

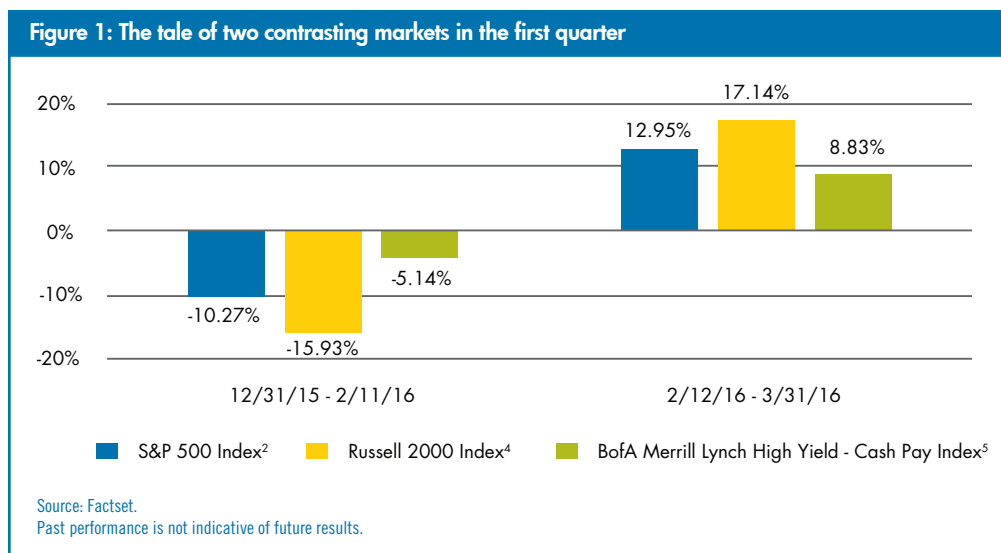
Focus on Fundamentals, not Sentiment

Pax World investment outlook: Second quarter 2016

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It's often said that snapshots in time don't tell the whole story. That was exemplified in first quarter equity returns, which gave the (mis)impression that not much had changed since the start of the year. Global equities were basically flat (-0.35% as represented by the MSCI World Index¹) while the S&P 500 Index² delivered a ho-hum return of 1.35%.

Of course “ho-hum” hardly characterizes the first quarter, which could be more accurately described as a “tale of two markets.” The return magnitudes pre- and post-February 11 were at levels more commonly witnessed over calendar years, not weeks. Figure 1 illustrates the extent of the volatility that also carried over to high yield corporate bonds, an asset class that struggled mightily, and then posted its third strongest recovery since 1999.³



KEY TAKEAWAYS

- The first quarter was a tale of two markets, shaped by sharp changes in investor sentiment.
- Value stock leadership and rosier economic prospects suggest the rebound may have been supported at some level by fundamentals, not just sentiment.
- Climate change and women's empowerment are two sustainability themes subject to shifting sentiment in the media but with strong grounding in investment fundamentals.
- Sorting through sentiment to identify fundamental grounding is the key to making better long-term investment decisions.

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¹ The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. One cannot invest directly in an index. Returns are shown net which includes dividend reinvestments after deduction of foreign withholding tax. One cannot invest directly in an index.

² Standard & Poor's 500 Stock Index is an unmanaged index of large capitalization common stocks. One cannot invest directly in an index.

³ JP Morgan, Credit Strategy Weekly, April 1, 2016.

⁴ 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. One cannot invest directly in an index.

⁵ The BofA Merrill Lynch High Yield Cash Pay Index is an unmanaged index used as a general measure of market performance consisting of fixed-rate, coupon-bearing bonds with an outstanding par which is greater than or equal to \$50 million, a maturity range greater than or equal to one year and must be less than BBB/Baa3 rated but not in default. One cannot invest directly in an index.

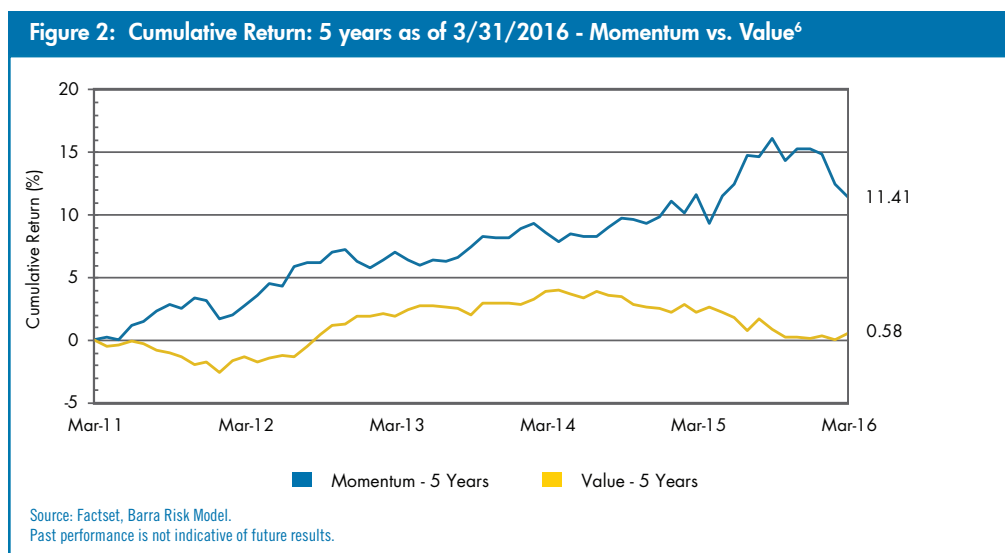
SHIFTING SENTIMENT

Over the course of the quarter there was a sharp and significant change in investor sentiment. Negative sentiment in the first half of the quarter was driven by global growth concerns and the expectation for rising U.S. interest rates. Once those fears began to lift, the markets recovered briskly.

Like snapshots in time, relying solely on sentiment obscures the broader context needed to make sound investment decisions. Sure, sentiment can at times influence near-term investment flows and short-term performance, but it can also miss the mark. (Case in point: the consensus view over the past few years has been that interest rates would go up—very soon.) The question now for investors is how much of the reversal in sentiment is related to underlying fundamentals.

Value vs. momentum

One data point that supports the recent shift in sentiment is investor appetite for value over momentum. Momentum, an investment style premised on buying stocks based purely on recent price performance with little regard for the underlying fundamentals, trailed value by -4.18%⁶ in the first quarter after outperforming for more than five years (see Figure 2). Value, meanwhile, is an investment style that is grounded in fundamentals tied to a stock's price. Value's leadership during the quarter suggests that the rebound may have been supported at some level by fundamentals, not just improved sentiment.



Too far, too fast?

As sentiment has changed, investors are now grappling with whether asset classes once arguably oversold have come back too far, too fast. It may be possible to justify the move to higher equity asset class valuations if rosier economic prospects actually translate into stronger company earnings growth. Recent strength in the PMI (Purchasing Managers Index) and ISM (Institute

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⁶ The return differential between the Barra Momentum Factor and the Barra Value Factor. Source: Factset.

of Supply Management) Index, widely followed measures of manufacturing sector activity that serve as leading indicators of economic strength, have provided optimism for equity investors.

Investors nevertheless remain cautious as defensive areas of the market like Utilities performed strongly throughout the first quarter. Similarly, investors favored more defensive, high-dividend companies in the first quarter, during both the sell-off and rebound. These two performance factors suggest investors are seeking further confirmation of economic strength, and in turn, earnings growth.

In the fixed income markets, directional calls on interest rates continue to defy prediction. We believe focus on relative value is paramount. Despite the extraordinary run of high yield bonds in February and March, we believe the asset class continues to offer value. Current spreads of ~700 basis points⁷ above Treasuries are sufficiently high enough to account for the expected rising default rates and any potential modest increases in interest rates. Like the equity markets, the timing and degree to which spreads can contract and translate into performance depends on U.S. economic strength.

SENTIMENT AND FUNDAMENTALS IN SUSTAINABILITY THEMES

Sentiment also plays a role in sustainability themes, particularly as the media and the general public shift their focus to specific issues. Climate change and women's empowerment are two themes that shared the spotlight in the first quarter.

Climate change ups and downs in the media

The media's coverage of climate change was all over the map in the first quarter. There was a great deal of optimism—some of it bordering on euphoria—following the 21st conference of the parties to the Kyoto Protocol (COP21) in Paris last December, followed by a sense of impending disaster when the Supreme Court issued a stay on implementation of the EPA's Clean Power Plan.

The EPA plan was one of the U.S.'s major contributions to COP21 and represents the first long-term national plan to deliberately reduce greenhouse gas emissions. Changes in the Supreme Court following the death of Justice Scalia have made the court's role much more uncertain, at least in the short-term.

However, for investors, the scientific fundamentals support the notion that climate change is going to have a very long-term influence on economies, and therefore on markets.

While short-term developments like an unusual Supreme Court action may sway sentiments for a while, over the longer term, investors are increasingly aware of the fundamental scientific grounding for the implications of climate change and are committed to managing the associated risks and opportunities.

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⁷A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

Gender equality gaining momentum

Another idea that's been around for a long time and has picked up steam recently as an investment theme is gender equality, particularly in the ranks of senior decision makers. It's an idea that has informed Pax's investment approach and fund lineup for many years, but a few years back we were still getting questions about whether gender diversity on corporate boards or in company management make any difference.

Now the evidence is in: a growing body of research underscores that diversity is correlated with stronger business results, and more and more investors are including gender-based funds, research, or commentary in their wheelhouses.

We were gratified, but not surprised, to be able to announce that following the creation of the Pax Global Women's Leadership Index⁸ in 2014, it outpaced its comparable broad market benchmark, the MSCI World Index, for the two-year period ended February 29, 2016.⁹

ULTIMATELY IT COMES DOWN TO FUNDAMENTALS

Fundamentals anchor investment decisions in the face of ever shifting sentiment. Sorting through sentiment to identify fundamental grounding is the key to making better long-term investment decisions. While sustainability themes may be swayed by the prevailing political and business climate in the short term, don't discount the scientific and economic fundamentals that are likely to be more durable long-term market drivers. Similarly, while markets and individual stocks may react to near-term economic sentiment, their ultimate direction will be determined by fundamentals.

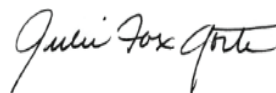
Sincerely,



Chris Brown,
Chief Investment Strategist



Steve Falci, CFA®
Chief Investment Officer



Julie Fox Gorte, Ph.D.,
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⁸The Pax Global Women's Leadership Index is a custom index based on MSCI World. Returns are shown net which includes dividend reinvestments after deduction of foreign withholding tax. The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. One cannot invest directly in an index.

⁹The Pax Global Women's Leadership Index has outperformed the MSCI World Index by 4.44% cumulative from 2/28/14 to 2/29/16. Comparable returns since index inception are shown net which includes dividend reinvestments after deduction of foreign withholding tax. Past performance is no guarantee of future results. One cannot invest directly in an index.



Christopher H. Brown, Chief Investment Strategist, is Portfolio Manager for the Pax Balanced Fund. He has been with Pax World Management LLC since 1998. He

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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.



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.



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