THE WALL STREET JOURNAL

Pax May Bless Some 'Sin' Stocks

By Diya Gullapalli
Updated Sept. 1, 2006 12:01 a.m. ET

Maybe sin isn't quite as bad as it sounds.

That is what Pax World Funds, one of the biggest of the "socially responsible" mutual-fund families, has decided. In a few weeks, the company will hold a shareholder meeting where it will take action on the most significant change to its investment practices since it was launched about 35 years ago.

Socially responsible investing, or SRI, generally involves avoiding so-called sin stocks -- for instance, breweries, casinos and weapons makers. Pax was one of the first to give this strategy a try, and has maintained its approach since its founding by two Methodist ministers in Portsmouth, N.H.

Biggest Do-Gooders

A look at how some of the big socially responsible mutual funds have fared, vs. the broader market

FUND NAME/ MORNINGSTAR CATEGORY	TOTAL RETURN YTD	3 YEAR*	5 YEAR*
Pax World Balanced Moderate Allocation	4.18%	10.00%	5.91%
Ariel Midcap Blend	0.78	10.45	9.38
Ariel Appreciation Midcap Blend	-1.46	8.14	6.83
Domini Social Equity Large Blend	2.75	7.97	3.19
S&P 500 Index	5.83	10.97	4.74

Note: Data through Aug. 30, 2006; *Annualized
Source: Morningstar Inc.

Now, Pax wants to tone down that objective. Shareholders in August were sent a proxy statement to vote on whether to eliminate a zero-tolerance policy specifically against alcohol and gambling. The change would enable Pax to selectively invest in these industries based on a company's "entire social-responsibility profile."

But in other areas, the fund is trying to add new ways to screen out companies it might disapprove of. Shareholders will also vote on whether fund managers should consider a company's record on environmental issues, for instance.

These shifts illustrate how SRI funds are trying to tweak their strategies amid sagging returns. SRI investors are sometimes willing to exchange a few points of returns for socially conscious stock picking.

But many SRI funds have faltered because they tend to focus on "large growth" stocks, or big companies that offer fast-climbing earnings, an area that has done poorly in recent years. Large-growth funds have returned about 1% in the past year, but large-growth SRI funds have returned just 0.21% for the 12 months through July. Pax World Balanced Fundhas returned only 4% in the 12 months through July, trailing more than half its peers.
By contrast, funds like Vice Fund -- which actively seeks out sin stocks -- have handily beaten most SRI funds recently. In the past three years, Vice Fund has posted a 20% average annual return.
A host of other SRI funds are also fiddling with their approaches. In December, Domini Social Investments LLC will abandon its traditional approach of passively tracking an index of socially responsible companies in its Domini Social Equity Fund, and instead will become an actively managed fund, picking its own stocks to invest in. Last year, it launched a new fund, Domini European Social Equity Fund, which was actively managed from the start. In May TIAA-CREF, the teacher's-pension giant, announced the formation of a new social and community investing department, and Ariel Capital Management LLC started Ariel Focus Fund last year.

In recent months, a slew of new SRI funds have cropped up that reflect this changing landscape. Parnassus Workplace Fund started last year to focus on companies that treat employees well, and minority-owned Creative Investment Research in Minneapolis launched the Diversity Index Portfolio this summer that uses employee diversity as a selection criterion.

Even exchange-traded funds, which trade on exchanges like stocks, are getting in on the do-gooder action. Barclays Global Investors has an SRI ETF and filed with regulators in August to launch another, iShares KLD 400 Social Index Fund, which would track a popular SRI index.

For Pax, the move comes after it had to sell a lucrative stake in Starbucks Corp. last year when the company set up a deal to launch a coffee liqueur with whiskey maker Jim Beam. The funds' 375,000 shares were valued at $23.4 million at the time, and had to be relinquished even though some SRI researchers estimate liquor-related sales contributed less than 1% to Starbucks's revenue. Similarly, Pax sold its stake in Yahoo Inc. last year after discovering that company had business ties to Internet gambling.

VIDEO REPORT

Reporter Diya Gullapalli talks with money editor Jesse Pesta about how a socially responsible mutual fund is changing its stripes and how others are following suit.

"I thought these were absurd results," says Joe Keefe, Pax's chief executive, who took that job last year. Mr. Keefe says he voiced this opinion during his interview for the job, and has been reading competitors' prospectuses to decide the best way to change the wording of Pax's own mandate.

SRI experts think dropping the ban on alcohol and gambling makes sense for Pax, because it will still try to avoid companies that derive substantial revenue from these areas. The company saw its biggest inflows in its history last year, roughly doubling its assets to more than $2 billion across its funds, and it is continuing to expand.

On Tuesday, Citizens Funds, another SRI fund company in Portsmouth, disclosed in a filing that it has signed a nonbinding letter of intent for Pax to buy its funds, which have about $800 million in assets. Terms weren't disclosed.

"I think it makes sense what they're doing," says Bill Rocco, an analyst who helps cover SRI funds for Morningstar Inc., the fund-research company. Some of his family members own Pax World Balanced Fund, he says, but "I also drink beer in moderation."

Jay Falk, president of SRI World Group Inc., a research company, agrees. "A screen on alcohol is a bit puritanical," he says.

The Pax funds are also taking steps to focus more on the corporate governance of the companies they invest in, such as whether the board of a company is sufficiently independent from management.

Separately, the Securities and Exchange Commission has been inquiring into issues related to the financial reporting at Pax's high-yield funds for more than a year. The SEC is also looking at potential conflicts of interest, given that the family of Pax's chairman owns Pax World Management Corp. and part of Pax's distribution company. Mr. Keefe declined to comment about the SEC inquiry.

Other SRI funds say they won't change their own sin-stock mandates just yet, with each varying slightly in guidelines like numerical cutoffs. Domini generally doesn't invest in companies that derive more than 1% of sales from alcohol production or more than 15% from alcohol retailing. Sometimes it can be even stricter than that. Domini decided not to buy toy maker Hasbro Inc. a few years ago despite the fact it made less than 1% of its money from licensing its Monopoly brand name to casino slot machines. Domini concluded it was inappropriate to use a children's game for gambling purposes.
For now, alcohol and gambling is "a place where Domini is not going to change," says Jeffrey MacDonagh, an SRI portfolio manager at Domini.

Ariel Capital Management, another large SRI fund company, doesn't screen for alcohol or gambling but does avoid tobacco and weapons companies. Unlike Domini, this has allowed the Ariel Fund to hold Hasbro among its 40 or so stock positions. Another SRI fund group, the Calvert Funds, won't invest in companies that derive more than 20% of revenue from selling or distributing alcohol, or 10% from weapons sales.

Still, such funds have changed other screens in recent years. Ariel added a screen against handguns in 2003, and Calvert added one about preserving the rights of indigenous people in 1999. Others have added more contemporary factors like nondiscrimination based on sexual orientation.

Write to Diya Gullapalli at diya.gullapalli@wsj.com