Pax World Investments

For Tomorrow®

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

CONTINUED

KEY TAKEAWAYS

- A growing body of evidence has shown that taking ESG factors into account can enhance portfolio management as well as meet the needs of two growing demographics - women and millennials.
- We have amassed a database of nearly 300 studies that examine the relationship between various forms of ESG and financial outcomes, all of which show that ESG is positively and significantly linked to performance or risk management.
- Integrating ESG makes good business sense. There are few reasons left not to think about sustainable or impact investing.

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.

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 financial services. Prior to joining Pax World, he was Head of Strategy Development, Sustainable Investment at Kleinwort Benson Investors, Chief Investment Officer, Equities at the Calvert Group and Principal and Senior Portfolio Manager at Mellon Equity Associates. 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. He is a CFA® charter holder. CFA® is a trademark owned by the CFA Institute.

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 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 World Management LLC

Pax World is a leader in sustainable investing, the full integration of environmental, social and governance (ESG) factors into investment analysis, security selection, portfolio construction and risk management. Pax World combines rigorous ESG analysis with equally rigorous financial analysis in seeking to identify better-managed, industry leading companies that meet positive corporate responsibility standards, have a clear vision for managing risk, and are focused on delivering long-term value to shareholders. Pax World launched the first socially responsible mutual fund in 1971 and today offers a family of seven mutual funds, ESG Managers® Portfolios, multi-manager asset allocation portfolios powered by Morningstar Associates, LLC, and separately managed accounts. For more information, visit paxworld.com.

The statements and opinions expressed are those of the authors of this report. All information is historical and not indicative of future results and subject to change. This information is not a recommendation to buy or sell any security.

This article was originally published on the Huffington Post website on February 27, 2015. Reprinted with permission.

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.

Copyright © 2018 Pax World Management LLC. All rights reserved. Distributor: ALPS Distributors Inc.: Member FINRA.
ALPS is not affiliated with Pax World Management LLC or Morningstar Associates.