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CAUSEWAY CAPITAL MANAGEMENT LLC
NEWSLETTER

The Long Haul:

Rebuilding Profits in a Credit-Constrained World

The end of the massive credit and housing bubble implies more subdued private sector revenue and profit growth over the next few years compared with the 2003 – 2007 period. "Peak earnings" has a new, more tepid definition. This month, Causeway's research roundtable turned its focus to the valuation of stocks in cyclical sectors in 2009 and beyond. The discussion featured two of our portfolio managers, James Doyle and Jonathan Eng, and research associate, Conor Muldoon.

Q: What are some examples of cyclical sectors that appear most undervalued today?

JE: Materials stocks—such as chemicals and metals/mining—have slid to the bottom of the performance barrel over the past 12 months. Year-to-date, however, materials and information technology returned to favor, producing the best performance of all sectors in the global equity markets. Investors appear to have anticipated an economic turning point. Over the past four quarters, we took advantage of historically low valuation levels for many of the best quality cyclical stocks. We identified companies exhibiting superior financial strength, market and product leadership, and managerial excellence. With the turn in leading economic indicators last March, equity markets started to recover. Now, our challenge is to estimate the level of renewed profitability of the most economically-geared companies with a two-year forecast, and determine how this recovery should differ from previous cycles. As a backdrop, we expect credit to remain tight. Cautious lending should impede consumption in the developed world. With this in mind, our research has taken a distinctly conservative approach in estimating revenues, earnings, and cash flow for the companies we follow closely. Despite our muted economic view, we have identified some of the world's best materials companies for client portfolios. We've always wanted to own these stocks – and finally have a chance. The most competitive market-leading cyclical firms boost their earnings with cost-cutting and other restructuring. Our research has spent considerable time and effort estimating efficiency savings and how those savings should support profits, despite the drag of lower demand.

> "I want to be clear that we have a very long haul here because, even if the economy begins to turn up in terms of production, unemployment is going to stay high for quite a while, so it's not going to feel like a really strong economy."
>
> –Ben S. Bernanke, Chairman Federal Reserve System in Congressional testimony July 2009.

Q: Who are these increasingly efficient companies?

JE: One of our favorites is Shin-Etsu Chemical, the global market leader in the manufacturing of semiconductor silicon wafers. With advances in technology, wafers are used in a variety of devices. Innovation in electronics drives demand for semiconductors and the need for increasingly sophisticated wafer production. The Company is also the world's largest and lowest cost maker of polyvinylchloride (PVC), an essential raw material in building and construction. Earnings should significantly improve once the supply/demand balance improves and prices rise for 300 millimeter semiconductor wafers. This rise in wafer prices is estimated to require 300 millimeter plant utilization rates of 90% or more. Given the recent

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Rebuilding Profits in a Credit-Constrained World continued

curtailment of capacity additions by competitors, higher utilization rates will inevitably push up silicon wafer prices over the next 12 months. If we are correct, the market is undervaluing Shin-Etsu's future earnings power. If the semiconductor recovery takes longer than we anticipate, Shin-Etsu's sturdy balance sheet with zero debt and surplus cash should enable the Company to outlast its competitors. Under such a scenario, we think Shin-Etsu would likely gain significant market share.

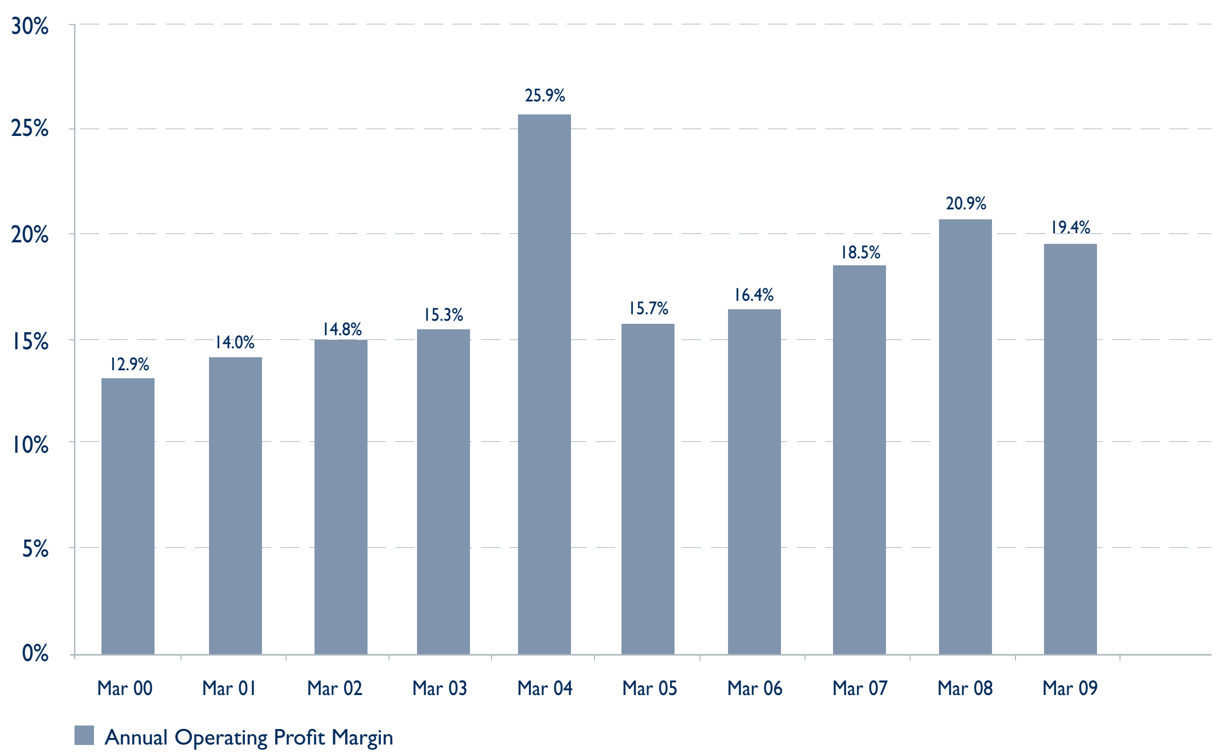
Q: In contrast with the market pessimism surrounding electronic chemicals, technology stocks have performed very well this year. If you believe that global growth will resume gradually, have the tech stocks anticipated too much good news too quickly?

JD: Although we are not surprised by the first signs of recovery in the technology product markets, the magnitude of the rebound in stock prices has raised eyebrows. In the second half of last year, we identified several technology cyclical stocks as attractively valued. In particular, we focused on semiconductor production equipment (SPE) companies that make the capital equipment sold to semiconductor manufacturers. The two stocks we added to client portfolios were ASML of the Netherlands and Tokyo Electron of Japan. They have been two of our best performing stocks this year.

> "The most competitive market-leading cyclical firms boost their earnings with cost-cutting and other restructuring"

We share the market's concerns with the SPE industry. The prior semiconductor equipment cycle peak from 2005 – 2007 was particularly powerful, and the semiconductor industry overspent relative to near-term demand. Furthermore, semiconductor demand has decelerated on a structural basis, driven by many factors, but in particular by weaker growth in the all-important personal computer end market. Finally, semiconductor companies must become more capital efficient, meaning that for a given level of production, they must purchase less capital equipment than in prior periods. Of course, the global economic crisis has made this restructuring a major challenge.

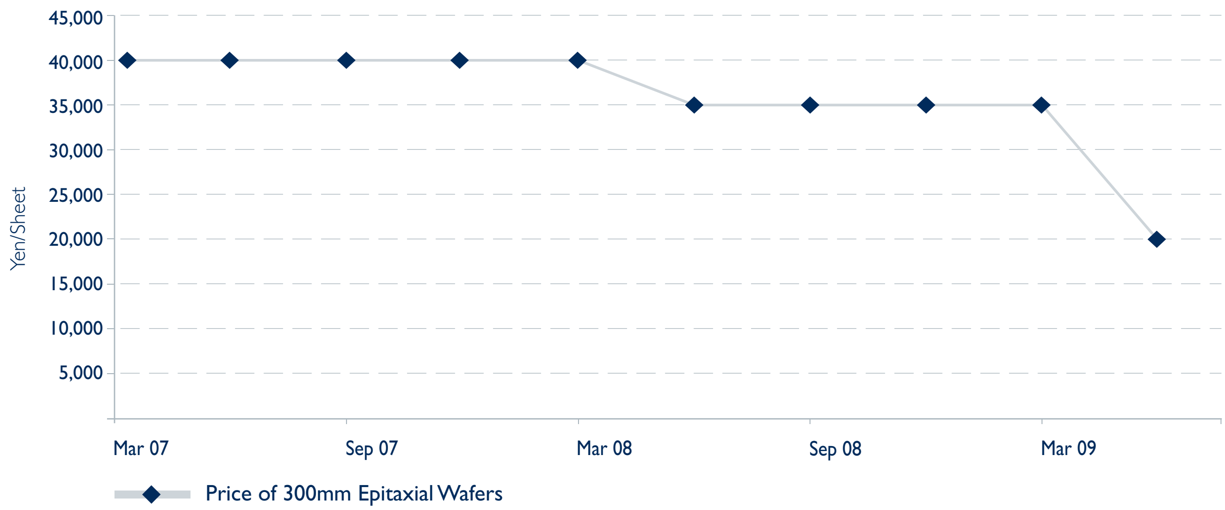
Shin-Etsu Chemical: Strong Operating Margins Lead to Future Earnings Power



Source: Company reports, fiscal year-end March

Rebuilding Profits in a Credit-Constrained World continued

Peak-to-Trough: Semiconductor Wafer Prices are Poised for a Recovery

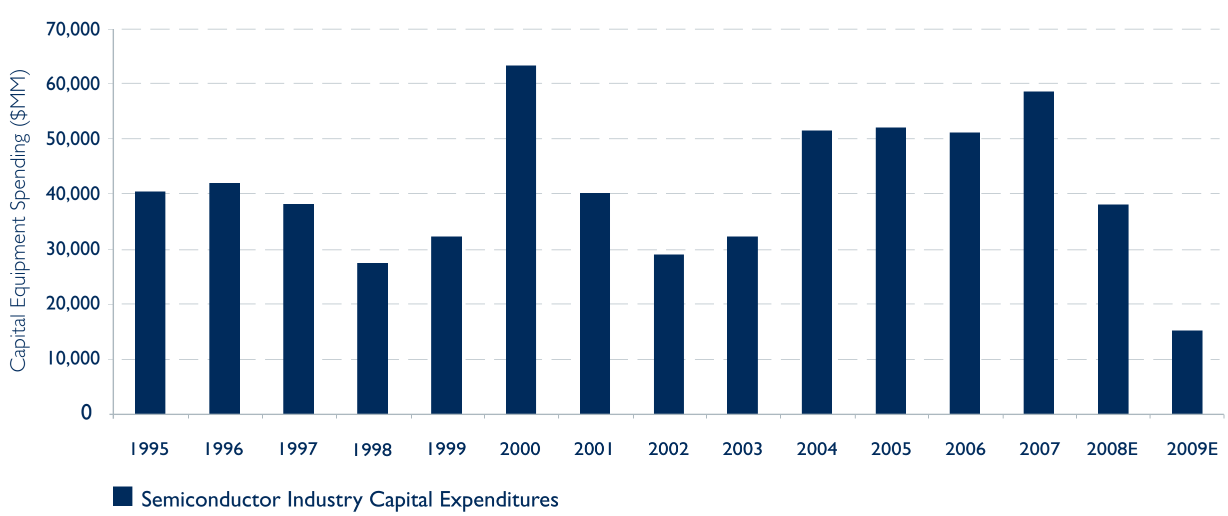


Source: Credit Suisse, Rare Metal News

Even with structural change, the semiconductor industry is poised for a cyclical upswing. The industry will eventually recover, as semiconductor companies need to purchase equipment to prepare for new technology and to drive down production costs. We think our two investments, ASML and Tokyo Electron, should be long-term industry leaders, each boasting dominant market shares, leading edge technology and excellent managements. Furthermore, they both have strong balance sheets with no net debt. All that financial strength allows these companies to fund research and development projects, and to demonstrate financial viability to their customers. As a result, not only should they survive the downturn, they may find themselves in better shape than the years before the current global recession.

In our valuation work, we do not assume that the next cycle will be as robust as the last cycle. Nor do we give our SPE companies substantial credit for restructuring and greater returns on capital. Assuming that the industry has a modest recovery, and that these companies can hold their market share, we believe that the share prices of both ASML and Tokyo Electron do not yet discount normalized levels of profitability. However, should these stocks perform as we anticipate, we will take profit in them and reinvest in more undervalued opportunities.

Nowhere to Go but Up? Semiconductor Capital Equipment Spending Reaches 15-year Low



Source: Company information, Worldwide Semiconductor Equipment Market Statistics, Auriga USA

Rebuilding Profits in a Credit-Constrained World continued

Q: What are some other examples of materials companies where Causeway is projecting lower levels of demand and lower prices than experienced in the last few years?

CM: In materials, our only metals & mining stock in 2009 has proven volatile and a successful investment. For years we admired Rio Tinto (Rio), one of the world's leading mining companies, and we invested in, sold, and re-invested in Rio during the past three years. Late in 2008, Rio's share price collapsed after suitor BHP Billiton revoked its acquisition offer. This left Rio without a solution to its weighty debt problem, just as spot prices of the Company's metals spiraled downward. The plunge in Rio's share price brought us an opportunity to build a sizable position at an extremely low valuation. The underlying quality of Rio's asset base (low cost and long reserve life) added to our confidence in the upside potential for this stock. Within months of the sell off, investor optimism returned. Demand from developing countries such as China and India supplanted fears of a global slowdown. As a result, most metals prices have stabilized and recovered from their lows. Due to the quality of its asset base, Rio solved its balance sheet problem through a series of non-core asset sales and a recent capital raise from existing shareholders. We believe our valuation assumptions are well grounded, as we base our forecasts on more normalized margins/commodity prices than what the Company achieved in the "super cycle" era of 2006-2008. While commodity prices have recovered, and in some cases are now well above our expectations, we view this as icing on the cake.

"As value managers, we are reluctant to assume sustainable profitability akin to previous cycle peaks."

As value managers, we are reluctant to assume sustainable profitability akin to previous cycle peaks. Even with such conservative assumptions, these quality cyclical stocks rank competitively as investment candidates versus other purchase opportunities. This conservatism gives us confidence that we have built a promising portfolio for our clients.

Rio Tinto: from Acquisition Target to Indebted Spinster - and back to Financial Health

Source: FactSet, Causeway Analytics – representative international value equity account