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CAUSEWAY CAPITAL MANAGEMENT LLC
NEWSLETTER

Super Cyclicals:

Capitalizing on Emerging Markets Opportunities

It's no surprise that investors are taking notice of emerging markets. While the US equity market delivered 0% annualized over the past decade to 9/30/09, the MSCI Emerging Markets Index returned 12% annualized over the same period. That's not even a horse race. We can suggest several reasons for the surge in popularity of emerging markets. This decade's proliferation of free trade has contributed significantly to prosperity and rapid growth in these less developed regions of the world. Add fiscal and monetary discipline into the mix, and the relative attractiveness of emerging markets becomes even clearer.

With such a sizable performance gap over developed stock markets, and valuations now surpassing developed markets, what's next for emerging countries? We spoke with the Causeway portfolio managers who run Causeway Emerging Markets Fund, and who are responsible for the Fund's sizable lead over the benchmark this year. Arjun Jayaraman, PhD, an 11-year veteran of quantitative portfolio management, and Duff Kuhnert, also well-experienced in quantitative portfolios, have proven to our clients that an active quantitative strategy can produce superior returns, and fully participate in the most ebullient of market rallies.

> "We believe a quantitative strategy is the best way to exploit the multiple sources of alpha in emerging countries."

Q: Why does Causeway employ a quantitative strategy in emerging markets?

AJ: We believe a quantitative strategy is the best way to exploit the multiple sources of alpha (i.e., return in excess of the MSCI Emerging Markets Index) in these markets. Our analysis confirms a combination of both value and growth works well in these markets, but combining these two approaches can be problematic for fundamental investors. In our quantitative model, we analyze historical efficacy, correlations, and volatility and use that information to assign weights to value versus growth factors. This flexibility gives our quantitative process the ability to outperform a pure value or growth strategy in the long run.

Although we emphasize stock selection, our model also uses top-down factors to assess the relative attractiveness of countries and sectors. Our research has shown that top-down approaches are very important in emerging markets. We estimate that country risk comprises nearly 30% of a stock's expected risk in these lesser developed markets, so ignoring the country dimension would be a mistake. Fundamental investors often cannot reconcile bottom-up versus top-down investment approaches, as most research analysts typically come from one school of thought or the other. In a quantitative framework, we can seamlessly combine these very different investment styles.

Quantitative approaches are also effective for running strategies with significant breadth. We build portfolios from a universe of over 1,000 emerging market stocks, which we assess daily for their relative attractiveness. Investment approaches with greater breadth typically have greater consistency. Using a quantitative approach also allows us to invest in small cap stocks. These smaller stocks have the greatest degree of mispricing, especially in emerging markets, as global managers who invest in the asset class tend to focus on the most liquid investments, typically companies with large market capitalizations.

Now is definitely the time to invest in emerging markets with a quantitative strategy, given the tremendous improvement in emerging market data and corporate disclosure. In fact, it's not just the availability of the data, but also the reliability and timeliness that have improved considerably. We monitor the accuracy of our data by cross-checking our numbers using multiple data sources.

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Q: Causeway's fundamental strategies (International and Global Equity) have concentrated the number of stocks in the past few years. But in emerging markets, your portfolios contain 90-120 stocks. Why do you need so many holdings?

DK: From an expected return perspective, we seek to generate alpha from a variety of different avenues: valuation, earnings growth, technical, top-down, and bottom-up. By maintaining a more diversified portfolio, we can gain exposure to these important sources of excess return. And from an expected risk perspective, we believe that emerging markets are inherently more volatile than developed markets. By holding over 90 stocks in the portfolio, we can diversify away more sources of risk so that it is less likely that any individual country, sector, or stock will make (or break) performance relative to our benchmark.

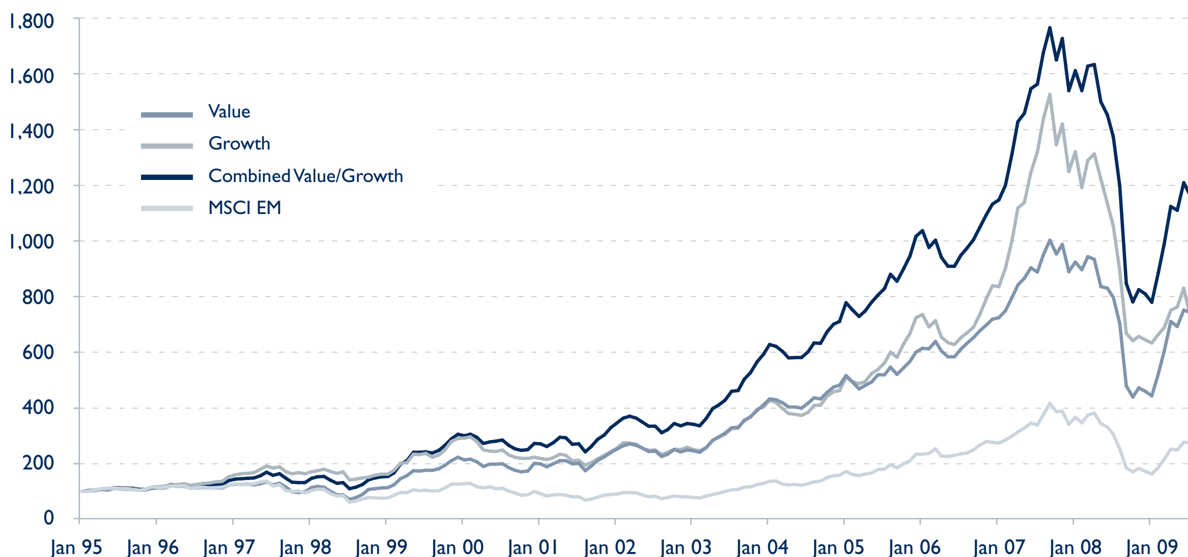
Q: What happens to your models when the investment winds shift, and past trends are no longer valid? How do you adjust your factors for these changes?

AJ: Sharp turning points in the markets can pose problems for quantitative models, which assume a certain degree of consistency. In fact, trends in company earnings and sales, stock prices, and country gross domestic product growth rates have been the norm historically, which is why we include factors that capture these phenomena in our models. The key, however, is to measure the trend over the correct time interval. If the period is too long, the model will not be quick enough to capture real changes in the markets. Too short a period could result in frequent short-term portfolio shifts and excess turnover, as the model gets fooled into thinking a trend is no longer in place when, in fact, it is.

> "Powerful evidence suggests that emerging markets may continue to outperform over a lengthier time horizon."

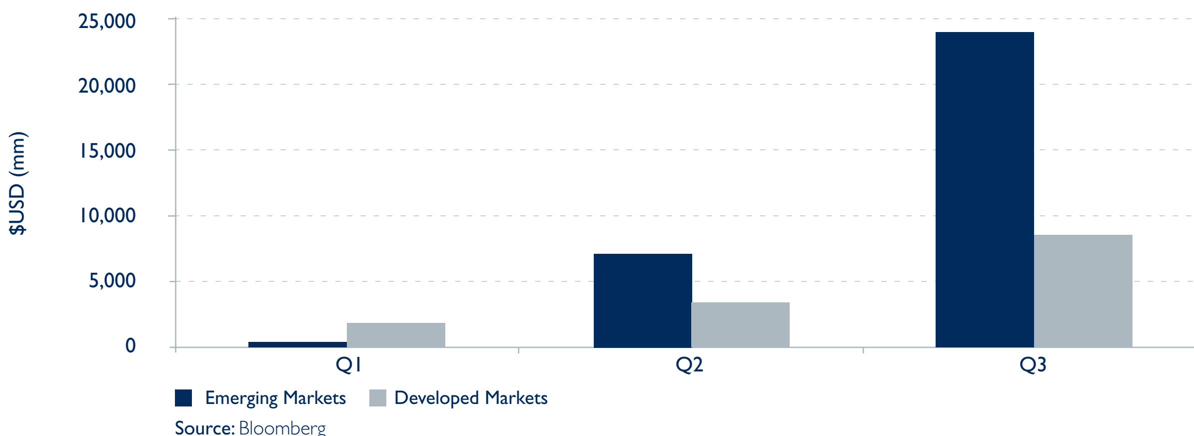
Our model hedges its reliance on trend-following factors by including valuation factors, which have a reversion aspect to them. Put more simply, stocks that score well on valuation often have underperformed recently, whereas stocks that score well on momentum typically have outperformed. The inclusion of valuation factors was especially helpful earlier this year when cyclical stocks began to outperform. Our earnings growth and momentum factors were still defensively oriented, but our valuation factors indicated that cyclical stocks were very cheap.

Lastly, we include quality factors as risk constraints in our process. This allows us to ensure that the portfolio is diversified in areas such as financial leverage, earnings uncertainty, volatility, and cyclicality.



Source: MSCI Emerging Markets Index, Causeway Analytics. See important disclosures.

Capitalizing on Emerging Markets Opportunities continued



We introduced these factors in mid-2008 in response to the crisis in financial markets, as we realized that high quality stocks would command a valuation premium in such an environment.

Q: How do you explain the superior performance of Causeway's Emerging Markets strategy relative to peers and benchmark thus far in 2009?

DK: Some years, we find growth and momentum factors work best—while other years we find valuation really pays off. Likewise, sometimes top-down approaches outperform bottom-up methods. In 2009, the bottom-up valuation factors have been extremely powerful. Earlier this year, cyclical and smaller-cap stocks in areas like Indonesia and Poland started ranking exceptionally well in our alpha models as they traded down to earnings and book multiples that we have rarely seen before in the data. Even after controlling for lack of momentum, poor perceived growth prospects, and some financial uncertainty, the expected returns on these stocks were still very large. Through our disciplined and quantitative framework, we were able to buy into the fear of others by allocating part of our risk capital to these stocks. Subsequently, many of these shares significantly outperformed. Our top-down models also did a good job this year, helping to boost exposures in places like Turkey and China at the right time, while keeping us away from some underperforming markets such as Mexico and Malaysia.

Q: The multi-trillion dollar question is, "What's next?" Will emerging markets continue their dramatic outperformance of the developed world?

AJ: To help answer this question, we can look to Causeway's emerging markets allocation model, which gauges the relative attractiveness of emerging versus developed markets using four weighted groups of indicators. Currently, the model still favors emerging markets, as our growth and yield curve indicators, which have greater weight in the model, are bullish whereas our valuation and risk aversion indicators are bearish. This is in contrast to earlier in the year, when all four indicators were positive.

Emerging countries have enviable economic growth rate forecasts versus their developed counterparts. We see no reason for this growth advantage to shift in the near future. Sell-side analysts are upgrading emerging markets companies' earnings at a faster rate than those in developed markets.

Steep yield curves in most economies point to emerging markets outperformance. On the short end, interest rates are low due to extremely accommodative monetary policy globally. Cheap money typically finds its way to high risk, high reward assets – namely the emerging markets. Worries about future inflation and an eroding US dollar have also led to investor demand for commodity-rich countries and equities. On the long end of the yield curve, higher rates indicate that markets expect growth to improve going forward, which also benefits emerging markets.

From a relative valuation perspective, emerging markets do not look particularly compelling, especially given their year-to-date outperformance. Relative valuations are still significantly below the extremes reached in 2007, so there may be room for further outperformance.

We also look at measures of risk aversion, which have shifted in the past several months from an obvious bias toward emerging markets to a more neutral position. We monitor data including the S&P 500 Volatility Index, the J.P. Morgan Emerging Markets Bond Index spread (yield on emerging market bonds – US Treasury yield), and the Merrill Lynch US Corporate and High Yield Master - Yield to Maturity Index (yield on high yield corporate bonds – US Treasury yield).

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These measures indicate some complacency among investors in assessing risk.

With the positive indicators outweighing the negative, we find emerging markets to be attractive over the next year.

DK: Supply certainly is responding to demand. This year we have seen tremendous initial public offering (IPO) activity in the emerging markets. Emerging country-domiciled companies comprised over two-thirds of all global IPO volume, including the top four largest global IPOs. We interpret this as a confirmation that the capital markets have recovered and risk tolerance has improved.

From a longer-term perspective, there is some powerful evidence to suggest that emerging markets may continue to outperform over a lengthier time horizon.

> "Emerging countries are driving global growth, and their financial markets suggest they have additional room to expand."

On a purchasing-power-parity basis[1], emerging countries now generate nearly 50% of global GDP, yet they represent less than 25% of total global market capitalization. Emerging countries are driving global growth, and their financial markets suggest they have additional room to expand.

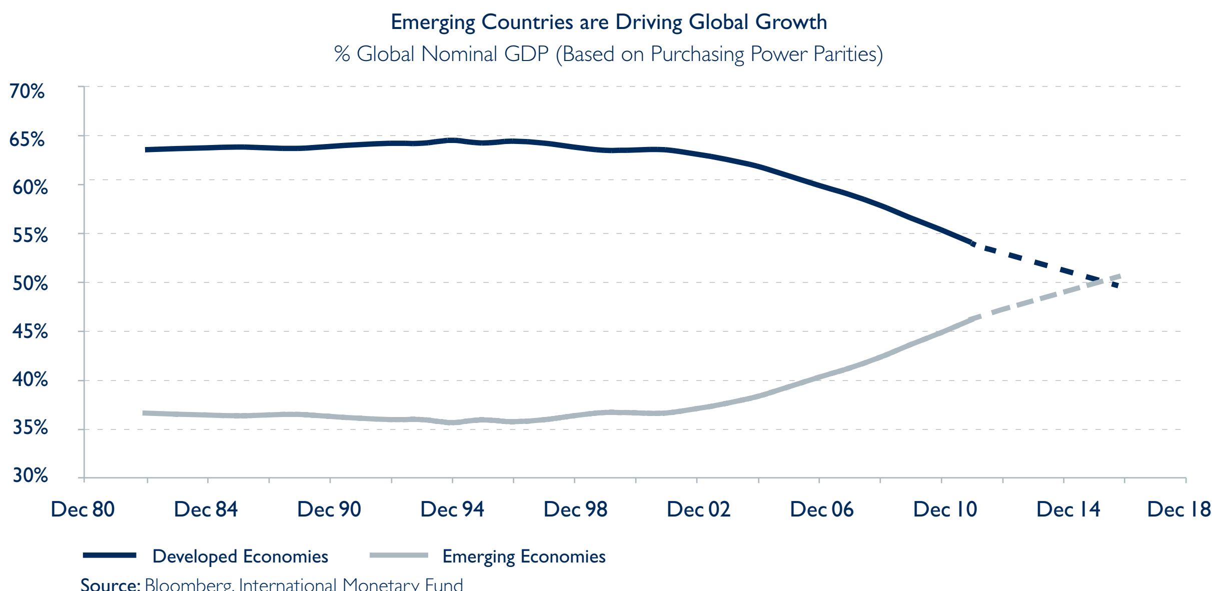
Stock markets within these countries continue to evolve in order to attract investment. Capital controls are becoming less restrictive. Settlement and custody have improved. Many emerging companies have embraced corporate governance, as they are finding it imperative to treat shareholders fairly. We believe all of these developments will work to lower the cost of capital for these companies and enhance asset prices in the future. On a more extended horizon, many emerging countries are also developing social safety nets such as pension, health-care, and education reform that allow families to reduce their sizeable rainy-day cash savings and become larger consumers.

These ongoing changes and improvements should provide the impetus for attractive emerging markets returns.

Q: How do you recommend that investors get the optimal exposure to all non-US markets?

AJ: As a firm, we believe – and have proven – that an active fundamental value investment strategy delivers the best long-term returns for clients in developed markets. In emerging markets, on the other hand, we believe a quantitative composite approach is most appropriate.

DK: We recommend that our investors gain access to a blend of all the best skill sets we offer at Causeway. For the developed world, this means intensive fundamental research implemented via a disciplined value approach. For the emerging world, this translates to a quantitative strategy tailored to the unique growth, momentum, and risk characteristics of developing markets. As portfolio managers, we have access to the most timely and accurate data available with which to gauge the relative attractiveness of developed versus emerging markets. Logically, we are well-equipped to make that allocation decision for our clients.



Source: Bloomberg, International Monetary Fund

1 The purchasing-power-parity between two countries is the rate at which the currency of one country needs to be converted into that of a second country to ensure that a given amount of the first country's currency will purchase the same volume of goods and services in the second country as it does in the first. (International Monetary Fund)

Important Disclosures

The market commentary expresses the portfolio managers' views as of 10/31/09 and should not be relied on as research or investment advice regarding any stock. These views and the 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.

"Combined Value/Growth Approach" in Emerging Markets

The "Combined Value/Growth" performance for the period 1995 through July 2009 in the graph on page 2 is not the performance of Causeway's emerging markets equity strategy. It shows simulated historical returns of three model portfolios of stocks sorted from a universe comprised of the companies in the MSCI Emerging Markets Index plus any of the largest 1,000 emerging markets stocks not included in the Index (typically 1,100 – 1,200 stocks total). The Value line graph is the average monthly performance (equal weighted) of the top quintile value stocks ranked by equally weighting standard value multiples including: forward (12 months) earnings/price, earnings/price, book value/price, cash-flow-operations/price, and EBITDA/enterprise value. The Growth line graph is the average monthly performance (equal weighted) of the top quintile growth stocks ranked by equally weighting standard growth multiples including: earnings upgrades-downgrades/total (last 3 months), Starmine Analyst Revisions Model, 6 month price momentum, and 12 month price momentum. The Combined Value/Growth line graph is the average monthly performance (equal weighted) of the top quintile value/growth stocks ranked by assigning a 2/3 weight to value multiples and a 1/3 weight to growth multiples. Performance is gross of trading costs and withholding taxes on dividends and capital gains, and is computed in U.S. dollars. Returns include the reinvestment of dividends and any capital gains. Performance is gross of management fees. For example, a $20 million account with a cumulative total return of 10% over two years would grow to $22 million gross and approximately $21.7 million net of investment advisory fees, assuming an annual investment advisory fee of 0.70%. Causeway's standard fee schedules are contained in Part II of its Form ADV.

There are numerous inherent limitations in the model results, particularly the fact that the model portfolios were created with the benefit of hindsight and thus such results may not reflect the impact that material economic and market factors might have had on portfolio managers' decision making if they were actually managing portfolios. Past simulated performance is no guarantee of future results, and the past model performance is not indicative of the future performance Causeway may experience managing its emerging markets strategy, which uses a different quantitative investment process.