More Talent at the Top

Pax makes a case that gender diversity improves investment returns.

UNDISCOVERED MANAGER

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In every issue, Undiscovered Manager profiles a noteworthy strategy that hasn't yet been rated by Morningstar Research Services' manager research group.

When Scott LaBreche and Barbara Browning are building the portfolio for their strategic-beta stock fund, it's much the same process as with any other factor-driven portfolio. But there's one big difference: The driving factor is gender diversity in top management.

The investment thesis behind the $228 million Pax Ellevate Global Women's Leadership Fund PXWEX is straightforward. Studies have found that companies with a greater representation of women among senior management—meaning on the board, in the C-suite, and among the top ranks of executives—perform better than companies with fewer women leaders. Therefore, it pays to invest more in companies with the highest levels of gender diversity.

"We really believe that this fund is proving out that research in real time, with real money and real investors," says Joe Keefe, chief executive officer of New Hampshire-based Pax World Funds, which manages $4.7 billion across 12 strategies offered via funds and separate accounts carrying an environmental, social, and governance, or ESG, investing mandate.

The canon of research supporting the thesis is growing. Some recent entries: Bank of America Merrill Lynch's quantitative research team found that companies with high gender-diversity scores generally had lower price and earnings volatility along with higher return on equity.[1] MSCI found that firms with more women on boards and stronger human capital policies had higher productivity growth.[2] And McKinsey reported that companies in the top quartile for gender diversity on executive teams were 21% more likely to outperform on profitability.[3]

Making the Case

Since adopting its current mandate in mid-2014, the Pax Ellevate Global Women's Leadership Fund has bested its benchmark, the MSCI World Index, and come in well ahead of its Morningstar Category average. From June 2014, through August 2018, the investor shares have returned an annualized 8.08%, compared with 7.79% for the MSCI benchmark and 6.86% for the average fund in the world large stock category.

Moderate costs may help extend this competitive record. The fund's expenses—0.80% for the investor shares and 0.55% for the institutional—aren't notably low for a strategic-beta index strategy, but they are competitive relative to similar share classes in the category.

Joseph Pessetto, a Washington, D.C.-based advisor with Wells Fargo, sees the fund as a diversifier away from traditional stock-picking methods. He uses it as one of 10 funds in client portfolios with a moderate or aggressive risk profile. The Pax Ellevate fund "is certainly a different way of looking at the world," he says.

Patricia Farrar-Rivas, chief executive officer of Veris Wealth Partners in San Francisco, tracks gender-diversity strategies. According to the firm's most recent data, there was $910 million under management in such strategies as of June 2017, up from $100 million in 2014. Veris counted 23 mutual funds and separate accounts with a gender-diversity component, up from eight only four years ago. Not all have gender diversity as the driving mandate, though. Farrar-Rivas notes that the Pax Ellevate fund makes a good proxy for gender diversity as an investment strategy.

A Refined Approach

When it launched in 2007 in its original incarnation as Pax World Global Women's Equality Fund, the fund was the first vehicle of its kind for U.S. investors. It was originally run as an active, concentrated strategy. While the process included gender diversity as a screen, the stock-picking itself was done on more traditional metrics, such as cash flow and return on equity.

Pax found that approach made it difficult to identify how much of the fund's performance could be attributed to the gender screen and how much to the traditional stock screens. In 2014, Pax decided to make gender diversity the overriding factor, and it switched to a strategic-beta approach, merging the original fund with the new Pax Ellevate Global Women's Index Fund. The fund adopted its current name this past February.

To start, Pax built what it says was the first index in the world consisting of companies with the highest percentage of women in corporate leadership roles. The Pax Global Women's Leadership Index, which launched in February 2014, begins with the universe of about 1,600 stocks in the MSCI World Index. To cull the

1 Subramanian, S., Hall, J.C., & Yeo, J. 2018. "Women: the X-Factor." Bank of America Merrill Lynch, White Paper, March 7.
2 Eastman, M.T., & Seretis, P. 2018. "Women on Boards and the Human Capital Connection." March. MSCI Research Insight, White Paper.
3 Hunt, V., Yee, L., Prince, S., and Dixon-Fyle, S. 2018. "Delivering Through Diversity." January. McKinsey Report, White Paper.

list, Pax first layers on a screen that removes companies with low ESG scores as rated by MSCI, along with tobacco companies and those that make or sell weapons. Then, Pax applies a gender-diversity scoring system to the remaining companies and selects the top 400 based on those characteristics for inclusion in the index. The final step in the construction of the index is to rank the stocks by market capitalization.

The fund itself takes the process a step further, using a factor-based approach to overweight gender-leadership factors, while maintaining risk characteristics similar to those of the index.

Stocks are reranked based on a more detailed assessment undertaken by Pax's analyst team, including five criteria. Representation of women on the board of directors and representation of women in executive management are weighted most heavily. The analysts also consider whether the firm has a female chief executive officer, whether it has a female chief financial officer, and whether it is a signatory to the United Nations' Women's Empowerment Principles.

Key Distinctions

The gender-diversity scoring requires Pax's five-person gender analyst team to comb through public company reports, websites, and other data sources to gather information that isn't compiled elsewhere. Adding to the complexity, companies define executive leadership differently, so Pax seeks to identify key division heads and other senior leaders with profit-and-loss responsibility, says Heather Smith, lead sustainability research analyst at Pax.

The fund weights companies with the highest gender-diversity scores at the top. If companies with more gender diversity perform better, fund manager LaBreche says, then it follows that this should be reflected in the portfolio.



Barbara Browning, **Heather Smith**, **Joe Keefe**, and **Scott LaBreche** of Pax World Funds.

Pax Ellevate Global Women's Leadership Fund PXWEX

Category	World Large Stock
Expense Ratio (%)	0.80
Morningstar Rating	★★★★
5-Yr Annlzd Return (%)	10.86
5-Yr % Rank in Cat	25

Source: Morningstar. Data as of 08/31/2018.

"We have an investment process where we have isolated gender-diversity leadership as a factor," LaBreche says. "When you look at the top 10 holdings, they are pure gender-diversity leaders."

As of June 30, the top stock in both the cap-weighted index and in the fund is Microsoft MSFT, which counts three women, including chief financial officer Amy Hood, among its senior executives. Women comprise 28% of the board of directors, and the company has signed the United Nations' Women's Empowerment Principles. Facebook FB ranks second in the index and in the fund, in part because women comprise 25% of the executives and 22% of the board.

But go a couple names down the list, and the differences between the cap-weighted index and the fund become clear. At the end of June, the next largest holdings for the fund were Kellogg K, American Water Works AWK, and Wolters Kluwer WKL. Each had about a 2% weighting in the fund but are only 0.1% of the market-cap-weighted index. In fact, the fund's third- through 10th-largest holdings comprise 15.8% of assets in the fund, but only 1.5% of the Pax index.

Pax doesn't divulge the scores it gives companies, and it considers the full list of index weightings proprietary. But here's a snapshot of what it takes for those companies to make it into the top 10, according to Pax's research:

- At Kellogg, women are 30% of the company's senior executives and 42% of its board of directors. The firm has signed the U.N. Women's Empowerment Principles and is a member of the CEO Action for Diversity and Inclusion.
- At information-services company Wolters Kluwer, 42% of the board of directors are women, more than 50% of the executive board are women, and the CEO is Nancy McKinstry.
- At utility American Water Works, women comprise 50% of the board and 35% percent of the company's executive officers are women, including CEO Susan N. Story and CFO Linda G. Sullivan, and the company has incorporated diversity hiring goals into its strategic business plan.

In addition to the gender screen, Pax layers on a standard risk model to identify security-level risk and has limitations on how large individual security holdings can be. Because of that limit, both the Microsoft and Facebook positions are smaller than they are in the cap-weighted index.

The fund's diversity profile is significantly different than that of the MSCI World Index. Among the fund's holdings, 91% have three or more women on their board, compared with 41% of companies in the MSCI index. About one third of the companies in the fund have a woman in the CEO or CFO seat, compared with only 14% of those in the index.

The gender-diversity screen also introduces some notable sector and regional tilts. For example, the fund had 2.6% of its portfolio in energy stocks as of June, less than half the weighting of the MSCI World benchmark. It also tends to be underweight materials and real estate. Meanwhile, it's overweight consumer staples by more than 4 percentage points, financials by roughly 4 percentage points, and utilities by nearly 3 percentage points.

Regionally, too, there are tilts that result from the gender-diversity screen. The fund has roughly two thirds of its assets in U.S. stocks, more than the benchmark's 57%. It also has less than half the exposure to Asia-Pacific stocks of the MSCI benchmark, and no emerging-markets exposure by Morningstar's measure.

"Japan has so few, if any companies" that pass the screen, "that we're always underweight Japan. We don't lower the standards," LaBreche says. The goal is not to get close to the index weights; it's to let the strategy play out.

As for the fund's overall ESG profile, it earns a Morningstar Sustainability Rating of 5 globes, making it one of the top choices in the world large stock category for ESG investors in general.

Muting Risk

Jon Hale, director of sustainability research with Morningstar, has observed that companies that are leaders in gender diversity tend to be high-quality firms with moats against competition.[4] While this fund's record is still relatively short, that portfolio characteristic is unlikely to change.

So far, the fund has demonstrated a lower risk profile than peers and benchmark. The fund's Morningstar Rating reveals above-average returns and below-average risk within the world large stock category. Since June 2014, the fund has a Sharpe ratio of 0.81, compared with 0.66 for the category and 0.71 for the MSCI World Index. That has translated to less money lost in downturns. The fund's downside capture ratio relative to the MSCI World Index since mid-2014 is 85%, even as it has captured 92% of the upside.

This moderate risk/return profile is influenced by the fund's geographic exposure, which in turn is a function of the fund's gender-diversity mandate. Pax says a bias toward high-quality and lower-risk companies is also an outcrop of that.

"It's just a byproduct of our strategy," LaBreche says. "We expect to be able to provide below-average risk with above-average return." Pax Ellevate Global Women's Leadership Fund has lived up to this expectation so far. M

Tom Lauricella is the editor of Morningstar Cloud.

4 See "Investing in Firms With Female Leaders" in the April/May 2017 issue of *Morningstar* magazine.

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Holdings listed in this article are subject to change. This information is not a recommendation to buy to sell any security.

Effective February 26, 2018, the name of the Pax Ellevate Global Women's Index Fund changed to the Pax Ellevate Global Women's Leadership Fund.

As of 9/30/18, the Morningstar Ratings™ for the Pax Ellevate Global Women's Leadership Fund Investor Class (PXWEX) were 4 stars out of 739 funds overall, 4 stars out of 739 funds for 3-years, 4 stars out of 611 funds for 5-years. Pax Ellevate Global Women's Leadership Fund Institutional Class (PXWIX) Morningstar Ratings were 4 stars out of 739 funds overall, 4 stars out of 739 funds for 3-years, 4 stars out of 611 funds for 5-years. The Morningstar Rating for funds, or 'star rating', is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product 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. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five- and ten- year (if applicable) Morningstar Rating metrics. The weights are 100% three-year rating for 36-59 months of total returns, 60% five-year rating, 40% three-year rating for 60-119 months of total returns, and 50% ten-year rating, 30% five-year rating, 20% three-year rating for 120 or more months of total returns. While the ten-year overall rating formula seems to give the most weight to the ten-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

The Morningstar Category Rankings are based on the World Large Stock Category. As of 9/30/18, the Pax Ellevate Global Women's Leadership Fund Investor Class (PXWEX) ranked 184 out of 895 with a 19% ranking for the 1-year period; 203 out of 739 funds with a ranking of 31% for the 3-year period; and 136 out of 611 funds with a ranking of 25% for the 5-year period. As of 9/30/18, the Pax Ellevate Global Women's Leadership Fund Institutional Class (PXWIX) ranked 163 out of 895 with a 17% ranking for the 1-year period; 167 out of 739 funds with a ranking of 24% for the 3-year period; and 113 out of 611 funds with a ranking of 20% for the 5-year period.

Morningstar Sustainability Rating™ measures how well the companies in a fund's portfolio manage their environmental, social and governance (ESG) risks and opportunities relative to the fund's peers. First, a Morningstar Portfolio Sustainability Score™ ranging from 0 to 100 is derived from an asset weighted average of the underlying company ESG scores quarterly. Next, scored funds are rated monthly: The top 10% receive 5 globes (High), the next 22.5% receive 4 (Above Average), the next 35% receive 3 (Average), the next 22.5% receive 2 (Below Average), and the bottom 10% receive 1 (Low). Sustainalytics provides company-level analysis used in the calculation of Morningstar's Sustainability Score. A higher score indicates that a fund, on average, has more of its assets invested in companies that score well according to the Sustainalytics methodology. For details, visit http://morningstar.com/company/sustainability.
Sustainability Score for the Pax Ellevate Global Women's Leadership Fund as of 6/30/2018 is 52. Percent Rank in Category is 6 and Sustainability Rating is 5 globes out of 307 World Large Stock funds as of 8/31/2018 based on 99% of AUM. Sustainalytics provides company-level analysis used in the calculation of Morningstar's Sustainability Score.

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On 6/4/2014, the Pax Global Women's Equality Fund merged into the Pax Ellevate Global Women's Leadership Fund (the Fund), pursuant to an Agreement and Plan of Reorganization dated March 4, 2014 (the "Reorganization"). Because the Fund had no investment operations prior to the closing of the Reorganization, Pax Global Women's Equality Fund (the "Predecessor Fund") is treated as the survivor of the Reorganization for accounting and performance reporting purposes. Accordingly, all performance and other information shown for the Fund for periods prior to 6/4/2014 is that of the Predecessor Fund. The Predecessor Fund acquired the Women's Equity Fund on October 29, 2007. Performance information shown for periods prior to the acquisition represents the performance of the acquired Women's Equity Fund.

Since Reorganization (51 months) as of 9/30/18, the Pax Ellevate Global Women's Leadership Fund Investor Class (PXWEX) had a Sharpe Ratio of 0.84, a Downside Capture of 87.03%, and an Upside Capture of 91.91%. For the same time period, the Pax Ellevate Global Women's Leadership Fund Institutional Class (PXWIX) had a Sharpe Ratio of 0.87, a Downside Capture of 86.40%, and an Upside Capture of 93.36%.

The annualized returns for the Pax Ellevate Global Women's Leadership Fund – Individual Investor class as of 9/30/18 were, 1 year: 12.27%, 3 year: 13.67%, 5 year: 9.79%, 10 year: 6.96%. The annualized returns for the Pax Ellevate Global Women's Leadership Fund – Institutional class as of 9/30/18 were, 1 year: 12.60%, 3 year: 13.96%, 5: year 10.07%, 10 year: 7.23%. The returns for the MSCI World Index as of 9/30/18 were, 1 year: 11.24%, 3 year: 13.54%, 5 year: 9.28%, 10 year: 8.56%. The returns for the Pax Global Women's Leadership Index as of 9/30/18 were, 1 year: 11.43% and 3 year: 13.93%.

Performance data quoted represent past performance, which does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current

performance may be lower or higher than the performance data quoted. For most recent month-end performance information, visit www.paxworld.com.

Total annual Pax Ellevate Global Women's Leadership Fund operating expenses are 0.80% for the Investor Class, 0.55% for the Institutional Class as of the 05/01/2018 prospectus. The management fee is a unified fee that includes all of the costs and expenses of the Fund (other than taxes, charges of governmental agencies, interest, brokerage commissions incurred in connection with portfolio transactions, distribution and/or service fees payable under a plan pursuant to Rule 12b-1 under the 1940 Act and extraordinary expenses), including accounting expenses, administrator, transfer agent and custodian fees, Fund legal fees and other expenses.

Top Ten holdings as of 9/30/18: Microsoft Corp. 4.0%, Intuit, Inc. 2.1%, Michael Kors Holdings, Ltd. 2.0%, Wolters Kluwer NV 2.0%, Target Corp. 2.0%, Estee Lauder Cos, Inc., The, Class A 2.0%, Swedbank AB, Class A 2.0%, Canadian Utilities, Ltd., Class A 2.0%, Ulta Beauty, Inc. 2.0%, Cisco Systems, Inc. 2.0%. Holdings are subject to change.

The Pax Ellevate Global Women's Leadership Fund 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 "Women's Index"), while maintaining risk characteristics that Pax Ellevate Management LLC ("PEM") believes are generally similar to those of the Women's Index.
*A custom index based on MSCI World.

Definitions
Return on equity (ROE) is a ratio that provides investors insight into how efficiently a company (or more specifically, its management team) is managing the equity that shareholders have contributed to the company.
Beta reflects the sensitivity of a Fund's return to fluctuations in its benchmark; a beta for a benchmark is 1.00: a beta greater than 1.00 indicates above average volatility and risk.
Sharpe ratio determines a risk-adjusted return using standard deviation; a high Sharpe ratio indicates greater return per unit of risk and demonstrates if performance was based on smart investments or on excess risk.
Standard deviation measures a Fund's variation around its mean performance; a high standard deviation implies greater volatility.
Downside capture measures an investment manager's overall performance in down-markets and is used to evaluate how well or poorly an investment manager performed relative to an index during periods when that index has dropped. A downside capture ratio less than 100 indicates that the investment manager has outperformed its index during down-markets, while downside capture ratio greater than 100 indicates that the investment manager has underperformed its index during down-markets.

Index Definitions
The **MSCI World (Net) Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World (Net) Index consists of the following 23 developed market country indices: 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. Performance for the MSCI World (Net) Index is shown "net," which includes dividend reinvestments after deduction of foreign withholding tax.
The **Pax Global Women's Leadership Index** is a customized index of the highest-rated companies in the world in advancing women's leadership, as rated by Pax World Gender Analytics, and that meet key environmental, social and governance (ESG) standards, as rated by MSCI ESG Research. Companies are rated by Pax World Gender Analytics based on multiple criteria of gender leadership, including: representation by women on the board of directors and in executive management, woman CFOs, woman CEOs and whether they are signatories to the Women's Empowerment Principles. Inception date of The Index is 02/28/14. A custom index calculated by MSCI.
One cannot invest directly in an index.

RISKS: 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. The Fund does not take defensive positions in declining markets. The Fund's performance would likely be adversely affected by a decline in the Index. 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. There is no guarantee that the objective will be met and diversification does not eliminate risk.

An investment in the Pax World Funds involves risk, including loss of principal. 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.

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