



CAUSEWAY CAPITAL MANAGEMENT LLC  
NEWSLETTER

# Price and Liquidity:

## The Winning Combination

Clients have asked us recently about the crippling sovereign fiscal burdens and a future of politically unpopular public debt repayment for Europe, Japan and, yes, the US. We admit the situation doesn't look good. In the next breath, clients question us about developing country economic stability, manufacturing labor wage inflation, and geopolitical tensions. What happens if the euro zone unravels? How can equities possibly thrive in this environment? Global connectivity and a dash of contagion could undermine each region, sending investor risk aversion to levels reminiscent of 2008.

In short, we give the global market meltdown scenario a very low probability in this post-credit-crisis decade.

And even if such a highly correlated plunge in investor confidence did happen, it probably wouldn't last long. Why? Because the debt problem largely resides with governments – not with companies. Furthermore, investors are hungry for performance. We all need to pay for retirement, and for those who haven't squirreled away lots of money, fixed income returns won't do the job. Of course, doom & gloom makes for provocative newsletters. Are we blind to the combustible global dangers? Is Causeway attempting to shelter portfolios in cash (or stocks that behave like cash) in our long-only mandates? No to both. All these economic challenges are real, but global monetary liquidity and valuation remain the dominant drivers of equity returns. We believe that

Equities are Attractive Versus Bonds  
MSCI World Index January 1988–June 2011



Source: Factset, Causeway Analytics

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## The Winning Combination continued

central banks in the mature countries will err on the side of easy money for at least the next few years. Raising interest rates beyond token levels removes critical stimulus from economies staggering under debilitating fiscal expenditure cuts. What central banker wants to be remembered for the Great Recession? We can't think of any. Sustained accommodative monetary policy implies low cost of financing, and bond yields at current levels will prove poor substitutes for equity returns. In the emerging equity markets, interest rate hikes should not derail their economic expansion - or make them less appealing than the mature markets for investment. Growth and apparent fiscal flexibility will cement their position as major repositories for global liquidity. As for valuation, we survey overall markets, as well as the thousands of individual stocks in our weekly value screens. This data gives us confidence in equities, with global developed markets trading at an average two-year forward price-to-earnings ratio of 10.6x. This compares with a 5-year average of 12.5x and a 10-year average of 14.0x. In contrast, stock markets offered much less upside in the 2006 and 2007 credit-induced euphoria.

**“Europe has some sizable [bank] equity bargains, pockets of economic vitality and reasonably good disclosure.”**

Some of the most thoughtful Causeway analysis emanates from our financials research cluster, a subset of our entire research effort. The earnings prospects of banks mirror their respective geographic exposures. We spoke to one of Causeway's fundamental portfolio managers, Conor Muldoon, and bank analysts, Tisha Berman and Alessandro Valentini, for a health check on the global financial system and the potential for contagion in Europe.

**Q:** Why own any bank stocks in this period of tremendous uncertainty over the euro zone, post-quake Japan, rumblings of enormous loan losses from Chinese provincial debt, overzealous western bank regulators, and dilutive equity issuances?

**CM:** The answer to why we own any stock is the same: because that stock ranks as one of our highest risk-adjusted return purchase candidates. Today, those prospective returns, if realized, will more than compensate our clients for the volatility. Admittedly, we have no Japanese or Chinese bank exposure in our international and global equity strategies. We would need to see some compelling evidence of a reversal in

Causeway Analysis of Bank Holdings' Sovereign Debt Exposure

		CCM Euro Banks	CCM Other Europe Banks	Total CCM Europe Banks
Weight in Causeway International Value Composite		3.9%	6.1%	10.0%
Risk Weighted Assets (RWA)		\$2,284.5	\$2,117.5	\$4,401.9
Core Tier I Capital		\$215.7	\$241.0	\$456.8
Net Exposure	Greece	\$8.5	\$1.8	\$10.3
	Ireland	\$0.6	\$1.1	\$1.7
	Portugal	\$5.2	\$2.1	\$7.3
	Total	\$14.3	\$5.0	\$19.3
Haircut	Greece	50.0%	50.5%	50.0%
	Ireland	26.0%	26.0%	26.0%
	Portugal	22.4%	22.4%	22.4%
After-Tax Loss	Greece	-\$2.8	-\$0.6	-\$3.4
	Ireland	-\$0.1	-\$0.2	-\$0.3
	Portugal	-\$0.8	-\$0.3	-\$1.1
	Total	-\$3.6	-\$1.1	-\$4.7
Core Tier I Impact (Loss as % of RWA)	Greece	0.12%	0.03%	0.08%
	Ireland	0.00%	0.01%	0.01%
	Portugal	0.03%	0.01%	0.02%
	Total	0.16%	0.05%	0.11%

Amounts in billions of USD. Composite weight as of 6/24/11; other data as of companies' last reported periods using USD conversion rate as of 06/24/11. RWA and Core Tier I as defined under Basel 2.

Source: Causeway data, company reports

## The Winning Combination continued

Japan's slow decline. As for China, inadequate domestic bank disclosure makes us cautious. Europe, on the other hand, has some sizable equity bargains, pockets of economic vitality and reasonably good disclosure. We targeted our research on the highest quality diversified banking franchises headquartered in the UK, France, Italy, Spain, Switzerland and Sweden. Causeway's international portfolio holdings consist of large capitalization bank stocks - and none of them call Greece, Portugal, or Ireland home.

**Q:** How did you assess the risk of holding European banks?

**AV:** We want to take advantage of market pessimism in instances where we think it is unjustified. In our research process, we stressed our banks' assets, imposing debt default haircuts of 50%, 26%, and 22% for Greek, Irish, and Portuguese government bond holdings, respectively. We used implied default rates from the credit default swap (CDS) spreads in the marketplace. Banks are, by their nature, leveraged. However, this haircut exercise results in minimal impact to our banks' core tier 1 equity capital (between 1 to 33 basis points). This is equivalent to approximately 7% of their combined after-tax annual income. While we seriously question Greece's debt sustainability, we want to make the distinction between the situation in Greece and in the rest of Europe's periphery. For example, while Ireland's debt as a percentage of gross domestic product (GDP) is 96% with a high fiscal deficit, the country has government-owned assets that could be sold to reduce its debt burden. We have learned that the Irish government purchased real estate assets from its sickly banks at an average 58% discount to book value. These bargain basement property holdings amount to 20% of Irish GDP. We like to see such a sizable financial buffer. Furthermore, Ireland has shown its willingness to make structural changes. Membership in the euro zone has brought immense rewards, especially attracting foreign direct investment. Ireland would likely agree to some type of fiscal union if it led to a sustainable upswing in employment. That's very important. Our analysis shows that the balance sheet positions of our European bank holdings are solid, and, barring a scenario where we witness a breakup of the euro, we are very comfortable with the fundamentals of our banks.

**“By committing hundreds of billions of euro to loans and guarantees, Europe has already shown its political willingness to do what is necessary to keep the euro alive.”**

**Q:** Aren't your assumed reductions in capital too low if sovereign bond investors shun Italy and Spain, sending government financing costs sky high and creating havoc in the financial services system globally?

**TB:** We believe Spain and Italy are in better shape than other peripheral European sovereigns. While Spain still must contend with its property bubble, it has shown the political will to make the necessary fiscal changes. The country's budget deficit narrowed by 1.9 percentage points in 2010 and should continue to improve in 2011, given that much of the deficit reduction measures were enacted in the second half of 2010. Italian bond yield spreads over German Bunds are widening, yet we have not seen any deterioration in the fundamentals of Italy. Italy's debt-to-GDP ratio is a formidable 120%, but the

country's budget is nearly in surplus territory. The government is currently in the process of passing an incremental correction to the budget and there seems to be bipartisan commitment to achieve a significant deficit correction by 2014. In addition, Italy's private sector balance sheet looks reassuringly healthy, and its sovereign debt market is internally funded. Ok, we admit that all these statistics can get pushed aside by panicky depositors and equally panicky lenders. A chain reaction

of defaults in Greek debt (sovereign and bank) damaging confidence in Portugal, Ireland, and possibly Spain and Italy remains a threat, albeit with a low probability. While Portugal, Ireland and Greece represent a relatively insignificant 6% of euro zone GDP, Spain and Italy comprise a substantial 28%. The markets are currently reacting to the recent Portuguese downgrade and to the apparent lack of decisive action by the European Central Bank politicians and regulators. Yes, the market is forcing greater fiscal harmonization in the euro zone, but that is ultimately what a currency union is all about. If contagion spreads, European politicians and electorate will need to make a significant commitment to Europe and the euro. This could mean issuing Eurobonds (guaranteed by all euro zone nations) leading to some fiscal unity. Fiscal unity looks politically challenging, but the current situation of heterogeneous fiscal policies in the euro zone is untenable. By committing hundreds of billions of euro to loans and guarantees, Europe has already shown its political willingness to do what is necessary to keep the euro alive.

## The Winning Combination continued

Causeway Bank Holdings Exhibit Underevaluation

	Causeway International Value Equity	MSCI World	MSCI EAFE
Number of Bank Holdings	7	101	80
Market Capitalization (\$US Bn)	\$79	\$65	\$63
P/E using FY2 Est	6.9	8.3	7.8
Price/Cash Flow	3.5	4.4	3.9
Price/Book	0.8	1.0	0.9
Price/Revenues	0.9	1.2	1.0

Causeway International Value Representative Account. Holdings as of 06/24/2011.

Source: FactSet

**Q:** What about the secondary effects of a Greek default (even without contagion) to other countries?

**AV:** The exposure of our clients' bank holdings to Greek non-government debt (corporate, consumer, and bank debt) is modest. Although the CDS market is notoriously opaque, we understand that most of these swap contracts are collateralized, thus mitigating the risk of losses. The biggest secondary impact of a Greek default would be a spike upward in investor and lender anxiety, raising financing costs for borrowers in Europe and possibly also in the US. Post-2008 and the Lehman shock, policymakers globally have learned a lesson. The lack of confidence in financial institutions can bring about the very demise that policymakers seek to avoid.

**Q:** Several well-respected economists claim the euro zone is heading for break-up, with the word "inevitable" implied in the headlines. Do you agree?

**AV:** Our central case remains that the euro survives this and future bouts of speculation. Over time, some euro zone members may leave the monetary union, and new members may enter. As Tisha mentioned, governments have the political will to see the euro survive. However, something more than simple monetary union must glue the members together. Euro zone countries may have no choice but to accept higher fiscal coordination. For example, Italy will give up some level of fiscal sovereignty to maintain access to the common market, which facilitates exports to other euro zone countries on a single currency basis. Additionally, the implications of a euro

exit would be disastrous to any of the peripheral countries in terms of soaring inflation and interest rates.

**“Shrinking the public sector across Europe, from the UK to Greece, and deregulation will likely become the silver lining to this debt crisis.”**

**CM:** The debt problems in Europe, not to mention in Japan and the US, will take many years to resolve. Meanwhile, the worst offenders must remove the barriers that have made their economies highly uncompetitive. Shrinking the public sector across Europe, from the UK to Greece, and deregulation will likely become the silver lining to this debt crisis. In that scenario, I'd much rather hold equities than fixed income. European banks would likely take the sovereign debt haircuts in stride, with

the larger banks able to generate earnings sufficient to absorb losses from debt restructuring. Some of the banks will choose to raise equity to bolster capital. We calculate that most of that earnings dilution is already embedded in European bank share prices.

We don't have all the answers to the fate of peripheral Europe. But we do know that the nervousness over European equities, especially the financials, will dissipate once the decision makers reach a solution to the peripheral sovereign debt crisis. As long-term equity investors, our portfolios are 100% invested. We appreciate that market gyrations cause consternation for some investors, but we have confidence in the financial viability of our investments. Uncertainty typically provides buying opportunities for the patient value investor. In turbulent markets, Causeway attempts to identify stocks with the highest risk-adjusted returns, in a variety of regions and sectors. Equities look very appealing to us in this environment, and careful stock selection has the potential to benefit our clients in the months and years ahead.

## **Market Commentary**

The market commentary expresses the portfolio managers' views as of 7/14/11 and should not be relied on as research or investment advice regarding any stock. These views and portfolio holdings and characteristics are subject to change. There is no guarantee that any forecasts made will come to pass. Any portfolio securities identified and described do not represent all of the securities purchased, sold, or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.