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# Pax World investment outlook: First quarter 2016

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## INFLECTION POINTS

Like New Year's resolutions, investment themes garner increased attention at the beginning of each year despite the fact that new ideas are developing throughout the year. In that spirit, as we head into 2016, we spotlight three investment themes that we believe display favorable risk-reward characteristics for long-term investors.

One way to identify an attractive investment theme is to spot a significant divergence in investment trends. Of course, attempting to exactly time portfolio changes around an inflection point in a trend can be a futile exercise since inflection points only become clear in hindsight. Still, awareness of significant divergences can help identify potential investment opportunities with an attractive risk-reward profile.

### Theme 1: Opportunity in international equities is ripe

Non-U.S. developed markets as represented by the MSCI EAFE Index[1] have underperformed U.S. markets in five of the last six calendar years. Figure 1 on the following page illustrates the magnitude and length of the divergence, as the five-year performance differential is at its peak over the trailing 10-year time period.

Differing regional economic cycles explain a large part of the divergence, specifically U.S. economic and dollar strength in addition to challenges experienced in Europe and Japan. We believe we may be near an inflection point and see three catalysts in place to support a performance rebound in foreign developed versus domestic equities.

1. **Valuation** – Europe and Japan forward price-to-earnings ratios[2] currently trade at attractive discounts to U.S. equities.
2. **Strong Dollar** – The strong dollar has made many foreign companies more competitive in terms of exporting their goods and services abroad. Therefore, we see

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## KEY TAKEAWAYS

- We see three investment themes that could be near inflection points and that we believe display favorable risk-reward characteristics for long-term investors.
- There are three catalysts in place to support a performance rebound in foreign developed versus domestic equities: valuation, the strong dollar and monetary policy.
- The recent divergence in momentum stock performance over value has been extreme. Value is primed to regain leadership in light of momentum stocks' stretched valuations relative to underlying company fundamentals.
- As the low carbon economy takes hold, investors should consider how COP21 winners, losers, and technology game-changers could impact the risk-reward profile of their portfolios.

[1] The MSCI EAFE (Europe, Australasia, Far East) (Net) 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.

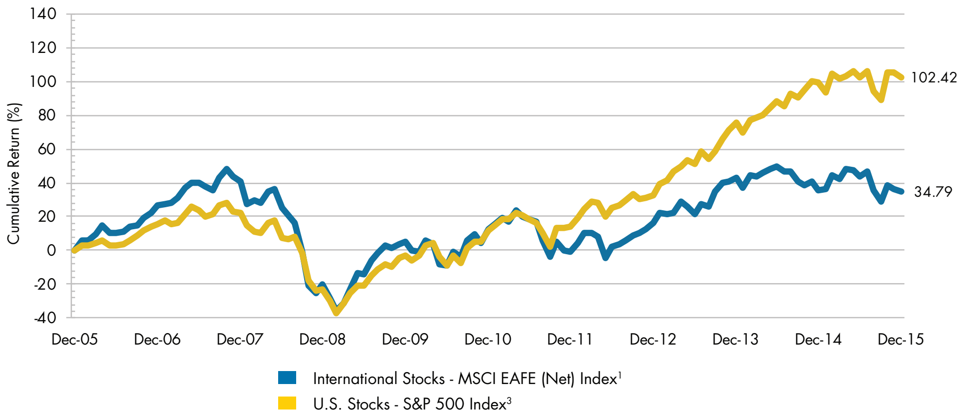
[2] The Price-to-Earnings Ratio or P/E ratio is a ratio for valuing a company that measures its current share price relative to its per-share earnings.

potential for foreign companies' margins to increase as well as their earnings multiples.

3. **Monetary Policy** – Quantitative easing is in earlier stages in Europe and Japan while the U.S. has just ended its huge stimulus efforts and the Federal Reserve is expected to gradually raise rates.

As a result, we believe developed markets outside the U.S., where economies may be at the early stages of economic recovery, are providing an attractive risk-reward opportunity for long-term investors.

**Figure 1: Cumulative Return: International vs. U.S. Stocks - 10 years from 12/31/2005 to 12/31/2015**




Source: Factset
Past performance is not indicative of future results.

## Theme 2: Momentum strength may give way to value

Momentum and value are dichotomous investment styles that have demonstrated the ability to add value over the long run. Momentum investing represents a bet on a stock's 3 to 12 month price trend continuing. Conversely, value investing is based on identifying stocks that are selling at a price below their intrinsic value.

The performance of each runs in cycles, and as Figure 2 illustrates, the performance spread between momentum and value has accelerated over the last three years.

What does this mean for investors going forward? While it is hard to determine precisely when momentum's run will end, we believe that fundamentals always catch up with stock prices, as it did when the tech bubble burst in 2000, and in the wake of the financial crisis in 2008.

Given that valuation for many momentum stocks has become stretched relative to underlying company fundamentals, we believe it is prudent from a risk-reward perspective for investors to scale back their exposure to momentum in favor of fundamentally sound stocks that are trading below their intrinsic value.

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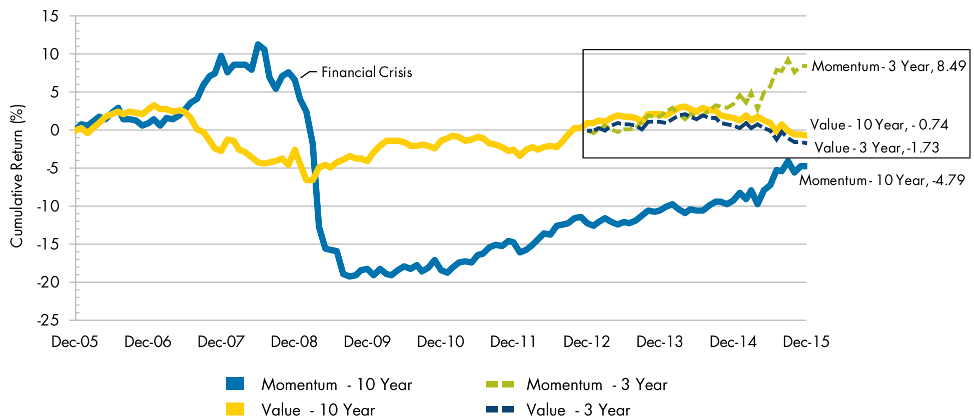
[3] Standard & Poor's 500 Stock Index is an unmanaged index of large capitalization common stocks. One cannot invest directly in an index.

**Figure 2: Cumulative Return: Momentum vs. Value - 10 years from 12/31/2005 to 12/31/2015**




Source: Factset
Past performance is not indicative of future results.

## Theme 3: The foundation for a low carbon economy has been established

Many believed that the transition to a low carbon economy was well underway in the first decade of the new Millennium. However, the global financial crisis in 2008 combined with (and related to) the disappointment of COP15[4] in Copenhagen in 2009 set back this transition.

We believe that the recent successful conclusion to COP21[5], which established global goals for greenhouse gas (GHG) reduction, has the ability to create an inflection point that puts the world on a path toward a low-carbon energy infrastructure.

For investors, there are clear winners and losers in that transition. At COP21, 195 nations agreed that GHG emissions would peak as soon as possible, and a balance will be achieved between carbon emissions and storage in the second half of the 21st century.

That will put increasing pressure on big emitters: utilities that depend heavily on fossil fuels (particularly coal), mining companies with significant revenues from coal mining, air carriers with older, less energy efficient fleets, and pretty much every aluminum producer and cement manufacturer on the planet.

The obvious winners are renewable energy producers, or companies that make the equipment to make electricity out of sunlight, wind, water, and other resources that don't require combustion to make energy. Manufacturers of efficient engines or energy efficiency equipment may also get an adrenaline boost.

There are also some technological game-changers that could be significant winners in the longer term. Electricity storage—whether in better batteries, more usable pumped storage, ultracapacitors, flywheels, compressed air, or other possibilities—is one of those. Another technology we'll be watching is carbon capture and sequestration—anything that can remove carbon dioxide from the atmosphere.

As the low carbon economy takes hold, investors should consider how potential COP21 winners, losers, and technology game-changers could impact the risk-reward profile of their portfolios.

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[4] COP15 stands for the 15th Conference of the Parties to the United Nations Framework Convention on Climate Change.
[5] COP21 stands for the 21st Conference of the Parties to the United Nations Framework Convention on Climate Change.

## Recognizing risk-reward opportunity

We believe these three themes—international equities, valuation focus and transition to a low carbon economy—present opportunity for investors in 2016. And again, the opportunity is to make sound long-term risk-reward decisions, rather than try to time inflection points.

Within each theme, there are substantial variables that can alter inflection points. For instance, the markets are grappling with the implications of economic challenges in China, when Internet-related stock momentum will fade, and the speed at which a low carbon economy takes hold.

Nevertheless, we believe it is prudent to recognize the asymmetric risk-reward prospect in each of these themes and appropriately position portfolios to benefit from the long-term opportunities they present.

Sincerely,

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**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.

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