosier than their outcomes. Average December forecast: 9.5% rise. Average performance: 3.9% rise.

Assessing the equity market in 2017 is particularly challenging given the nature of the extraordinary run equities enjoyed, the speculation driving the post election rally and the extremely rich valuation of equities at year end. The performance since February market lows was largely beta[2] driven, with higher risk stocks leading the way with little regard to underlying fundamentals. While the markets took a respite in October, the election of Trump reignited the beta-driven rally as expectations of increased economic stimulus in the form of lower tax rates and increased spending on infrastructure and defense would be good for the economy and the equity market.

This run has left domestic equity markets significantly overvalued in our opinion. The forward price-to-earnings (P/E) ratio[3] on the S&P 500 Index and Russell 2000 Index are at levels not seen since 2008. Further, for small cap companies in the Russell 2000 Index that are actually generating earnings, the median P/E is at the highest level in more than 30 years.[4] The market

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For index definitions, please see page 5.

[1] Bespoke Investment Group

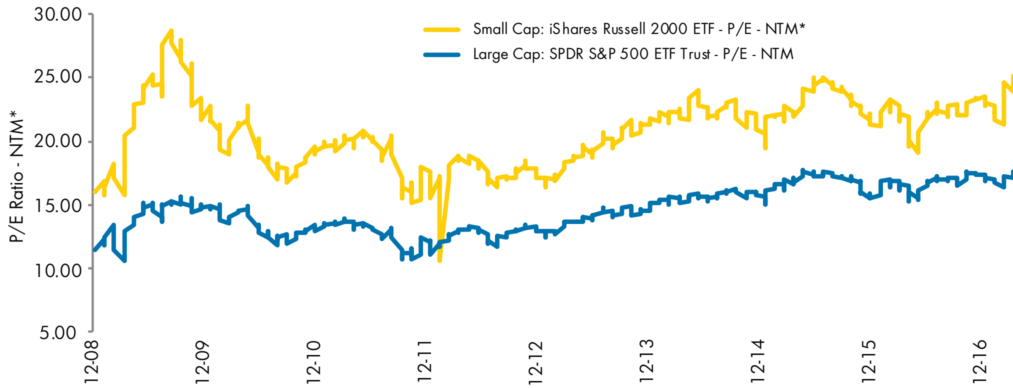
[2] Beta reflects the sensitivity of a fund's return to fluctuations in its benchmark; a beta for a benchmark is 1.00, a beta greater than 1.00 indicates above average volatility and risk.

[3] Forward Price-Earnings Ratio or P/E FY1 ratio is a ratio for valuing a company that measures its current share price relative to its per-share earnings over the next 12 months.

[4] Furey Research

run-up after the election reflects a very strong expectation that President Trump will be able to quickly deliver on his promises. If there are disappointments on the delivery or timing of these developments, the market might be vulnerable. We believe current equity levels fully reflect positive information on current policy, economic and corporate earnings expectations.

Large Cap and Small Cap Valuations: Forward Price to Earnings Ratio (P/E) 12/31/08 - 12/31/16



Source: Factset.
* NTM stands for the Next Twelve Months.
Past performance does not guarantee future results.

For investors interested in sustainability, however, expectations are more like "cloudy with a chance of catastrophe." That does not mean that sustainable investing returns are expected to lag broader markets; it means that the policy infrastructure that can accelerate or impede the progress of investments in more sustainable areas is expected to be much more difficult in the Trump administration than in the Obama administration. That policy underpinning might affect investment returns, and it might not. Drawing straight lines between any policy and investment returns is anything but simple, and often anything but correct.

Climate Change and the Transition to a Low-Carbon Economy

There's very little doubt that the incoming administration will be less friendly to policies designed to curb climate change and stimulate a low-carbon transition than the outgoing administration. But it is premature to assume that potential policy changes means woe for investors in cleaner energy and low-carbon technologies.

Why? Because the transition, which is already underway, is driven far more by economics and technology than by policy. The International Energy Agency's most recent medium-term forecast notes that growth in renewable capacity continues to set records and that for the first time in 2015, renewables accounted for more than half of net additions to power capacity and overtook coal in terms of installed capacity, worldwide. Lazard's annual Levelized Cost of Energy Analysis notes that some renewables technologies "continue to be cost-competitive with conventional generation." Bloomberg New Energy Finance's 2016 outlook notes that "Cheaper coal and cheaper gas will not derail the transformation and decarbonisation of the world's power systems. By 2040, zero-emission energy sources will make up 60% of installed capacity."

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Moreover, renewables still have considerable ability to capitalize on rapid technological improvements, and the well-known ability of technology to drive down costs. That is simply not true in the business of creating electricity from fossil fuels. The last time that business was considered a high-tech driver of innovation was about a century ago.

The momentum in renewables has benefited from some public policy, to be sure, including subsidies (many past, some present) for renewables. But that's even more true of fossil fuels than it is of renewables: the International Energy Agency estimated in 2013 that consumer subsidies for fossil fuels at $548 billion was more than four and a half times greater than subsidies for renewables at $121 billion. Clearly, subsidies don't explain all performance, especially recently. The economic currents driving the deployment of renewables are increasingly swift, making it ever more difficult for fossil fuel technologies to navigate up this river. It's hard to imagine any leader of a single nation being able to reverse this current, or dam it, especially when others are working to amplify it. China, for instance, is plowing $361 billion into renewable power generation in the next three years.

Moreover, when we consider the new administration's likely moves on energy and climate policy in light of another Donald Trump promise—to preserve jobs and create new ones—it's useful to remember that renewables employ more people than oil, gas and coal combined.

All the forces that contribute to impelling renewables forward apply in reverse to the dirtiest of the fossil fuels, coal. It would take a Herculean effort to bring coal back. The retirement of coal plants is a trend that's been underway for decades—U.S. Department of Energy's Energy Information Administration shows that clearly for the U.S., and that trend is also continuing in Australia, Germany, France, the UK, Finland, Holland, and many more countries. Even China, which is still quite dependent on coal, is committed to phasing out coal, and its coal use has fallen for at least two years in a row. Even if it reneges on its intentions to phase out coal, how likely would that result in a increase in coal production in the U.S.? Not very.

Michael Bloomberg summed things up in a way that makes sense to us: Obama didn't kill coal. The market did.

The Upshot

We are mindful that some of what the new Administration will bring can affect markets, and we're continually evaluating our own investments for exposure to potential risks and opportunities. That involves diligently evaluating developments from both a sustainability and financial standpoint and assessing their implication for the market, sectors and individual stocks.

We are also mindful that there may be an uptick in market volatility at these valuation levels as we obtain clarity on policy proposals. These events shouldn't be viewed as solely negative. Disciplined active managers can use those periods to put cash to work and buy stocks on sale. In an environment where positive earnings surprises may be one of the few market drivers, astute stock selection and nimbleness will be key.

Christopher H. Brown, Chief Investment Strategist for Pax World Funds and a member of the portfolio management team for the Pax Balanced Fund, Pax Large Cap Fund and Pax MSCI International ESG Index Fund. He has been with Pax World Management LLC since 1998, when he joined the company as Co-Portfolio Manager of the Pax Balanced Fund. Prior to joining Pax World, Chris was a Senior Manager at Fahnestock and Co., Inc., a New York Stock Exchange brokerage firm, from 1987 to 1998, and First Vice President from 1994 to 1998. Chris was also a Senior Vice President of H.G. Wellington and Co., Inc., from April 1998 to July 2006, where he served as an adviser on separately managed accounts. He is a graduate of the Boston University School of Management with a concentration in finance.

Steve Falci, CFA,® Chief Investment Officer, joined the Investment Management Department in 2014 to aid in fund strategy development, oversee the collaboration between investment analysis and environmental, social and governance-based research and enhance the firm's sustainable investing strategy. Steve has 30 years of experience in investment management. Prior to joining Pax World, he served as Head of Strategy Development, Sustainable Investment at Kleinwort Benson Investors, where his duties included strategic direction, product development and identifying new market opportunities in the sustainable investment business. Steve previously served as Chief Investment Officer, Equities at Calvert Group and was a Principal and Senior Portfolio Manager at Mellon Equity Associates. Steve serves on the board of directors of the US Forum for Sustainable and Responsible Investment (US SIF). He also serves on the Investment Committee for Mercy Investment Services. Steve has a Bachelor's of Science in Economics and a Master's of Business Administration from the Stern School of Business at New York University and a Master's of Arts from Pittsburgh Theological Seminary. Steve is a CFA® charter holder.

Julie Fox Gorte, Ph.D., Senior Vice President for Sustainable Investing, oversees environmental, social and governance-related research on prospective and current investments as well as Pax's shareholder advocacy and work on public policy advocacy. Prior to joining Pax, Dr. Gorte served as Vice President and Chief Social Investment Strategist at Calvert. Her experience before she joined the investment world in 1999 includes nearly 14 years as Senior Associate and Project Director at the Congressional Office of Technology Assessment, Vice President for Economic and Environmental Research at The Wilderness Society, Program Manager for Technology Programs in the Environmental Protection Agency's policy office and Senior Associate at the Northeast-Midwest Institute. Dr. Gorte received her Bachelor of Science in Forest Management at Northern Arizona University and a Master of Science and Ph.D from Michigan State in resource economics.

Index Definitions

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.

The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The **Russell Midcap Index** measures performance of the mid-capitalization sector of the US equity market. The index is a float-adjusted, capitalization-weighted index of the 800 smallest issuers in the Russell 1000 Index. The index is a subset of the Russell 1000 Index and serves as the underlying index for the Russell Midcap Growth and Value Index series. The Index is reconstituted annually.

The **S&P 500 Stock Index** is an unmanaged index of large capitalization common stocks.

The **Bloomberg Barclays US Aggregate Bond Index** is a broad base index, maintained by Bloomberg L.P. often used to represent investment grade bonds being traded in United States.

The **BofA Merrill Lynch High Yield Index** tracks the performance of below-investment grade, US-dollar-denominated corporate bonds publicly issued in the US domestic market.

One cannot invest directly in an index.

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