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Impact: The Next Stage of Sustainable Investing

Offering Solutions to Global Sustainability Challenges

by Joseph F. Keefe, President & CEO, Pax World Management LLC

Investing is no longer about style boxes. In the period ahead, it will increasingly be about goals, and about solutions. It will not be just about equities vs. fixed income, or large-cap vs. small-cap, or core vs. value vs. growth, or correlated vs. non-correlated. We saw a plethora of offerings in the so-called non-correlated or alternatives bucket following the 2008 downturn—long/short, market neutral, absolute return—and the financial services industry will continue to come out with new products, some of which are responsive to actual investor needs while others are designed primarily to gather assets and revenue. But new products alone are hardly the solution.

The fact is that investors remain somewhat spooked by the market. Once your 401(k) has been turned into a 201(k), you never really forget that—even after the market has surged back and your assets have been restored. Moreover, investors don't really trust big financial institutions, even if they trust their individual financial advisor. They are cautiously optimistic, however, and our industry needs to find ways to be responsive—both to their wary skepticism as well as to their cautious optimism.

Today, if we truly want to serve investors, it seems to me we need to have at least a partial answer to the question of trust, and the related issue of risk—which is always, of course, at the heart of investing. One way to do that is to speak to investors' goals, which go beyond diversification and asset allocation. Their goals ultimately involve the way they want to live their lives and what they want to accomplish over the course of their lives—and how their money relates to that. In this regard, while there is no single answer, I think sustainable investing, particularly as it enters its next stage, can be part of the solution.

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KEY TAKEAWAY

- Investors' goals go beyond diversification and asset allocation to involve how they want to live their lives, what they want to accomplish, and how their money relates to that.
- If we truly want to serve investors, we need to offer strategies that respond to investors' aspirations and growing desire to align their investments with positive social and environmental impacts while avoiding problematic ones.
- The next stage of sustainable investing's evolution–the "impact" phase–involves investing in high-impact, solutions-oriented companies that are confronting global sustainability challenges in order to become more explicitly linked to investing in the future–which is what investing is or should be all about.

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Not incidentally, we are also about to witness a significant generational transfer of wealth to certain emerging demographics—in particular, the millennial generation and women—who take a different approach to investing than did their largely white male predecessors.

A recent Merrill Lynch Private Banking & Investment Group report, "Millennials and Money," found that 29% of investors in their 20s and 30s want their financial advisor to provide "values-based investing." Of a list of nine priorities, this came in as the third highest.[1]

A 2013 U.S. Trust "Insights on Wealth and Worth" report found that 69% of millennials believe that investments "are a way to express my social, political and environmental values" (vs. 36% of baby boomers); 61% of millennials would be willing to accept a lower return in exchange for greater social and environmental impact (vs. 39% of baby boomers); and 72% would be willing to accept higher risk in exchange for greater social and environmental impact (vs. 35% of boomers). Some 69% of millennials reported that social, political or environmental impacts were considered "somewhat" or "extremely" important in investment decisions (vs. 40% of boomers).[2]

As for women, they start new businesses at twice the rate of men and comprise some 43% of Americans with gross assets of $1.5 million or more, according to the latest government figures. Women own 40% of U.S. businesses, which contribute $4 trillion to the nation's economy. They are the breadwinners or co-breadwinners in two-thirds of American households. In the U.S., women outnumber men in the attainment of college degrees (by 20%), are already responsible for 83% of all consumer purchases, hold 89% of U.S. bank accounts and 51% of all personal wealth, and are worth more than $5 trillion in consumer spending power—larger than the entire Japanese economy. As *Newsweek* reported in 2010, "Women are the biggest emerging market in the history of the planet."[3]

And women are more inclined than men to want their investments aligned with certain social and environmental values. The previously mentioned U.S. Trust survey of high net worth investors found that social, political or environmental impacts were considered "somewhat" or "extremely" important by 65% of women but only 42% of men. Another survey similarly found that nearly 42% of women—compared to less than 27% of men—report that they are "likely" or "very likely" to make environmentally responsible investments.[4] Still another reported that 53% of affluent women are interested in "environmentally responsible" investments and 47% are interested in "socially responsible" investments, compared in each case to only 33% of men.[5]

Significantly, a recently updated survey from the Center for Talent Innovation, "Harnessing the Power of the Purse: Female Investors and Global Opportunities for Growth," found that 90% of women surveyed say that "making a positive impact on society is important," while 77% of women want to invest in companies with diversity in leadership.[6]

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[1] "Millennials and money," Michael Liersch, Merrill Lynch Private Banking & Investment Group, 2014.
[2] "Insights on wealth and worth," U.S. Trust, 2013.
[3] "Women will rule the world," Jessica Bennett and Jesse Ellison, Newsweek, July 6, 2010.
[4] Adriana Reyneri, "Women Investors 'Go Green,'" March 8, 2012, Spectrum's Millionaire Corner, http://www.millionairecorner.com/article/women-investors-go-green.
[5] "Women Shun Energy Investments for Socially/Environmentally Responsible Funds," April 14, 2011, Spectrum's Millionaire Corner, http://www.millionairecorner.com/article/women-shun-energy-investments-sociallyenvironmentally-responsible-funds.
[6] "Harnessing the Power of the Purse: Female Investors and Global Opportunities for Growth," Sylvia Ann Hewlett and Andrea Turner Moffitt with Melinda Marshall, Center for Talent Innovation, 2014.

This gender divide among investors appears to play out among investment advisors as well. Female advisors report being more interested than their male counterparts in using sustainable investing funds or strategies—that is, those that integrate environmental, social and governance (ESG) factors into the investment process—by a margin of 59% to 34%.[7]

If we want to serve investors, we will not only need an answer to the question of trust, and the related issue of risk, but we will also need to offer strategies that are responsive to these aspirations, responsive to this growing desire that investments align with positive social and environmental impacts while avoiding problematic ones.

It is no surprise then that in the field of sustainable investing, there has been a marked evolution in the direction of impact over the last several years. When my company, Pax World, launched the first socially responsible mutual fund in the United States in 1971, this new model of investing—socially responsible investing (SRI)—was premised on screening out or excluding problematic companies or industries from investment portfolios based upon certain values choices: weapons, tobacco, gambling, alcohol, and so forth. SRI was greeted skeptically in traditional financial circles because the notion that you could achieve market or above-market returns by shrinking the investment universe was counterintuitive. Unfortunately, that bias—that SRI required one to sacrifice performance—congealed into conventional wisdom even though the data did not support it.

SRI also included from the very beginning, as a core component, shareholder engagement—from the struggle against Apartheid in South Africa to executive compensation (Say on Pay), board diversity, climate change, political and lobbying disclosure, and more. And of course it included not only public equities but other asset classes including in particular community investing, but also to some extent private equity and venture capital investing. These aspects of SRI, which were more focused on impact, were significant from the very beginning, and I will return to them in a moment.

This early SRI period, which continued right up into the last decade, strikes me as the first phase or first stage of sustainable investing.

The second stage literally involved the evolution from what was then called socially responsible investing to what has become known as sustainable investing, where the emphasis is no longer on excluding companies from portfolios based upon problematic products or practices, but rather the inclusion of companies based upon positive environmental, social and governance profiles or performance. Underscoring this evolution from SRI to sustainable investing was an emerging body of research suggesting that ESG factors have financial materiality, and therefore, integrating them into portfolio construction was a much smarter investment strategy than simply ignoring them, as was the case with traditional investment approaches.

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[7] Gateways to Impact–Industry Survey of Financial Advisors on Sustainable and Impact Investing, Calvert Foundation, et al, June 2012, www.gatewaystoimpact.org

Sustainable investing grew bolder in this second stage of evolution. Whereas in its first SRI phase, our industry would assert that one could incorporate values into investing, and exclude certain companies or industries, without sacrificing performance, sustainable investing made the case that, because ESG factors are material, incorporating them could actually help investors avoid risk and potentially achieve outperformance. A growing number of mainstream investors, including in particular institutional investors, became more attracted to this approach, and began to embrace sustainable investing as an actual investment discipline, rather than just a values choice, premised on the materiality of ESG. Growing numbers of investors began to accept the premise that the financial bottom line, in addition to social and environmental outcomes, could be improved by the inclusion of ESG research and analysis.

Before long, however, some disaffection set in—or perhaps not disaffection so much as a sense of urgency about wanting to achieve more. Investors effectively began asking, "Is that all there is?" Just as some SRI investors were earlier dissatisfied with the limits of an exclusionary screening approach that may have helped them sleep better at night but didn't sufficiently move the needle on social and environmental issues, sustainable investors similarly reached the conclusion that ESG was fine, but wasn't enough.

"So, my portfolio is composed of companies that meet certain ESG standards," these investors effectively asked. "Is this good enough? If a company makes Twinkies and party hats, and happens to meet ESG criteria because its sustainability profile is slightly better than other manufacturers of Twinkies and party hats, is this really good enough? Does it really make a difference, or have an impact? Can't I invest in companies that are actually making a positive difference in the world?"

The answer to this last question has to be, "Yes, you can," and the answer takes us beyond SRI and its negative screening, and beyond sustainable investing, if simply defined as integrating ESG factors into portfolio construction, to a new phase of development.

This third stage in the evolution of sustainable investing, what we might call the Impact phase, incorporates and builds upon the insights of the first two stages. It has two distinct features: First, it incorporates the premise that sustainable investing strategies should provide market returns, depending on the asset class, and that integrating ESG factors is a strategy for mitigating risk as well as uncovering value that can bolster investment portfolio performance. Second, it insists that investment portfolios, across asset classes, be designed to produce, or at least tilt in the direction of, positive social and environmental impacts.

What has come to be called impact investing, really started with community investing, but included private equity, so-called social venture capital (investing in a fair trade coffee plantation in Costa Rica, or a solar start-up in Oregon) and other strategies that didn't focus on public

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equities. It caught on, perhaps because the term, impact investing, seems to capture something that SRI and ESG couldn't, or at least didn't completely capture. It appeals to a growing number of investors for whom screening out bad companies (SRI), or even screening in better companies (ESG), just isn't enough. The impact component has to be there too.

This is a significant development. Just as ESG took hold over the past 5 - 8 years as additive to or perhaps a further evolution of, traditional SRI, so impact investing has taken hold—and captured a lot of hearts and minds—over the past 3 - 4 years as additive to or perhaps a further evolution of ESG.

However, there are limits to the appeal of impact investing, and serious constraints on its capacity to have, well, an impact, if its focus remains solely on community and private investments. Simply put, the vast majority of investors are not trust fund babies or successful Silicon Valley entrepreneurs or large institutional investors who have the capacity or the wherewithal, or even the desire, to allocate a slice of their capital to impact, if by that we are talking about private equity or venture capital or even community development finance. The vast majority of investors (individual investors, anyway) are invested in the market through their 401(k) or 403(b) plan at work, a rollover IRA from previous employers, or have a financial advisor who has them invested in stocks, bonds or mutual funds. They own public equities (and bonds), and if their money is going to have a positive impact, it will have to be largely through the public equity (and bond) markets.

It is this desire to have a positive impact, coupled with the fact that most of their investments are and will continue to be in public markets, that is leading to what I am calling the third stage of sustainable investing.

Historically, SRI and sustainable investing offered impact largely through shareholder activism and allocating part of a portfolio to community investments or other high impact investments, usually private. No claim was made that the broader portfolios themselves—after screening out problematic companies or screening in more acceptable ones—would themselves move the needle. Today, however, increasing numbers of investors will insist that investments in public equities accommodate this intentionality as well—that portfolios be made up of companies that have positive social and environmental impacts.

This third stage of sustainable investing involves, therefore, an increased focus on investing in high-impact, solutions-oriented companies that are confronting global sustainability challenges —not just start-ups and private placements but publicly traded companies as well. Meeting ESG criteria alone will no longer suffice; there will be an increased emphasis on designing portfolios that include companies whose products, services and technologies are proactively confronting global sustainability challenges.

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At Pax World, we currently offer three funds that definitely fall into this category:

Our **Pax Ellevate Global Women's Index Fund (PXWEX)** is the first and only mutual fund investing in the first and only index—the Pax Global Women's Leadership Index[8]—that is comprised of the highest-rated companies in the world in advancing women's leadership. Of the 400 plus companies in the index, 100% have a woman on their boards, 97% have two or more women, and almost 70% have three or more women on their boards. Significantly, research shows that when women's representation on corporate boards reaches three or more women—or approximately 30% of an average-sized board—governance improves and so does financial performance. In our Fund, women hold 31% of company board seats and 24% of executive management positions vs. global averages of only 11% in each instance.[9] We believe the Fund represents a market solution to a global business challenge—the need to increase the number of women on boards and in executive management. By investing in this Fund, you are helping direct investor capital toward those companies that are embracing gender diversity.

Our **Global Environmental Markets Fund (PGRNX)**, which has been fossil fuel-free from its inception, invests in resource efficiency or optimization strategies across four sectors of what we call "environmental markets:" energy efficiency and renewable energy; water and pollution control; waste and resource management; and sustainable food and agriculture.

Our **Growth Fund (PXWGX)** recently became fossil fuel-free as well, but we have also introduced a strong tilt in that Fund, which goes beyond replacing fossil fuel holdings, toward investing in high-impact, solutions-oriented companies that are confronting global sustainability challenges. The strong portfolio tilt toward these types of companies includes names such as:

- **Cree Inc. (CREE)[10]** – Makes light emitting diode (LED) products, which can deliver the same amount of light as incandescent light bulbs while using 85% to 90% less power.

- **Celgene Corp. (CELG)[10]**– A biopharmaceutical company focused on treatment for cancer and immune-inflammatory related diseases, which has set targets to reduce direct (Scope 1) and indirect (Scope 2) greenhouse gas (GHG) emissions by 2015, and to reduce water consumption by 2020.

- **Eaton Corp. (ETN)[10]** – Develops hybrid electric and hydraulic powertrains that boost fuel economy and reduce particulate emissions in trucks, buses and service vehicles; electrical power control systems for the efficient use of power; high-pressure hydraulic aircraft systems that reduce weight and improve fuel efficiency; automotive superchargers for enhanced fuel efficiency; and software that helps companies monitor energy efficiency, GHG emissions and identify reduction opportunities.

- **Pall Corp. (PLL)[11]** – The company's filtration, separation and purification products

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[8]A custom index calculated by MSCI. One cannot invest directly in an index.
[9]"2014 Global Balance Scorecard," 20-First March 2014; 2 A joint initiative of the UN Global Compact and UN Women.
[10]As of 3/31/14, Cree Inc. was 0.5% of holding of the Pax World Growth Fund. Celgene Corp. was 0.2% of holdings of the Pax World Balanced Fund and 1.1% of holdings of the Growth Fund. Eaton Corp. was 0.7% of holdings of the Balanced Fund and 1.4% of the Growth Fund. Holdings are subject to change.

enable customers to purify and conserve water, consume less energy, and minimize emissions and waste.

- **Valeo SA (FR FP)**[11] – Develops hybrid technology engines that significantly reduce carbon dioxide emissions and other pollutants, and has developed an alternator-starter that cuts the engine when the vehicle is stationary, improving energy efficiency.
- **Gilead Sciences Inc. (GILD)**[11] – Its product portfolio includes treatments for HIV/AIDS, hepatitis, serious respiratory and cardiovascular conditions, cancer and inflammation. The company is working with stakeholders on ways to expand treatments in emerging markets, such as a tiered pricing system for its HIV/AIDS drugs that reflect each country's ability to pay.

These companies are the future, and to the extent we focus on impact we are in fact investing in the future.

Pax World is not alone in moving in this direction. Amy Domini, who has long been one of the visionary leaders in our industry, recently launched **Nia Global Solutions (Nia)**, a separately managed account for qualified investors that takes impact investing into public stock markets by investing in renewable and efficient energy, inclusive finance, affordable housing, organic food, health care, affordable transportation and educational opportunities for the poor and disadvantaged.

Those millennial investors and woman investors I mentioned earlier are going to help catalyze this third stage of sustainable investing where the focus increasingly turns from what we might call acceptable companies to higher impact, solutions-oriented companies.

This third stage of sustainable investing will change the way financial advisors and asset managers do business. Individual company "stories" will become more important. A discussion of products, services and technologies in a portfolio will become more important. A portfolio's tilt in the direction of solutions to global challenges—climate change solutions, improved health care, access to education, sustainable infrastructure—will become more important. And this will increasingly be the case whether it's a large cap growth fund or a small cap value fund, domestic or international, active or passive.

Sustainable investing will therefore become more explicitly linked to investing in the future—which is what investing is or should be about anyway. We invest money today hoping that it will grow tomorrow, and increasingly we hope that it not only grows, but that this growth contributes to a safer, saner world.

Investing with our values, as SRI originally did and has always done. Yes. Integrating ESG factors into investment analysis and decision making, as sustainable investing allows us to do. Yes. But finally: investing for impact, investing in solutions, investing in the companies of tomorrow—

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[11]As of 3/31/14, Pall Corp. was 1.3% of holdings of the Pax World Growth Fund and 3.3% of the Global Environmental Markets Fund. Valeo SA was 0.9% of holdings of the Pax World Growth Fund. Gilead Sciences Inc. was 1.1% of holdings of the Pax World Balanced Fund and 1.2% of the Growth Fund. Holdings are subject to change.

companies that will shape a healthier planet and a better society. Yes, indeed.

This focus on impact will not of course solve the riddle of risk, or the riddle of trust, or completely restore investing to what it once was, before the financial crisis, before Too Big to Fail, before all the corporate governance meltdowns and scandals that have shaken the trust of investors. But our task is not to restore the past, it's to build the future. That's where the next phase of sustainable investing can really make a difference—and those of us who are engaged in it should resolve that it live up to that potential.

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 mutual funds including ESG Managers® Portfolios, multi-manager asset allocation portfolios powered by Morningstar Associates, LLC.

The statements and opinions expressed are those of the author 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.

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Fund Objectives: *The Growth Fund and the Global Environmental Markets Fund objectives are to seek long-term growth of capital.*

The Pax Ellevate Global Women's Index Fund's objective is to seeks investment returns that closely correspond to or exceed the price and yield performance, before fees and expenses, of the Pax Global Women's Leadership Index, the first and only broad-market index of the highest-rated companies in the world in advancing women's leadership, as rated by Pax World Gender Analytics.*

** A custom index calculated by MSCI. One cannot invest directly in an index*

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.

RISKS (Pax World Growth Fund and Pax World Global Environmental Markets Fund): Equity investments are subject to market fluctuations, the fund's share price can fall because of weakness in the broad market, a particular industry, or specific holdings. Emerging market and international investments involve risk of capital loss from unfavorable fluctuations in currency values, differences in generally accepted accounting principles, economic or political instability in other nations or increased volatility and lower trading volume.

RISKS (Pax Ellevate Global Women's Index Fund): You could lose money on your investment in the Fund or the Fund could underperform because of the following risks: the market prices of stocks held by the Fund may fall; individual investments of the Fund may not perform as expected; the Fund's portfolio management practices may not achieve the desired result. Funds focusing on small/medium companies generally experience greater price volatility. Investments in emerging markets and non-U.S. Securities are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation, intervention and political developments. The Pax Ellevate Global Women's Index Fund does not attempt to outperform the Index or take defensive positions in declining markets. Accordingly, the Fund's performance would likely be adversely affected by a decline in the Index. As this Fund can have a high concentration in some issuers the Fund can be adversely impacted by changes affecting issuers. There is no guarantee that the objective will be met and diversification does not eliminate risk.

Effective June 4, 2014, the Pax World Global Women's Equality Fund was reorganized into the Pax Ellevate Global Women's Index Fund.

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