CAUSEWAY CAPITAL MANAGEMENT LLC
NEWSLETTER

Beyond the Economic Malaise:

The Rise of Quality Cyclicals

Developed markets international equities have produced a 30-year average return of approximately 9%. The last 10 years to 12/31/08 have delivered a mere 1% return annualized. The current bear market has erased a decade of equity gains. We suspect much of the gap between long-term average performance and recent returns will be closed in a brief period of time. A reversion to the 30-year mean performance over the next two years implies an average return of 55%; over the next three years, 24%. In other words, those who invested early will enjoy the greatest upside.

When will the global stock market recovery occur? No one knows. Our primary goal is to position our client portfolios in the highest quality companies exhibiting superior financial strength. These companies should weather the downturn better than their peers, and can deploy their financial flexibility to take advantage of industry consolidation. The current global recession will result in less capacity in a broad array of industries, especially those suffering the greatest deterioration in demand. Examples of areas in need of consolidation include the construction, machinery, mining and ship building industries (to name just a few). Who are these dominant companies? How do we determine their balance sheet brawn, especially now with such scarce credit? Many of these examples reside in the capital goods industry, a major area of emphasis for our client portfolios.

Our primary goal is to position our client portfolios in the highest quality companies exhibiting superior financial strength.

We asked Causeway's capital goods experts, portfolio manager, Jonathan Eng, and research analyst, Foster Corwith, to explain our strategy.

MSCI EAFE® Rolling Ten Year Returns
12/31/1988 to 12/31/2008, Annualized USD

Source: MSCI EAFE®

CONTACT INFORMATION

SALES AND MARKETING – Mark Cone
email: cone@causewaycap.com
phone: (310) 231-6108

CLIENT SERVICE – Eric Crabtree
email: crabtree@causewaycap.com
phone: (310) 231-6145

The Rise of Quality Cyclicals continued

Q: Why have so many capital goods candidates appeared in our value screens?

JE: With an overwhelming supply of extremely negative economic news, investors have exited companies with cyclical earnings. This enables our clients to own world class companies at very low valuations. Looking beyond the next two years, we see industry leaders with better pricing power and more market share than before the credit crisis.

Looking beyond the next two years, we see industry leaders with better pricing power and more market share than before the credit crisis.

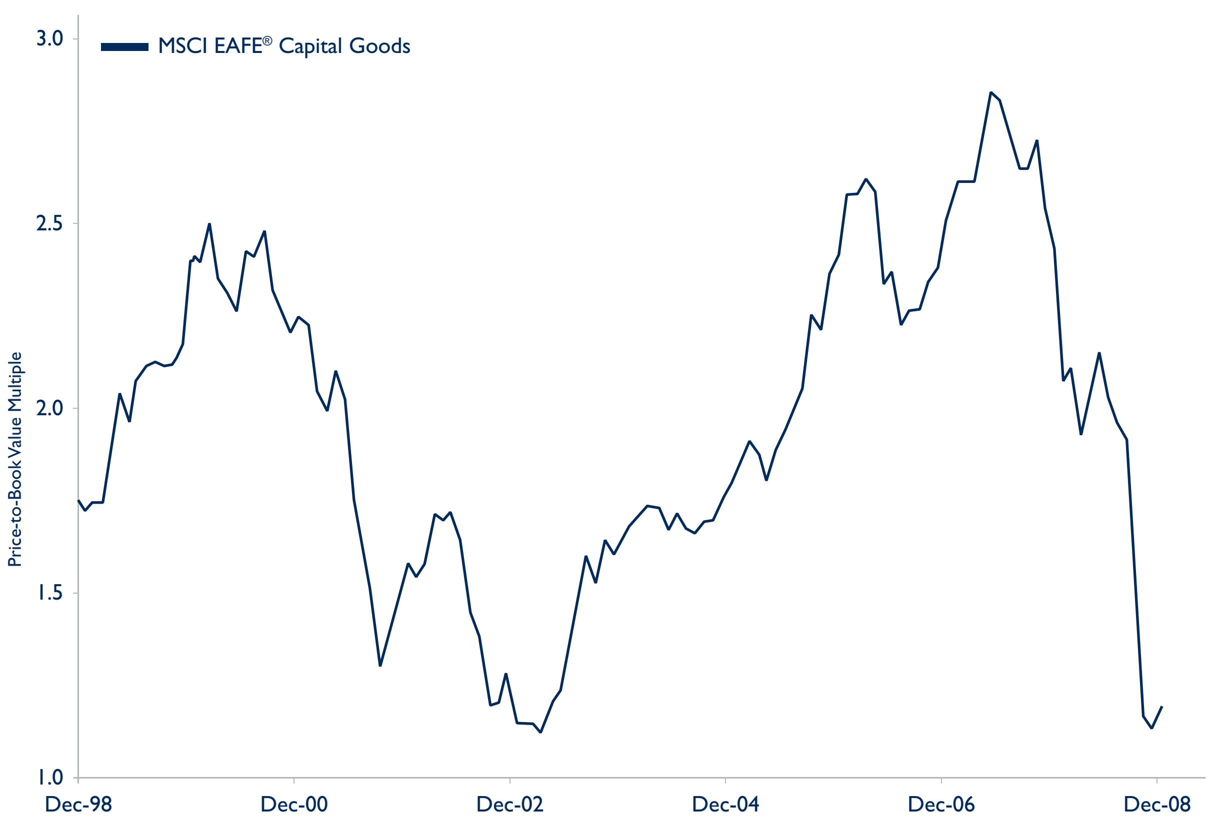
Q: How do you distinguish between those with the ability to outlast their weaker competitors, and those who don't?

FC: It's not as easy as you might think. A company with little or no debt should have negligible default risk. Unfortunately, this doesn't necessarily hold true. We dig much deeper, and analyze a company's overall capital structure and funding mix. Red flags include off balance sheet financing, typically in the form of operating leases, pension fund liabilities, unconsolidated associates and joint ventures, and restricted cash (often confined legally to a foreign jurisdiction, or already restricted to cover an existing liability). What you see isn't necessarily what you get. Our concerns also escalate when we see firms reliant on convertible bonds or preference shares. Typically, those companies have nowhere else to turn, and bankers may have mandated that shareholders take more of the burden. Sometimes, private investors require additional equity incentives. Time spent understanding these issues allows us to identify rock solid balance sheets and avoid potential disasters.

Q: Causeway portfolios have about twice the exposure to capital goods companies than MSCI EAFE®. What are the holdings, and why are you so confident?

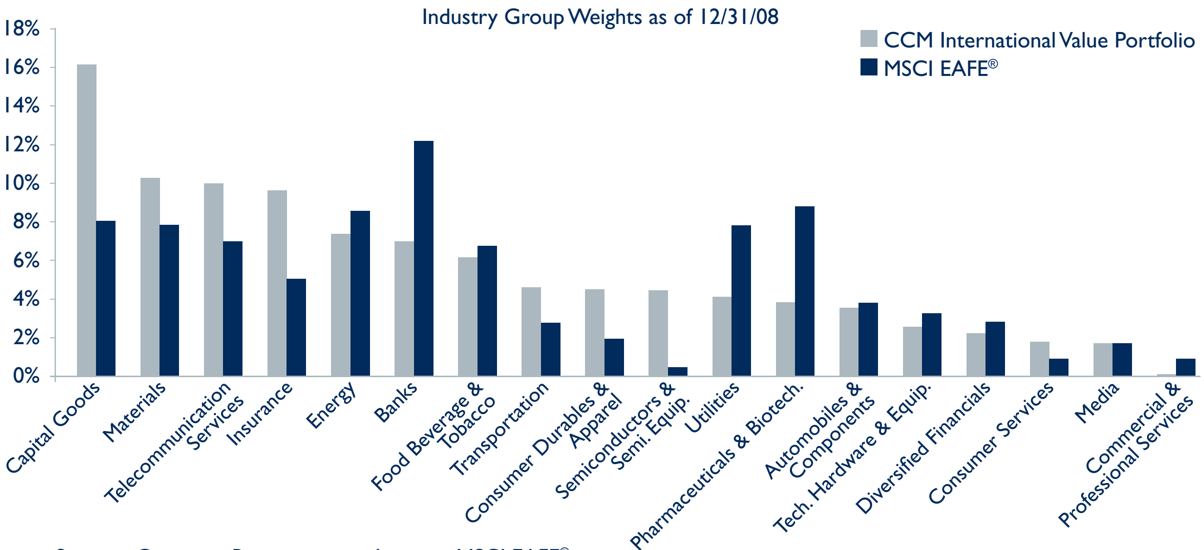
JE: Causeway has six capital goods companies in international client portfolios, namely BAE Systems (UK), Fanuc (Japan), Hyundai Heavy Industries (S. Korea), Philips (the Netherlands), Siemens (Germany), and Vinci (France). In our global portfolios, that list includes Rockwell Collins (US).

Capital Goods Companies are Trading Near Book Value



Source: MSCI EAFE®

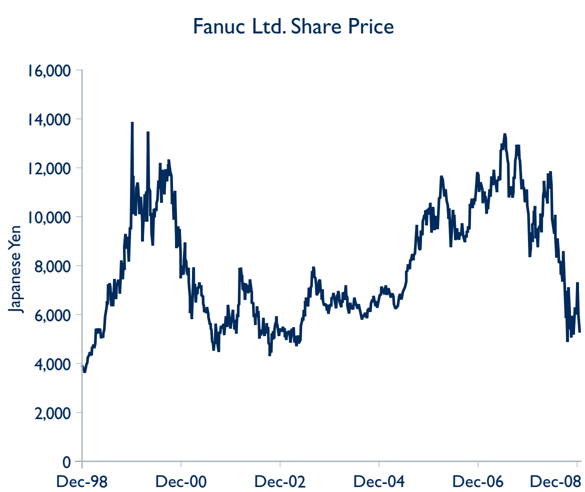
The Rise of Quality Cyclicals continued



Sources: Causeway Representative Account, MSCI EAFE®

FC: Fanuc is a company we have admired for many years and now have a chance to own at a slight premium to book value (historically it trades at 2x book value). Fanuc is the world's largest manufacturer of automation equipment, with a 50% market share in China. The Company also is a leading manufacturer of industrial robots. Earnings will decline sharply in 2009, as capital expenditures fall, but we believe the market has largely priced this decline into the shares. We will wait patiently for the eventual upturn, given Fanuc's market leading positions and its ability to generate free cash flow from operations, even during a difficult year. Fanuc has extraordinary financial flexibility given its strong balance sheet, with approximately $7 billion in cash and zero debt. That cash represents about half of the Company's market capitalization. The last cycle when orders bottomed was the fourth quarter of 2001, and Fanuc rebounded 40% over the next two quarters. We believe the risk-reward is in our favor.

JE: We also own a large position in Siemens, the German engineering conglomerate. Siemens has strong positions in energy / power distribution, factory automation and healthcare. Investors have been selling the shares in anticipation of several quarters of weak earnings. But Siemens is in the midst of a significant corporate restructuring implemented by a new management team. Over the next two years, management plans on selling non-core businesses and reducing operating expenses by over two billion euros, which accounts for 20% of operating profits. The restructuring should partially offset the expected decline in earnings in 2009 and should materially improve the company's profitability in the next cycle. In the meantime, Siemens trades at a slight premium to book value, yields 4%, and has very little debt.



Source: FactSet

Source: FactSet

The Rise of Quality Cyclicals continued

Q: What cyclical stocks make investors most nervous, and is this justified?

JE: Investors have been selling any companies with higher levels of financial leverage. One of the companies we own, Vinci, has non-recourse debt at the infrastructure asset level. Vinci has two businesses. The first is a civil engineering and construction business in France / Europe, which accounts for 40% of earnings. The second business, which accounts for 60% of earnings, comes from operating toll roads and parking spaces. Operating toll roads and parking structures is a consistent business where the revenues are indexed to inflation. This enables us to be comfortable with the debt levels of Vinci. The company's other business, construction, is more cyclical, but the French construction industry has consolidated to three players and Vinci is the largest and has the highest operating margins. In addition, the various fiscal stimulus plans implemented by governments worldwide should spur growth in infrastructure, benefitting Vinci. We believe current recessionary fears have created a significant buying opportunity in Vinci, a quality company with strong cash flows from its infrastructure assets. Furthermore, the company demonstrates superior project management skills and offers a secure 6% dividend yield.

> We want our clients' portfolios geared into the future recovery.

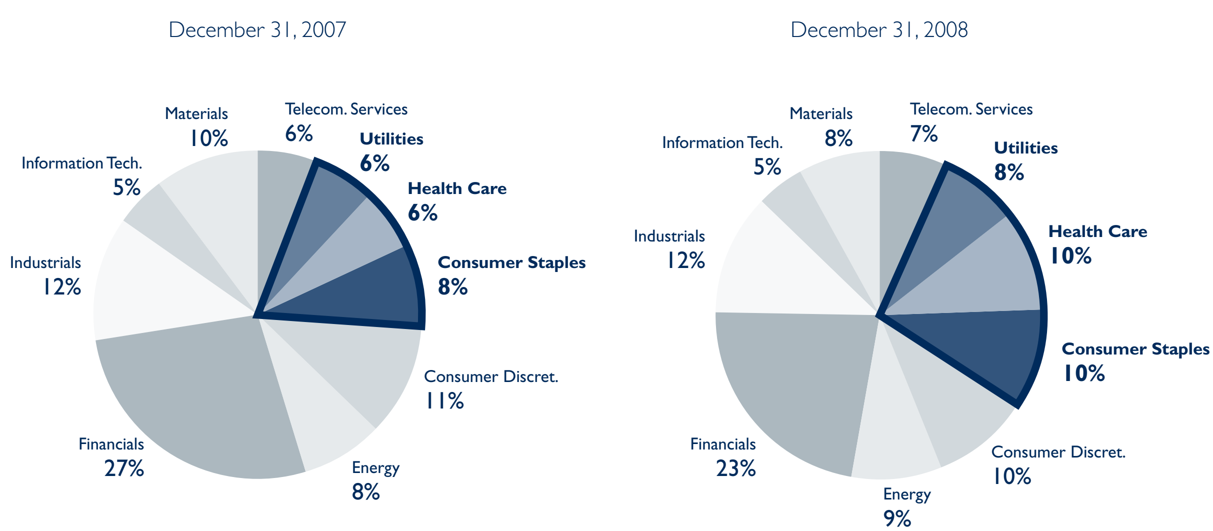
Q: Why are you confident that these capital goods stocks should outperform the broader international markets?

Vinci SA Share Price

Source: FactSet

JE: With the stampede out of cyclicals – and into defensives – global indices have seen their weights in healthcare, consumer staples and utilities soar. Take the MSCI EAFE® Index, for example: In December 2007, the Index had a combined weight in these sectors of nearly 21%. A year later, the weight had reached 28%. When equity markets begin to discount a turn in the global economy, those defensive sectors will act as a drag on benchmark performance. We want our clients' portfolios geared into the future recovery, the stage beyond the current economic malaise.

Traditional Defensive Industries Have Soared
MSCI EAFE® Sector Weights



Source: MSCI EAFE®