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Standing Still is Moving Backwards

Pax World Investment Outlook: Fourth Quarter 2016

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When everything is in motion, standing still just won't cut it. Amazon is a prescient example of an innovative company catching competitors on their heels, even those in different sectors. In this quarter's Investment Outlook we'll consider the investment risks associated with companies ill prepared for a paradigm shift, like the secular transition to a low carbon economy currently underway. But first, let's review a different sort of transition, the market move from "risk-off" to "risk-on" that shaped third quarter performance.

Market transition to higher beta stocks in Q3

Equity markets delivered solid returns in the third quarter. Small cap stocks as represented by the Russell 2000 Index[1] were the best performers returning 9.05% while the S&P 500 Index[2] was up 3.85%. Developed market foreign equities bounced back after the Brexit[3] sell off with the MSCI EAFE Index returning 6.43%.[4] Both growth and value stocks turned in strong results, but growth was modestly in favor across the capitalization spectrum, stamping out what appeared to be the makings of a value leadership trend in the first two quarters of the year.

Compared with earlier in the year, the market switched to a "risk-on" mode in June that carried through September. Beta[5] was the strongest factor driving stocks in Q3, indicating a preference for higher risk, lower quality stocks. Despite the current sentiment, a case for higher quality stocks over medium to longer time horizons has solid fundamental grounding. Higher quality companies tend to generate more consistent earnings and strong returns on equity or invested capital. While higher beta stocks with less solid fundamentals may outperform when investors are stretching for returns, higher quality stocks have been tried and true performers over the longer term.[6]

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KEY TAKEAWAYS

- We believe the transition to a low-carbon economy will be truly transformational for entire sectors, industries and individual companies.
- History has shown repeatedly that dominant firms in one technological era or paradigm almost always fail to make the transition successfully to be leaders in the next generation.
- A lot of the dominant tech companies already see reasons to be part of the low-carbon transition, as do companies in less prominent areas of the market, like those focused on energy-efficiency.
- While understanding cyclical transitions in market performance is important, we believe it's essential to identify secular trends and evaluate a company's ability to manage change and competitive threats.

[1] The Russell 2000 Index ("Benchmark") is an unmanaged index and 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. One cannot invest directly in any index.

[2] The S&P 500 Index is a widely recognized, unmanaged index of common stock prices. One cannot invest directly in an index.

[3] "Brexit" is short for "British exit" and refers to the June 23, 2016 referendum vote by British votes to leave the European Union.

[4] 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

[5] Source: Factset. The Beta style factor from Barra explains common variations in stock returns due to different stock sensitivities to market or systematic risk.

[6] Robert Novy-Marx, "The other side of value: The gross profitability premium," Journal of Financial Economics, Volume 108, Issue 1, April 2013, Pages 1–28. http://www.sciencedirect.com/science/article/pii/S0304405X13000044

We believe it is important to pay attention to these short-term cyclical market transitions, but not stray from our investment discipline, and to focus on high quality company traits. We are equally attentive to identifying longer-term secular shifts. We believe the transition to a low-carbon economy will be truly transformational for entire sectors, industries and individual companies.

Transitioning to a lower-carbon economy

Right now, we're at the thin end of the wedge on a global transition to lower-carbon economies. If we fail to achieve it, we'll be in a different transition adapting to the increasingly severe impacts of climate change. But let's stick with the former, hopeful possibility: the transition to a low-carbon economy.

For most people, that will sound like code for "more renewable energy." That is indeed part of the transition, but it's far more profound than that, and it will involve far more than turning oil majors into solar panel manufacturers, which probably won't happen anyway. History has shown repeatedly that dominant firms in one technological era or paradigm almost always fail to make the transition successfully to be leaders in the next generation. What new technologies and new paradigms do is blur the existing definitions and silos that defined competitiveness in the past, and fail to recognize that can be costly for companies, and for investors as well.

You'd probably have to be Rip Van Winkle not to notice that only three of the top ten companies in the S&P 500 Index in 1980 were in the top ten in 2016,[7] and two of those (Exxon and Mobil) have become one. In 1980, seven of the ten top companies in that index were in the energy business; in 2016, there was only one. In 2016, three of the top four companies (Apple, Microsoft, and Amazon) are all technology-driven companies, and none of those even existed in 1980. That the world is going digital is not news to anyone, but that the tech world is blurring the boundaries of traditional business may not be so clear to everyone.

1980	2016 (as of 10/12/2016)
IBM	Apple Inc.
AT&T	Microsoft Corporation
Exxon	Exxon Mobil Corporation
Standard Oil of Indiana	Amazon.com, Inc.
Schlumberger	Johnson & Johnson
Shell Oil	Facebook, Inc. Class A
Mobil	Berkshire Hathaway Inc. Class B
Standard Oil of California	General Electric Company
Atlantic Richfield	JPMorgan Chase & Co.
General Electric Company	AT&T Inc.

Amazon's expanding reach

Let's take the example of Amazon. It is increasingly clear that Amazon is no longer just a bookseller, or even just a retailer. Amazon's business model may also prove disruptive, or at

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[7] For a list of the top ten S&P 500 constituents over the years, see Michael Johnston, "Visual History of the S&P 500," http://etfdb.com/history-of-the-s-and-p-500/#2013.

least challenging, for several other businesses as well, including REITs that specialize in mall properties, as Amazon's position grows ever more dominant in many different areas of retail. The Wall Street Journal recently noted that Amazon may be pushing into the delivery business, not just for itself, but for competing with existing freight heavyweights UPS and Fedex.[8]

Another thing that Amazon is doing (at least its web service business), along with other tech giants like Apple, Google, Microsoft, Intel and Facebook, is moving more into renewable energy.[9] Often this is for data centers, which consume a lot of energy, something that most people don't immediately think of when they think "tech companies" and "energy." While there are sound reputational reasons that consumer-facing tech companies invest in renewables, there are also economic reasons: renewable energy is already cost-competitive with grid power in many places.[10] That can augment the advantages of renewables, especially in places where existing utility electricity systems may be increasingly vulnerable to the impacts of climate change, like drought. In short, a lot of the dominant tech companies already see reasons to be part of the low-carbon transition.

It's not just tech companies that see those advantages, of course. However exciting renewables are, it will take some time—hopefully not decades, but certainly years—to end our dependence on fossil fuels, particularly for transportation. The improving cost-competitiveness of renewables is great for electricity production, but for vehicles the attractiveness of renewable energy hasn't improved as rapidly so it's likely that internal combustion will be around for a while longer. That puts a premium on energy efficiency, something that makes companies like Borg Warner attractive, with their emphasis on products for energy efficient propulsion. Or Garmin, which can help drivers find the most energy-efficient routes.

Ability to manage change

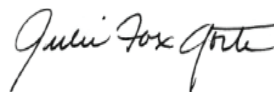
The low-carbon transition isn't just a matter of Solar City versus ExxonMobil. It is a paradigm shift in which companies in many industries and sectors can have a positive role. It's also a shift that might penalize companies that prefer to stick with yesterday's energy infrastructure for the foreseeable future.

While understanding cyclical transitions in market performance is important, we believe it's essential to identify secular trends and evaluate a company's ability to manage change and competitive threats. And not just from the traditional fundamental and financial perspective. Environmental, social and governance (ESG) analysis provides additional insight into whether a company is forward-thinking, anticipating risk, and focused on the long-term forces that may shape future markets, like a low-carbon economy.

Sincerely,

Chris Brown,
Chief Investment Strategist

Steve Falci, CFA®
Chief Investment Officer



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[8] Greg Bensinger and Laura Stevens, "Amazon's Newest Ambition: Competing Directly With UPS and FedEx," The Wall Street Journal, September 27, 2016.

[9] Ben Adler, "Which Tech Companies Are the Greenest?," Mother Jones, May 14, 2015.

[10] International Renewable Energy Agency (IRENA), Renewable Power Is Cost-Competitive, Renewable Power Generation Costs In ReMap 2030. http://www.irena.org/Remap/REmap-FactSheet-7-Cost%20Competitive.pdf

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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 serves on the Investment Committee for Mercy Investment Services. He 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.

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As of 9/30/16, Apple, Inc. was 1.9% of the Pax Balanced Fund and 3.2% of the Pax ESG Beta Quality Fund. Microsoft Corp., was 1.9% of the Pax Balanced Fund, 1.6% of the Pax ESG Beta Quality Fund, and 2.6% of the Pax Ellevate Global Women's Index Fund. Amazon.com, Inc., was 1.1% of the Pax Balanced Fund and 2.2% of the Pax ESG Beta Quality Fund. Johnson & Johnson was 1.8% of the Pax Balanced Fund, 2.9% of the Pax ESG Beta Quality Fund and 1.9% of the Pax Ellevate Global Women's Index Fund. Facebook, Inc. was 0.5% of the Pax Balanced Fund, 1.0% of the Pax ESG Beta Quality Fund and 1.8% of the Pax Ellevate Global Women's Index Fund. Berkshire Hathaway, Inc. was 1.0% of the Pax Ellevate Global Women's Index Fund. AT&T, Inc. was 0.9% of the Pax Balanced Fund, 2.5% of the Pax ESG Beta Quality Fund and 1.5% of the Pax Ellevate Global Women's Index Fund. United Parcel Service, Inc. was 0.8% of the Pax Balanced Fund, 1.2% of the Pax ESG Beta Quality Fund and 0.5% of the Pax Ellevate Global Women's Index Fund. Fedex Corp. was 0.3% of the Pax ESG Beta Quality Fund. Intel Corp. was 1.0%of the Pax ESG Beta Quality Fund. BorgWarner was 0.4% of the Pax ESG Beta Quality Fund and 2.1% of the Pax Global Environmental Markets Fund. Exxon Mobil Corp., General Electric Co., JPMorgan Chase & Co., Google, Garmin and Solar City were not held by any Pax World Funds. Holdings are subject to change.

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