

Why Values-Based Investing Just Might Work

Characteristics inherent in ESG could give investors an edge

by Shannon Zimmerman, Senior Investment Consultant for Morningstar Associates, LLC

Among the many lenses through which investors can gauge their portfolios' broad exposures, assessments of style and strategy are perhaps the most commonly used. Aiming to build and maintain well-diversified portfolios, prudent investors and their advisors typically settle on an asset-allocation game plan with exposures to the market's capitalization range and valuation spectrum that best aligns with the investor's timeline and tolerance for what is called "risk" (but is really volatility). Subsequent investment decisions are then driven by determining which of the available options seem the most sensible for new money, given the investor's initial asset-allocation game plan and how a portfolio has been shifted by market movements over time.

That's, of course, an ideal-world description of how portfolios are built and maintained. Actual mileage may vary and usually does. Opportunities may arise (high-yield bonds in early 2009, say) that seem like obvious buys, even though they were underweighted, or perhaps not accounted for at all, in the initial design of an investor's portfolio. Moreover, while many investors (and presumably all advisors) at least attempt to build portfolios of funds that complement one another not just in terms of style but also in terms of strategy, assessing the particulars of a manager's approach to security selection is sometimes, and perhaps even usually, equal parts art and science.

At the same time, during a period of heightened correlations¹ among equity markets, diversification at the level of strategy has become a more pressing portfolio-construction goal for

KEY TAKEAWAYS

- Investors and advisors attempt to build portfolios of funds that complement one another not just in terms of style but also in terms of strategy, assessing the particulars of a manager's approach to security selection is sometimes equal parts art and science.
- The universe of ESG funds are sometimes criticized on the grounds that investing on the basis of nonfinancial, values-based criteria hamstring money managers competing against rivals who are free to invest purely on the basis of financial merit and wherever they see opportunity.
- Assets in alternative funds have nearly doubled since 2011, roughly \$74 billion. The number of funds using social screens remains quite small—just 170 distinct funds out of the 8,016 in Morningstar's database are flagged as socially conscious.
- While additional research is needed, it may be the case that ESG criteria, which often results in higher-quality, growth-leaning portfolios, provides an edge in a part of the market where advantages are hard to come by.

CONTINUED

¹Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management. Diversification does not eliminate the risk of losses.



Shannon Zimmerman is a senior investment consultant and portfolio manager for Morningstar Investment Management. In this role, he is responsible for manager assessment and selection as well as portfolio construction. Zimmerman has been in the investment industry since 1998. Upon returning to Morningstar in 2010, Zimmerman served as associate director of active strategies research and director of training for Morningstar's manager research team. He covered domestic- and international-equity strategies and served as the lead analyst for the Oakmark, ClearBridge, and John Hancock fund families. He also oversaw the manager research analyst training program. Prior to this, he worked for Motley Fool as a senior analyst, advisor, and portfolio manager simultaneously from 2004 through 2010. He was responsible for all client communication and an advisor of four research offerings. He also served as the principal architect of the Motley Fool's asset management business, and the principal writer of the prospectus for the Motley Fool Independence Fund. Zimmerman initially joined Morningstar in 2002 as a fund analyst. Zimmerman holds a bachelor's degree in English from Rollins College and a doctorate in English from the University of Georgia.

Top-Rated ESG Funds

These four funds are the only Morningstar medalist funds that follow ESG strategies.

Name	Morningstar Category	Morningstar Rating Overall ³	Morningstar Analyst Rating ⁴	Upside Capture Ratio 06/01/2000 to 05/31/2015 ⁵	Downside Capture Ratio 06/01/2000 to 05/31/2015 ⁵	Longest Manager Tenure (Years)
Neuberger Berman Socially Rspns Inv NBSRX ²	Large Growth	★★★	Silver	103.13	90.27	14.00
Parnassus Core Equity Investor PRBLX ²	Large Blend	★★★★★	Silver	91.53	69.83	14.08
TIAA-CREF Social Choice Equity Instl TISCX ²	Large Blend	★★★★★	Bronze	101.52	100.27	9.50
Vanguard FTSE Social Index Inv VFTSX ²	Large Blend	★★★	Bronze	107.41	115.53	3.50

Data as of 05/31/2015.

many investors and their advisors. Not for nothing have assets in alternative funds—which the industry continues to roll out at a feverish pace—nearly doubled since 2011.⁶

For most of us, however, the bulk of our portfolio's strategic diversification will likely come from a mix of index funds and actively managed vehicles whose investment approaches complement one another. For example, the best-in-class purveyors of deep-value and growth-at-a-reasonable-price approaches to security selection can augment returns via distinct return streams while helping to tamp down volatility over time.

A Different Kind of Value Investing

That's also true of values-based investing, even though conventional wisdom, and perhaps intuition as well, seems to suggest otherwise. The universe of funds once called SRI (socially responsible investing) and that now go by Sustainable or ESG (environmental, social, governance) are sometimes criticized on the grounds that, all else being equal, investing on the basis of nonfinancial, values-based criteria hamstrings money managers competing against rivals who are free to invest purely on the basis of financial merit and wherever they see opportunity.

CONTINUED

²As of 6/30/2015 Neuberger Berman Socially Responsive Individual Class (NBSRX) was not held by any ESG Managers Portfolio's; Parnassus Core Equity Investor Shares (PRBLX) was not held by any ESG Managers Portfolio's; TIAA-CREF Social Choice Equity Institutional Class (TISCX) was 5.5% of holdings of the ESG Managers Growth Portfolio, 7.6% of holdings of the ESG Managers Growth and Income Portfolio, 6.6% of holdings of the ESG Managers Balanced Portfolio and 6.4% of holdings of the ESG Managers Income Portfolio; Vanguard FTSE Social Index Investor Shares (VFTSX) was not held by any ESG Managers Portfolio's. Holdings are subject to change.

³The Morningstar Ratings™ shown are as of 5/31/15 and are based on risk-adjusted 3-, 5-, and 10-year (if applicable) returns, and past performance is no guarantee of future results. The Neuberger Berman Socially Responsive Individual Class (NBSRX) Morningstar ratings were 3 stars out of 1543 funds overall, 4 stars out of 1543 funds for 3-years, 3 stars out of 1326 funds for 5-years and 3 stars out of 920 funds for 10-years. The Parnassus Core Equity Investor Class (PRBLX) Morningstar ratings were 5 stars out of 1369 funds overall, 4 stars out of 1369 funds for 3-years, 4 stars out of 1223 funds for 5-years and 5 stars out of 845 funds for 10-years. The TIAA-CREF Social Choice Equity Institutional Class (TISCX) Morningstar ratings were 4 stars out of 1369 funds overall, 3 stars out of 1369 funds for 3-years, 3 stars out of 1223 funds for 5-years and 4 stars out of 845 funds for 10-years. The Vanguard FTSE Social Index Individual Class (VFTSX) Morningstar ratings were 3 stars out of 1369 funds overall, 5 stars out of 1369 funds for 3-years, 5 stars out of 1223 funds for 5-years and 2 stars out of 845 funds for 10-years. Ratings are subject to change every month. For each fund with at least a three-year history, Morningstar calculates a Morningstar Ratings™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Overall Morningstar Ratings™ for a fund is derived from a weighted average of the performance figures associated with its 3-, 5-, and 10-year Morningstar Ratings™ metrics.

⁴The Morningstar Analyst Rating for funds is the summary expression of Morningstar's forward-looking analysis. Morningstar analysts assign the ratings globally on a five-tier scale with three positive ratings of Gold, Silver, and Bronze, as well as Neutral, Negative, and Under Review designations. The move to three positive ratings enables our fund research analysts to highlight conviction in a fund more precisely than previously. The Analyst Rating is based on the analyst's conviction in the fund's ability to outperform its peer group and/or relevant benchmark on a risk-adjusted basis over the long term. The Analyst Rating does not express a view on a given asset class or peer group, but seeks to evaluate each fund within the context of an appropriate benchmark and peer group given what the fund is trying to achieve with its portfolio.

⁵Upside/downside capture ratio show how much a given fund has outperformed a broad market benchmark, in this case the S&P 500, during periods of market strength and weakness. A ratio over 100 indicates the fund performed better than the index.

⁶Source: Morningstar Direct.

Diversification does not eliminate the risk of losses. Asset Allocation and Diversification are investment methods used to help manage risk. They do not ensure a profit or protect against a loss.

Primary Prospectus Benchmark	Fund Size (\$ Mil)	Annual Report Net Expense Ratio	Total Ret % Rant Cat 3-Yr (Qtr-End)	Total Ret % Rant Cat 5-Yr (Qtr-End)	Total Ret % Rant Cat 10-Yr (Qtr-End)	Total Ret % Rant Cat 15-Yr (Qtr-End)
S&P 500 ⁷	2,362	0.86	34	51	54	2
S&P 500	11,821	0.87	7	38	1	5
Russell 3000 ⁸	2,777	0.18	42	42	18	33
FTSE4Good US Benchmark ⁹	1,820	0.27	3	10	53	—

For investors steeped not in social activism but financial analysis—i.e., the vast majority of us—that claim may seem commonsensical. It isn't borne out by the data, though, as we'll see. And yet the notion that investors can't do well by doing good persists, even among sophisticated investment professionals who don't typically trust intuition over calculations.

History Lesson

To be fair, a part of their skepticism may be a well-justified overhang from the SRI industry's early days, a period in which assets in socially screened funds were modest and expenses—always a leading indicator of any fund's relative results—were correspondingly high. Lopsided sector weights—the result of exclusion screens that essentially eliminated energy and many industrials stocks—sometimes generated volatility that investors weren't sufficiently compensated for, too.

Much has changed, however, during the SRI industry's evolution toward ESG. Although the number of funds using social screens remains quite small—just 170 distinct funds out of the 8,016 in Morningstar's database are flagged as socially conscious—the assets in those funds are substantial, now standing at roughly \$74 billion.¹⁰ As you would expect, as assets have risen, fees have fallen. The typical socially screened fund now weighs in with a price tag of 1.06%; more than half earn Morningstar Fee Level Ratings of Average or better.

In turn, those lower fees¹¹ have led to more competitive results, particularly on a risk-adjusted basis. Of the 105 socially screened funds with track records of at least three years, 77 (73%) earn overall Morningstar Risk Ratings—a volatility gauge that penalizes poor returns in down markets—of Average or better.

The improved risk characteristics and smoother ride that values-based investors now enjoy reflect another change: an industry-wide trend toward relative social screening. While the

CONTINUED

⁷Standard & Poor's 500 Stock Index is an unmanaged index of large capitalization common stocks. One cannot invest directly in an index.

⁸Russell 3000[®] Index is a market capitalization-weighted index that measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. One cannot invest directly in an index.

⁹The FTSE4Good Index is a series of ethical investment stock market indices launched in 2001 by the FTSE Group. A number of stock market indices are available, for example covering UK shares, US shares, European markets, and Japan, with inclusion based on a range of corporate social responsibility criteria. All rights in a FTSE Index vest in FTSE International Limited (FTSE). FTSE[®] is a trademark of London Stock Exchange Group companies and is used by FTSE under license. One cannot invest directly in an index.

¹⁰Source: Morningstar Direct.

¹¹Redemption fees are a fee collected by an investment company from traders practicing mutual fund timing. This stiff penalty is used to discourage short-term, in-and-out trading of mutual fund shares. Generally, the fee is in effect for a holding period from 30 days to one year, but it can be in place for longer periods.

exclusion screens of the past certainly haven't vanished, many, perhaps even most, ESG money managers are now free to invest in firms they believe to be the best-in-class players in their industry. The clearest consequence of this shift can be seen in the level of energy exposure among equity ESG funds, whose allocations to the sector now hover much closer to index and peer group norms than they once did.

Indeed, at 7.3%, **TIAA-CREF Social Choice Equity (TISCX)**, a passively managed fund that seeks to match the returns of the Russell 3000 Index with a portfolio of socially screened companies, comes closer to its boggy's 7.6% energy stake than does the **iShares Russell 3000 ETF (IUV)**¹², a plain-vanilla index tracker whose exposure to energy stocks hovers near 7%.

While the move toward relative social screening may strike ESG purists as a watered-down approach to values-based investing, having a seat at the table provides a clear advantage over exclusion screens: an opportunity to influence best-in-class players to become even better. That's particularly true in the realm of corporate governance, an area of concern for all investors but, historically, not an area of emphasis for the SRI industry. For noninvestors, after all, it is difficult if not impossible to advocate effectively for such things as greater independence on a company's board, more diversity in its workplace, or closer adherence to environmental regulations.

Relative screening does pose a challenge for investment analysts. Assessing how strictly a fund abides by exclusion screens is a straightforward task; judging how well a manager has used "quiet diplomacy"—through proxy votes, for example, or by support for ESG-related shareholder resolutions—to achieve social ends is more challenging.

On the whole, however, relative screening has been a positive development, helping those who want to invest in socially responsible ways do so via portfolios constructed in financially responsible ways: by managers who have access to all the market's sectors.

Investing Is All About Constraints

Still, while the relatively recent changes highlighted above have served values-based investors well, the notion that managers of socially screened funds face uphill-battle constraints that other managers don't has always been a flawed premise. True go-anywhere managers are the fund industry's equivalent of an urban myth. To varying degrees, all managers contend with constraints on their investment approach that more or less arbitrarily eliminate companies from their investable universe, companies that might otherwise be strong candidates for their portfolios.

Some managers, for example, are required to target just a particular segment of the market's capitalization range. Others face limits on the degree to which their funds' sector weights may deviate from the benchmark's. International funds may require a manager to invest exclusively in developed markets or, if emerging-markets exposure is permitted, cap the percentage of assets that may be invested in those regions. Other managers can't invest in any company that doesn't pay a dividend, a requirement that in some cases extends to the manager's sell discipline. If a

CONTINUED

¹²As of 6/30/2015 iShares Russell 3000 ETF (IUV) was not held by any ESG Managers Portfolio's. Holdings are subject to change.

company suspends a dividend, for example, its shares must be sold, no matter the reason for the suspension or the manager's assessment of the firm's subsequent valuation.

Add to those product-level constraints the constraints that portfolio managers themselves impose—aka the fund's strategy. Bill Nygren of Oakmark won't add a new name to the portfolio of any of the funds he manages unless it trades at a discount of at least 40% to his estimate of the company's "true business value." At the **Oakmark Fund (OAKMX)**¹³, that requirement typically nets a portfolio of 50 to 60 stocks; at **Oakmark Select I (OAKLX)**¹⁴, Nygren's approach winnows the number to just 20 names.

My point with these examples of product- and strategy-level constraints isn't to suggest that such limitations on a manager's investable universe are at odds with the goal of superior investment results. On the contrary. Winnowing a vast investment universe down to just the options that meet a particular fund's criteria is precisely what security selection is.

That said, these widely shrugged-at restrictions often have a far more draconian impact on the scale of a manager's investable universe than even especially stringent ESG screens do. TIAA-CREF Social Choice Equity, for example, was early among socially screened funds to eliminate **Apple (AAPL)**¹⁵ from its investable universe, primarily on concerns about workplace practices among certain third-party vendors. An index-plus fund seeking to deliver the Russell 3000 Index's returns via a portfolio of socially screened stocks, Social Choice Equity holds nearly 800 names nonetheless.

What About Fundamentals?

Still, even if ESG managers are free to choose securities from an investable universe that's as expansive, if not more so, as those of many non-ESG rivals, aren't their particular constraints ancillary (if not antithetical) to the fundamental factors that ultimately drive stock prices? Targeting just small-cap stocks or bypassing companies that don't pay dividends is one thing; not owning Apple because of concerns about its supply chain seems extreme.

Given the dearth of published research on the connections between social criteria and investment results, that's an understandable question. After all, an upside earnings surprise resulting from a company's successful new product launch can boost that company's shares literally overnight. The same firm's attempt to reduce carbon emissions, on the other hand, might weigh on near-term results owing to the costs involved.

As most investors understand, though, no two distinct investment approaches are likely to generate comparable results at precisely the same pace or in precisely the same market environment—that's what makes them useful for the purposes of portfolio construction. While on the one hand, funds with strategies based on earnings momentum can offer near-term payoffs if their managers make the correct calls, research suggests that seven years, historically, has been the optimal time frame for assessing the effectiveness of a deep-value manager such as Richard Pzena, who has achieved long-haul success at **John Hancock Classic Value (PZFBVX)**¹⁶ despite protracted periods of underperformance and above-average volatility.

Then, too, in the clearest recent example of why prudent investors diversify across not just the market's capitalization range and valuation spectrum but across investment strategies as well, those funds that fared

CONTINUED

¹³As of 6/30/2015 Oakmark Fund (OAKMX) was not held by any ESG Managers Portfolio's. Holdings are subject to change.

¹⁴As of 6/30/2015 Oakmark Select I (OAKLX) was not held by any ESG Managers Portfolio's. Holdings are subject to change.

¹⁵As of 6/30/15, Apple, Inc. was 3.1% of holdings of the Pax World Balanced Fund and 5.9% of holdings of the Pax World Growth Fund. Holdings are subject to change.

¹⁶As of 6/30/2015 John Hancock Classic Value (PZFBVX) was not held by any ESG Managers Portfolio's. Holdings are subject to change.

best during 2008's flight to quality weren't the ones generally atop the leaderboard amid the next year's fast and furious beta rally.

Values as a Strategy

If by "investment strategy" we mean a consistently applied approach to security selection that can result in a differentiated source of returns, ESG is indeed an investment strategy. Of the 105 socially conscious equity funds in Morningstar's database whose track records are long enough to earn a star rating (i.e., at least three years), well over half have earned ratings of 3 stars or higher. Roughly one fourth of them earned ratings of 4 or 5 stars. These socially screened funds competed head to head; that is, against rivals that target the same parts of the market that they do and whose managers aren't constrained by values-based screens. In roughly 60% of the cases, the ESG funds delivered risk-adjusted results on par with or better than those of their average category peers.

The stats are more impressive once you control for fees. Among socially conscious equity funds with fee-level ratings of Average or better, fully 77% have earned star ratings of 3 stars or higher; slightly more than 35% earn ratings of 4 or 5 stars. In both cases, the ESG group's star-rating percentages are slightly higher than those of the broad universe of equity funds. Among that group, 75% earn ratings of 3 stars or higher, with slightly more than 34% earning 4- or 5-star ratings.

Clearly, social criteria hasn't been a hindrance to ESG funds' performance, on average, during the measurement periods used to calculate their star ratings (up to 10 years depending on the life of the fund). Moreover, in the case of funds earning 4 and 5 stars, it seems reasonable to suggest that not only didn't the social screens hurt, they appear to have helped.

Interestingly, values-based investors enjoyed particular success during the measurement period in Morningstar's large-blend category. There, and irrespective of fees, eight of 21 ESG funds (38%) earned either 4- or 5-star ratings in a peer group whose members target the most efficient part of the market. All told, 15 of 21 large-blend ESG funds (71%) earned ratings of 3 stars or higher.

ESG Edge

While additional research is needed, it may be the case that ESG criteria, which often results in higher-quality, growth-leaning portfolios, provides an edge in a part of the market where advantages are hard to come by.

More broadly, during a period of relatively tight correlations for equities in which strategic diversification is more important than it's ever been, both the data and the investor-centric evolution of values-based investing recommend ESG as a strategy that even agnostic investors may want to at least consider for their portfolios.

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.

About Morningstar Associates, LLC

Morningstar Associates is a premier provider of investment management solutions for institutions to help investors reach their financial goals. As a registered investment advisor and wholly owned subsidiary of Morningstar, Inc., Morningstar Associates provides investment management and advisory services on behalf of institutions and individual investors.

Shannon Zimmerman is a senior investment consultant for Morningstar Associates, LLC, and provides manager selection and portfolio construction services for the ESG Managers® Portfolios. Zimmerman wrote the Value-Based Investing article for the August/September 2015 Morningstar magazine for informational purposes only. His opinions are expressed as of the date of publication and are subject to change without notice.

Morningstar Associates shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses or opinions or their use. The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. Please note that references to specific securities or other investment options within this piece should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell that specific investment. The performance data shown represents past performance. Past performance does not guarantee future results.

In no way should the opinions presented within be considered indicative or a guarantee of the future performance of a client's portfolio with the same strategy; considered indicative of the actual performance achieved by clients in the same strategy; viewed as a substitute for the actual portfolio recommended to individual clients, or viewed as a substitute for the ESG Managers® Portfolios.

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.

An investment in the funds involves risk, including loss of principal. You should consider ESG Managers® Portfolios' investment objectives, risks, 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 ESG Managers® Portfolios involves risk, including loss of principal.

Past performance is no guarantee of future results.

Pax World Management LLC is the investment adviser to the ESG Managers® Portfolios. Morningstar Associates, LLC, a registered investment adviser and wholly owned subsidiary of Morningstar, Inc., serves as portfolio construction adviser to the ESG Managers® Portfolios responsible for manager selection, asset allocation, portfolio construction and monitoring, but does not serve in the capacity of investment adviser to individual investors. The Morningstar name and logo are the property of Morningstar, Inc. Morningstar is not affiliated with Pax World Management LLC. ALPS Distributors, Inc. is not affiliated with Morningstar Associates, LLC.

ESG Managers® Portfolios are multi-manager funds, which are a mix of underlying funds and sleeve subadviser portfolios. The Funds' allocations may change due to market fluctuations and other factors.

ESG Managers® Portfolios are available only through registered financial advisors and qualified retirement plan providers.



ESG Managers® Portfolios
30 Penhallow Street, Suite 400
Portsmouth, NH 03801
800.372.7827
info@paxworld.com
www.esgmanagers.com

Separately managed accounts and related advisory services are provided by Pax World Management LLC, a federally registered investment adviser. ALPS Distributors, Inc. is not the distributor for Pax World's separately managed accounts.

Copyright © 2015 Pax World Management LLC. All rights reserved. Distributor: ALPS Distributors Inc.: Member FINRA. ALPS is not affiliated with Morningstar Associates, LLC, Motley Fool, Oakmark, ClearBridge Investments, Parnassus Investments, Neuberger Berman, TIAA-CREF Asset Management, Vanguard, iShares or John Hancock.