



Pax World Investments

For Tomorrow®

Sustainable Investing and the Next Economy

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My remarks tonight are set against the twin backdrops of the Financial Crisis and what I will call the Sustainability Crisis—twin crises that should challenge our thinking about investing, certainly, but also about economics more broadly, as they betray deep-seated, systemic problems that neither government nor markets, the public sector or the private sector, as they are presently constituted, seem designed to address.

We need a new design. We need to take this moment in time to imagine what the Next Economy might look like—an economy that is both post-Sustainability Crisis and post-Financial Crisis.

It seems clear to me, first of all, that over the next few decades, market capitalism will need to undergo a Sustainability Revolution equal in significance to the Industrial Revolution that ushered in the modern period. In order for this to happen, corporate behavior, market behavior and investor behavior will need to change. In each case, they will need to become more sustainable—which means, among other things, to behave in a way that focuses more on the long term.

Investors can play an important role in this great transformation, as well they should: the transition from an industrial age economy powered by coal and oil to a sustainable economy powered by clean energy and new technologies will unleash a new era of economic and investment opportunities. Sustainable Investing, as I am using the term, is not only a strategy to hasten this historic transformation, but also to harvest the potential investment returns associated with it.

Climate change may be the most urgent and potentially calamitous challenge before us, but it is only one aspect of a much larger Sustainability Crisis confronting humanity in the early decades of

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the 21st Century. Simply put, the vast stock of natural capital on which human life depends—air, water, minerals, oil, fisheries, forests and rainforests, grasslands, savannas, wetlands, estuaries, oceans, coral reefs—is deteriorating at an unprecedented rate. In the past fifty years, the world has lost a fourth of its topsoil and a third of its forest cover. In the last thirty years alone, one-third of the planet’s resources—the earth’s “natural” wealth—have been consumed. We are losing freshwater ecosystems at the rate of 6 percent per year, marine ecosystems at the rate of 4 percent per year, and at present rates of destruction we will lose 70% of the world’s coral reefs in our lifetime, host to 25 percent of all marine life. The world is fast approaching or has already crossed the sustainable yield thresholds of many natural systems.

Meanwhile, between 1950 and today, world population increased from 2.5 billion people to 6.5 billion people, and is expected to grow to 9 billion people by 2050. Virtually all of this projected future growth will take place in the developing world, where countries are already overpopulated, grinding poverty persists and natural ecosystems—the source of food and nutrition—are strained to the breaking point.

And then there is climate change. A growing global economy and growing global population mean growing demand for and use of energy, and the fact that our present and projected energy mix is so carbon intensive is setting in motion a developing ecological catastrophe that will include rising sea levels, melting polar ice caps, coastal erosion, increasingly dramatic storms, floods and other natural disasters, accelerating species and habitat extinctions and unimaginable changes to life—including human life—on planet earth. Not to mention the ongoing threat of accidents and

ecological disaster—which we have experienced acutely of late—associated with our continued reliance on coal and oil.

As the beat poet Lawrence Ferlinghetti once wrote: “Man burns down his own house to roast his pig.”

Which brings us to the second crisis, the Financial Crisis, and the Great Recession that it set in motion. This was not your typical business cycle downturn like recessions past. Instead, the Financial Crisis is more akin to the Sustainability Crisis, in that it was set in motion by a species of short-term thinking not unrelated to the short-term thinking that is undermining our planet’s ecological balance.

A speculative bubble in housing (which essentially replaced the previous speculative bubble in technology), excessive consumption and borrowing predicated on inflated asset prices, financial engineering (mortgage-backed securities and opaque derivatives like CDOs and credit default swaps) and excessive risk taking and leverage associated therewith, coupled with inadequate government regulation and oversight, leading ultimately to the collapse of Wall Street itself, is only the most recent example of a financial culture whose excessively short-term focus is undermining the long-term health of our markets, our economy and our way of life.

An economy harnessed to and dependent upon speculative bubbles is one where short-term investors have triumphed over long-term investors. Corporations—including, in this most recent crisis, our largest financial institutions—are transformed into vehicles whose primary purpose becomes making a small group of insiders enormously rich over extremely short periods of time.

Moreover, the excessive focus on quarterly earnings and the alignment of compensation incentives—stock options, bonuses and other get-rich-quick schemes—with short-term outcomes, places the interests of management insiders at odds with those of ordinary shareholders, and in particular retirement investors, who by their nature are long-term investors whose nest eggs truly shouldn't be exposed to so much risk.

When the short-term interests of corporate managers conflict with the long-term interests of corporate shareholders, the idea of the publicly traded corporation itself becomes to some extent delegitimized, as does the idea of public markets, where the savings of ordinary Americans are made available to corporations and financial institutions are relied upon to allocate capital to its most productive uses. Financial institutions and markets haven't been performing this function very well of late. And a process of de-legitimization is clearly underway; Americans hardly trust banks any more than they trust Congress—or BP*.

Meanwhile, our bubble-based economy has become ever more tilted toward, with a larger and larger share of GDP attributable to, the financial sector, which does not create wealth in the classic sense of production of goods and services, but rather creates profits through financial engineering. In fact, much of the financial services sector is no longer really engaged in investing; it is engaged in trading, and trading and investing are not the same thing. The financial engineering and trading of increasingly esoteric and opaque financial instruments may yield immense profits to the financial engineers and traders but at great risk to long-term investors.

As we know, ordinary investors and their

retirement nest eggs were devastated by the Financial Crisis and recession. Given that 401ks have essentially become *the* retirement plan for America, it seems to me abundantly clear we cannot afford again to allow bubble economics to replace sound financial practices on behalf of America's investors.

To be fair, prior to the crisis financial professionals were only relying on generally-accepted models of how markets and prices are supposed to behave. The efficient market hypothesis told us that prices are always right because they reflect all known information; the capital asset pricing model told us that we could diversify away company risk and achieve optimal systematic risk; and the Black-Scholes formula told us that we could then virtually eliminate systematic risk through options or portfolio insurance—shorting the market as it falls, thereby escaping loss.

Why wouldn't we be irrationally exuberant when the leading financial theories were telling us we couldn't lose? Why would one expect anything *but* excessive leverage and risk taking?

Well, these elegant theories turned out to be imperfect, to say the least. Moreover, the *laissez faire* market fundamentalism that told us that markets (and asset prices) are always right—and that, conversely, government regulation is always a bad thing—has been devastatingly refuted.

In under-regulated markets where investors are deprived of information and influence, and where boards of directors fail to do their jobs in representing shareholders and overseeing managers, business corporations have a natural tendency to focus on short-term profit and share price, and take on undue risk, to the detriment of long-term investors and the broader economy. The

*Portfolio holdings as of 6/30/10. Holdings are subject to change. BP is not currently held by the Fund.

smooth functioning of capital markets requires checks and balances on excessive risk taking and leverage, runaway executive pay, misaligned incentives and predatory financial practices.

The twin crises—the Sustainability Crisis and the Financial Crisis—are not dissimilar. In fact, they are related in that they both result from an excessively short-term focus that is costing us dearly. They both call for a new economic model where corporate managers, boards of directors, shareholders, as well as government regulators—private actors and public policy makers—behave differently so that markets produce different, better outcomes.

The Next Economy will need to focus on real, long-term value creation as opposed to short-term profits derived from financial engineering and trading. We need to create an economy whose trajectory points not toward yet another bubble and inevitable crisis but instead toward long-term growth that is sustainable in the full sense of the term—the creation of durable or enduring value, and wealth creation strategies that meet the needs of the present generation without compromising the ability of future generations to meet their own needs.

Sustainable Investing is a strategy—not the only one, but an important one—for birthing this Next Economy into being. Let me explain why.

First, some definitions:

By Sustainable Investing, I mean the full integration of environmental, social and governance (ESG) factors into investment analysis and decision making. Sustainable Investing is, in fact, an emergent investment discipline premised on the financial *materiality* of ESG factors, and

therefore the need to fully integrate them into investment analysis and decision making.

When I refer to Sustainable Investing I am distinguishing it to some degree from what is popularly known as socially responsible investing or SRI. While the two share elements in common, I would distinguish them in this respect:

Socially responsible investing or SRI is many different things but historically it became popularly understood as investing with “values,” often religious in origin, typically through the use of exclusionary screens—shunning alcohol, gambling, tobacco, firearms, interest or usury for the Muslim investor, contraceptives for the Catholic investor, and so on. This exclusionary approach regarding certain types of companies, or whole industries, based on certain values choices, meant that SRI historically became defined in the popular mind in terms of what it *didn't* invest in rather than what it did invest in.

Moreover, this negative or exclusionary approach was partly responsible for the skeptical reception that SRI received in mainstream financial circles, as the notion that you could deliver market performance by shrinking the investment universe—for non-financial reasons—was considered counterintuitive. So far as I am aware, there is little or no empirical evidence to suggest that SRI funds historically underperformed, but the strongest performance case that SRI in its classic formulation would make was that you could invest with your values without *sacrificing* performance—again, a negative formulation.

Sustainable Investing, by contrast, is a positive discipline that defines itself in terms of what it *does* invest in rather than what it doesn't invest in. What it does invest in are companies with superior

ESG or sustainability performance. Sustainable Investing maintains that ESG criteria have financial *materiality*, and that taking them into account—both through fundamental analysis and shareholder engagement—is a smarter way to construct and manage investment portfolios over the long term. Unlike SRI, which made the case (and I think the evidence supports) that one needn't *sacrifice* performance in order to invest with their values, Sustainable Investing makes the case (and again, I think the evidence supports this) that integrating ESG analysis can be a strategy for *outperformance*.

Ultimately the label doesn't matter, and different firms use different language, but whether it's called SRI or Sustainable Investing, or green investing, the point I want to underscore is that the investment discipline I am talking about tonight—what we at Pax World call “Sustainable Investing”—is not premised on screening out *bad* companies but on identifying *good* companies to invest in. And we identify those companies by integrating ESG or sustainability factors into our financial analysis.

A growing body of evidence demonstrates positive links between ESG performance and financial performance:

- **Association of British Insurers¹:** “Between 2002 and 2007, the stock prices of well-governed companies delivered an additional 37 basis points² per month, adjusted both for industry and for risk.”
- **Innovest Strategic Value Advisors³,** a financial research firm that is now a division of MSCI, has conducted studies showing higher returns for companies ranked highly by eco-efficiency measures, outperforming both a

market proxy and companies with lower rankings.

- **The Haas Business School at Berkeley and the Social Investment Forum⁴** awarded their 2005 annual research prize to an academic paper, entitled “The Economic Value of Corporate Eco-Efficiency,” which concluded that the most eco-efficient firms do better than the laggards, earning an “abnormal return”—that is, above average—of between 2.8% and 5% over the period from 1997 through 2004.
- **UNEP Finance Initiative⁵:** Conducted a survey of other studies on ESG performance and concluded: “[W]e were impressed by the quantity of reports that showed a strong link between ESG issues, profits, business activities and, ultimately, stock prices.”
- **Goldman Sachs GS Sustain initiative⁶:** “Companies that are considered leaders in ESG policies are also leading the pack in stock performance by an average of 25%.”
- **Mercer Consulting⁷,** one of the world's largest financial consultants, announced a year or so ago that henceforth it will include ESG questions and analysis in all its manager searches on behalf of all its clients, not just clients looking for socially responsible or green investments.
- **Bloomberg** now provides ESG data on its terminals⁸, while **Fidelity** provides ESG performance ratings in its stock research on its web site.⁹ NYSE **Euronext**, the world's largest exchange group, has announced that it will begin to make available ESG information on 2,800 of the world's largest

companies.¹⁰ And **MSCI** announced just last week that it will begin to incorporate ESG criteria—including the environmental or political risks—into its stock indices.¹¹

I could go on but you get the picture: there is now substantial evidence linking ESG performance and financial performance, or put another way, demonstrating the financial *materiality* of ESG factors. And mainstream financial institutions are beginning to pay attention.

The premise underlying Sustainable Investing is as elegant in its simplicity as it is potentially transformative in its implications: Companies that do a better job of integrating environmental, social and governance (ESG) criteria into their business models are better positioned than their less enlightened competitors to provide investment performance over the long term. Therefore, combining rigorous financial analysis with equally rigorous ESG analysis in an effort to identify those companies is arguably a better, smarter way to invest—avoiding the risks associated with substandard ESG performance and capturing the benefits associated with superior ESG or sustainability performance.

But this isn't just about harvesting superior returns. It's also about affecting corporate behavior and ultimately market behavior. Should investors conclude that companies with thoughtful long-term management of ESG issues are better-run companies, then presumably those companies would trade at a premium. Investors could impact markets by buying the securities of more sustainable companies and selling the securities of less sustainable companies—buying the leaders and shorting the laggards. This in turn would further incentivize companies to improve their ESG or sustainability performance.

A sort of virtuous circle would be created: investors rewarding stock prices where sustainability is integrated, and companies responding by further improving their sustainability performance. A fixation on meeting quarterly earnings estimates and other short-term yardsticks would give way to longer-term thinking as a more expansive business agenda is recognized and rewarded by investors. The long-term financial interests of corporations would be better aligned with the long-term interests of their various stakeholders—not only shareholders, but employees, customers, the communities where they do business and the natural environment.

That, at least, is the theory, and I think it superior to any investment theory that ignores ESG factors or disregards the sustainability imperative altogether. Why superior? Because Sustainable Investing, unlike other investment approaches, attempts to address two of the fundamental reasons that corporations and markets fail to produce better outcomes: the problem of *agency* and the problem of *externalities*.

The problem of agency is essentially the separation of ownership and control at the heart of the modern corporation, and increasingly at the heart of most financial institutions, where agents or fiduciaries invest and control other people's money. This is the problem I identified a few moments ago, where the short-term focus of management insiders, or traders, can be at odds with the long-term interests of shareholders and investors.

The problem of externalities is that market transactions often impose costs on others not party to the transaction, and I can think of no bigger externality than climate change, but all of the developing ecological imbalances I listed

earlier can be understood as the externalities of commerce.

The premise underlying Sustainable Investing is that the best companies—and the best investments—are those where, first, management and shareholder interests are aligned (the agency problem), and second, where the interests of management and shareholders are aligned with the interests of other stakeholders, including employees, the public and the natural environment (the externalities problem). To invest in more sustainable companies, to invest in companies with superior ESG performance, is to invest in companies that are better addressing the issues of agency and externalities.

Which brings me to another core feature of Sustainable Investing: Sustainable investors not only seek out those companies to invest in because we believe they are better long-term investments, but once invested, we use our influence as shareholders in those companies to proactively address on an ongoing basis these problems of agency and externalities. We call this shareholder advocacy. A fundamental principle of Sustainable Investing is that long-term shareholders be engaged and empowered. Among the reasons the recent Financial Crisis was so acute is that boards of directors are simply not doing their job—which is to represent shareholders and to oversee management. Investors need to advocate for boards of directors and corporate managers who are more accountable; and to hold them accountable.

I am happy to report that financial reform legislation currently under consideration in Congress does contain several vital provisions that have been priorities for the sustainable investment community for some time, as they will empower

shareholders to play a greater role in overseeing corporate governance and holding boards and managers accountable:

Proxy access: The Securities and Exchange Commission needs clear authority to require companies to include director nominees from shareholders in their proxy statements. This “proxy access” will give shareholders a much needed tool to hold corporate boards and managements accountable. Today, shareholders are not even allowed input into who is nominated to represent them on a company’s board of directors. They should have the right to meaningfully participate in nominating and electing directors, and they should have the right to place resolutions on the corporate proxy ballot addressing issues—including ESG issues—they deem material to companies’ financial performance.

Say on Pay: One of the best ways to curb excessive compensation and perks for corporate CEOs and managers is to give shareholders a “Say on Pay.” In the aftermath of the financial crisis, shareholder support for “Say on Pay” resolutions has been strong. In 2009 alone, 76 shareholder proposals came to votes—and Pax World was a co-filer on some of these resolutions—and averaged 46 percent support, with 24 majority votes recorded. Some 65 companies have voluntarily adopted “Say on Pay” policies, including some of America’s largest and most well-known firms.

Majority voting: Directors should receive support from a majority of voted shares in order to be elected, as opposed to the current plurality standard that allows uncontested directors nominated by the existing board to win election with a single vote.

Senator Robert Menendez (D-NJ) has offered an amendment which I would also like to see become law, that would require companies to disclose the median annual total compensation of all employees except the CEO, the total annual compensation of the CEO, and the ratio of median employee annual total compensation to that of the CEO. The sustainable investment community strongly supports greater corporate disclosure, and this amendment would assist investors in identifying companies with better compensation and governance practices.

In the view of many in the sustainable investment community, including myself, the Securities and Exchange Commission (SEC) should also consider mandating disclosure of environmental, social and governance (ESG) data by publicly traded corporations. This is relevant, material information. Simply put, a reasonable long-term investor may want to avoid the risks associated with substandard ESG performance while capturing the benefits associated with superior ESG performance. Thousands of companies worldwide now voluntarily publish corporate social responsibility or sustainability reports containing ESG data. The availability of ESG information could help make markets more efficient while simultaneously encouraging more sustainable business practices.

Bloomberg/Business Week reported just yesterday that a June 3 proxy vote calling on Layne Christensen, a mining and production company, to produce a sustainability report drew support from over 60 percent of shareholders, while shareholder resolutions demanding greater disclosure by natural gas producers about their hydraulic fracturing practices have drawn supportive votes ranging from 26 percent to 41 percent of shareholders, five to six times what

they've received in prior years. The article forecasts a greater role by shareholders in the years ahead when it comes to oversight and disclosure of environmental and safety management issues in the wake of the BP disaster.

Empowered shareholders can make companies more accountable, and ultimately make their business models more sustainable.

Let me give you a concrete example of this by looking at an issue that we are deeply engaged in at Pax World: gender equality. As we are talking about sustainability, I don't think it's an exaggeration to say that the number one impediment to sustainable development around the globe is gender inequality. Conversely, as the historian David Landes wrote in *The Wealth and Poverty of Nations*: "The best clue to nation's growth and development potential is the status and role of women."

At my company, we happen to believe that the status and role of women is also an excellent clue to a *company's* growth potential. There is considerable evidence that gender diversity and the advancement of women is a key driver of *business* success—that companies that integrate gender diversity and women's empowerment into their business models are likely to be more successful than their less enlightened competitors. Conversely, holding back half of the world's population through unequal educational and job opportunities, unequal wages, let alone violence and oppression, is not only morally reprehensible, it's dumb economics. We believe investing in companies that advance and empower women is simply a smart investment strategy.

So, among other things, we favor investing in companies where women are represented on the

board of directors and in upper management. We do this in all of our funds, and we have a particular fund, the Pax World Global Women's Equality Fund, which is the only mutual fund in America whose focus is investing in companies that are global leaders in advancing gender equality and women's empowerment. But we try to advance gender equality and women's empowerment in other ways as well, including one that I only wish other mutual funds would adopt:

When we receive a company's annual proxy with its slate of directors submitted for shareholder election, we will withhold votes from, or where possible vote against, *all* slates of director nominees that do not include women. Pax World then registers its concerns with the company through a follow-up letter explaining the reason for our opposition, urging them to embrace gender diversity on their board and providing them with model charter language for their nominating committee establishing a board diversity policy and process for implementation.

This is a very simple step that any mutual fund or pension fund or other money manager could take to promote greater board diversity and advance women. And yet, if you are invested, through your 401(k) or 403(b) plan at work, or in an IRA, or directly in mutual funds, it may be worth considering that 98% of the mutual funds in America do not vote their proxies in this manner. Instead, the overwhelming majority of mutual funds rubber stamp most if not all management-supported proxy proposals, including a company's hand-picked slate of all-male directors. So, if you believe women should be better represented in the board rooms of corporate America, not only because it's the right thing to do but because it makes business sense, you are not only foregoing an opportunity to do something about it, you are

actually part of the problem—or at least your investments are.

We have a choice in the way we invest: we can have an impact on board diversity and gender inequality, or again, we can be part of the problem.

We have a choice on carbon emissions too: we can invest in companies that do a better job managing and reporting on their emissions, or those that don't. We can invest in companies where executive compensation structures are aligned with shareholder interests or those where runaway CEO and executive pay betray larger corporate governance and agency problems. We can invest in companies that are doing a better or lesser job on safety management issues, and we need no reminder, in the aftermath of the BP debacle, that the externalities can be significant.

We can mobilize our influence as investors to make a difference—to push and prod and cajole and induce and incentivize publicly traded companies, and ultimately markets, to produce better outcomes. Or, put another way, to price in sustainability, to internalize externalities.

Obviously, the degree to which Sustainable Investing can affect corporate behavior and markets, or promote sustainable development more generally, will depend in large measure on improved public policy. The prospects for alternative energy and clean technology, for example, will very much depend on changes in public policy—a price on carbon, increased support for sustainable energy sources through tax and spending policies, and so forth. Another proposal to encourage long-term thinking and investing, supported by Warren Buffet and others, is to levy capital gains taxes on a sliding scale

based on the length of time an asset is held. But public policy is not the focus of my remarks tonight. Legislators and regulators obviously will weigh in, and may play a larger or lesser role in shaping the Next Economy, depending on the prevailing political winds.

My point is that investors can and should weigh in as well, that private actions—of investors, of corporations, of markets—have public consequences. We need to take responsibility for those consequences. We need to challenge short-term thinking and begin asking companies to focus more on long-term outcomes. We need to take steps to better align the interests of shareholders and management insiders—on executive compensation and other issues. We need to marshal our power and influence as investors and play a decisive role in shaping the Next Economy rather than simply being shaped by it.

Sustainable Investing is an investment approach that empowers us to play such a role.

Sustainable Investing must become the investment arm of the Sustainability Revolution just as classical conservative investing was the investment arm of the Industrial Period. While classical conservative investing—think Milton Friedman’s famous dictum that the only duty of a corporation is to make a profit—largely ignored questions of agency and externalities, Sustainable Investing posits a role for investors in addressing them. If our current economic paradigm has failed to sufficiently account for these problems, and if continued financial bubbles and periodic economic crises, together with a deepening Sustainability Crisis, are the results, then, as I said at the outset, we need a new design.

Markets can be re-designed and must be re-designed, through the combined efforts of government regulators, investors, business leaders and stakeholders, in a way that delivers favorable environmental and social outcomes alongside favorable financial outcomes. They can be re-designed in a way that *links* environmental, social and financial outcomes so that they are interdependent. This is the Next Economy we should like to bring about. We need not tolerate environmental degradation and poverty and inequality as the necessary byproducts of market capitalism—as if these things were somehow beyond our control. The Next Economy is *our* economy; it is for *our* children and grandchildren. It is *our* responsibility.

So, go out and vote, support the non-profits of your choice, serve in your local community, eat organic food, drive a hybrid, do all the other things you think will make a difference, but for God’s sake, don’t ignore your power as investors. Don’t leave that arrow in your quiver.

You can either invest in a way that advances sustainability, and helps shape a better Next Economy, or you can invest in a way that ignores these imperatives. Sustainable Investing represents a new investment approach for the new epoch—a potentially transformative investment approach that can align positive investment outcomes with positive societal and environmental outcomes. Good for investors, good for corporations, good for markets, and right for the times. I am biased, obviously, but I would strongly suggest that you consider joining us.

Thank you.

¹Association of British Issuers: Association of British Insurers – Mariano Selvaggi and James Upton, "Governance and Performance in Corporate Britain," ABI Research and Investment Affairs Departments, February 2007.

²Basis point is defined as one one-hundredth of a percent, used in measuring yield differences among bonds.

³Innovest: Innovest – Innovest Strategic Value Advisors, "Carbon Beta and Equity Performance: An Empirical Analysis: Moving from Disclosure to Performance," October 2007.

⁴The Haas Business School at Berkeley & Social Investment Forum: Nadja Guenster, Jeroen Derwall, Rob Bauer and Kees Koedijk, "The Economic Value of Corporate Eco-Efficiency," July 25, 2005.

⁵UNEP Finance Initiative: United Nations Environment Programme Finance Initiative, "Show Me the Money: Linking Environmental, Social and Governance Issues to Company Value," Asset Management Working Group, 2006.

⁶Goldman Sachs GS Sustain: Goldman Sachs – Goldman Sachs Global Investment Research, "Overview: Introducing GS SUSTAIN," July 2, 2007

⁷Mercer Consulting: Mercer manager research developed to consider environmental, social and governance factors. May 21, 2008.

⁸Bloomberg: Business Week – Mindy Lubber, "Companies Come Clean on Climate Change," June 3, 2009.

⁹Fidelity: Source: Fidelity.com

¹⁰NYSE Euronext: New York Stock Exchange – "New Solutions to Help NYSE-Listed Companies Enhance Corporate Governance and Transparency," May 19, 2009.

¹¹MSCI: FinancialTimes.com – Telis Demos, "MSCI to Incorporate ESG Risks Into Indices," June 11, 2010.



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