

Hope Over Experience in the Japanese Market

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NEWSLETTER

With the election of Prime Minister Shinzo Abe and the appointment of Bank of Japan (BoJ) Governor Haruhiko Kuroda, Japan is embarking on a grand experiment in monetary and fiscal policy.

We have faced ebullient rallies in the Japanese equity market several times in the 22-year history of our international value strategy. In 2005, a post-election rally led investors to a buying surge that left the Japanese market 40% higher by year-end. We resisted the temptation to jump on the bandwagon, as most of the market movers lacked adequate valuation support and the much-discussed structural reform never materialized. Three subsequent years of poor Japanese market performance validated our concerns. Similar to 2005, this latest Japanese market rally has contributed to slippage in Causeway's portfolio performance in the first quarter versus Japan-laden benchmarks such as the MSCI EAFE Index. To understand the Causeway team's view of the current Japanese market environment, we interviewed Causeway's president, Harry Hartford.

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Harry, why is the Japanese market doing so well this year?

With the election of Prime Minister Shinzo Abe and the appointment of Bank of Japan (BoJ) Governor Haruhiko Kuroda, Japan is embarking on a grand experiment in monetary and fiscal policy. Judging by the 30% advance in the market since the Liberal Democratic Party (LDP) election victory on December 16, investors anticipate an improvement in many of the deep-seated challenges facing corporate Japan. At present, my colleagues and I remain skeptical that an attempt to debase the currency and the establishment of a 2% inflation target will cure the Japanese

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Absent more rapid rates of profit growth, there is insufficient justification for Japanese equities to trade at a significant premium to US equities and at a level almost twice that of European equities.

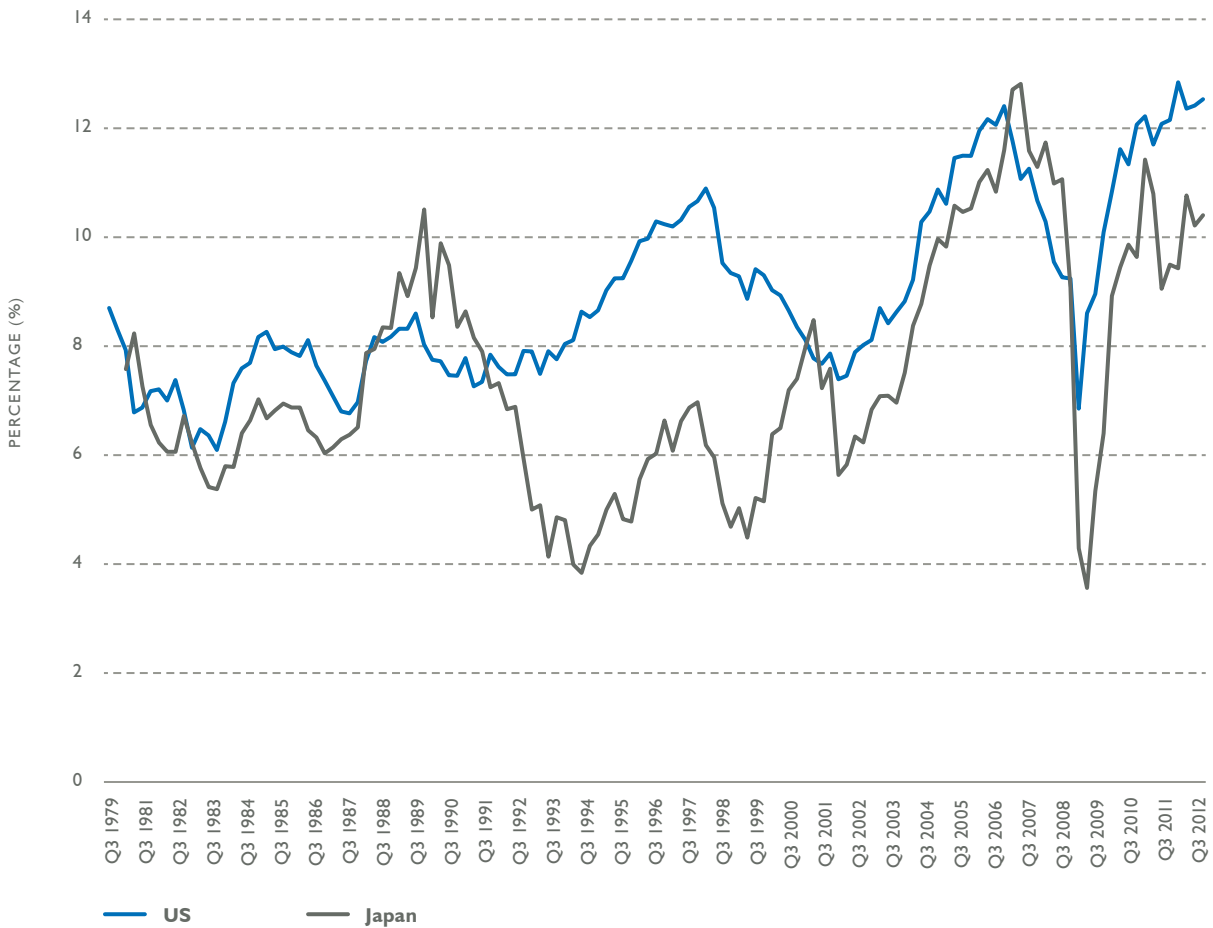
economy and revitalize its long-suffering equity market. As fundamental, bottom-up investors, we are not inclined to invest based on sheer optimism for Japan's future. Rather, we require some confirmation of the significant structural changes necessary to improve the operating fundamentals of Japanese companies and justify the recent rally. The reversal in monetary policy has the potential to aid the earnings recovery of export-oriented companies with significant overseas revenues. However, at 16x March 2014 forecast earnings (already the most expensive developed equity market globally), we believe the Japanese market has already reflected this earnings boost. Our reservations don't end there, particularly in light of the nation's perilous fiscal position as the most indebted developed economy in the world.

Why do you disagree with the optimists on Japan?

As investors, we face the conundrum of the reaction of the Japanese bond market to the nation's monetary easing. If inflation is an explicit goal, why hasn't the bond market reacted and sent Japanese government bond (JGB) prices lower and yields higher? The opposite has happened, suggesting the bond market is skeptical of the inflation target. Japanese-listed banks are among the greatest beneficiaries of the recent market rally. Yet, the near-100% share price appreciation in these bank equities from last November is at odds with this continued downtrend in JGB yields. Absent the increase in reported earnings from the higher valuations of equities on banks' balance sheets, the future reported profitability of the banking sector will likely be lower. And, if interest rates do rise, those highly indebted corporations will experience higher borrowing costs with the potential to impose significant losses on both shareholders and lenders. In the short term, the rate of earnings growth in Japan will likely surpass that of other markets. Some of this growth will stem from the unique Japanese practice of booking unrealized gains as income, and some from translating foreign revenues back to a

weaker base currency. Think of these as accounting benefits rather than sustainable drivers of profitability. In the long run, Japanese companies are unlikely to earn higher margins and experience superior revenue growth than non-Japanese companies. We've seen at least a decade of very low returns on equity for Japanese corporations; while an improvement is inevitable, we think the market has already discounted the implied boost to returns. Absent more rapid rates of profit growth, there is insufficient justification for Japanese equities to trade at a significant premium to US equities and at a level almost twice that of European equities.

PROFIT SHARE AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT



Source: Thompson Reuters, Credit Suisse research

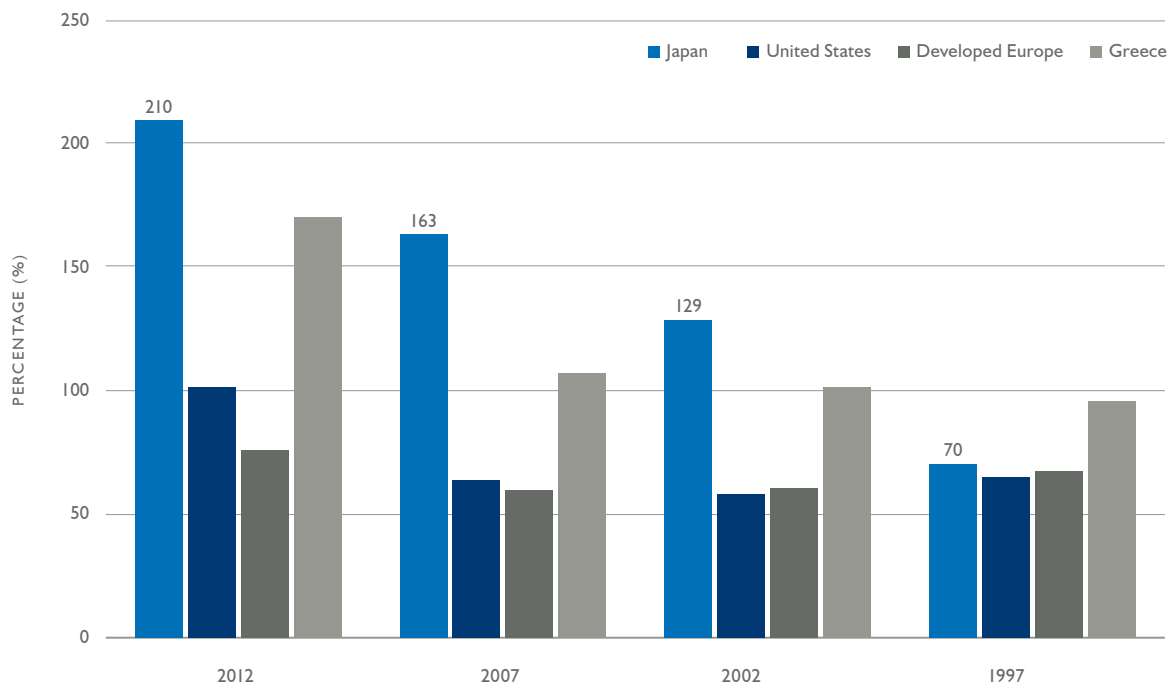
What is really required for Japanese equities to sustain their momentum is deep-seated structural reform, including fiscal and tax reforms, liberalization of trade and labor markets and de-regulation.

Profit share as a percentage of gross domestic product (GDP) in Japan is anticipated to be close to 13% by the end of 2014. At its peak in 2007, it was 13%. It is difficult to envisage a significant expansion beyond the peak reached in 2007. Devaluing the yen for an economy that has virtually no domestically sourced raw materials will result in significantly higher input costs. In the absence of higher output prices, margins for Japanese companies will be lower, not higher, and profit share as a percent of GDP will not rise.

You can't deny the more competitive yen versus the US dollar and euro. Why doesn't that alone justify buying the market, from a top-down perspective?

Since the leadership turnover last December, the Japanese yen has fallen 15% versus the US dollar, to a multi-year low. This weakness appears to be little more than speculative selling in anticipation of the BoJ's intervention to depreciate the currency, thereby boosting competitiveness and input prices. The BoJ, under the new administration, is attempting to create inflationary expectations to stimulate demand-led growth. The hope is that consumers, accustomed to price deflation, will reverse their longstanding behavior and in short order become profligate in anticipation of rising prices. Such an experiment is unproven and fraught with challenges, especially given the staggeringly high level of Japanese government debt. Gross debt is approximately 210% of GDP and rising. At current interest rates, 24% of government revenue is required to pay interest on the national debt. If interest rates rise, as they should in anticipation of higher inflation, the debt interest charges will increase and compromise the government's ability to fund the debt without meaningfully impacting the taxpayer. Alternatively, the printing of money, which most people anticipate will lead to higher inflation, will debase the value of savings. Given Japan's aging population, this measure is tantamount to financial depression.

DEBT AS PERCENTAGE OF GROSS DOMESTIC PRODUCT



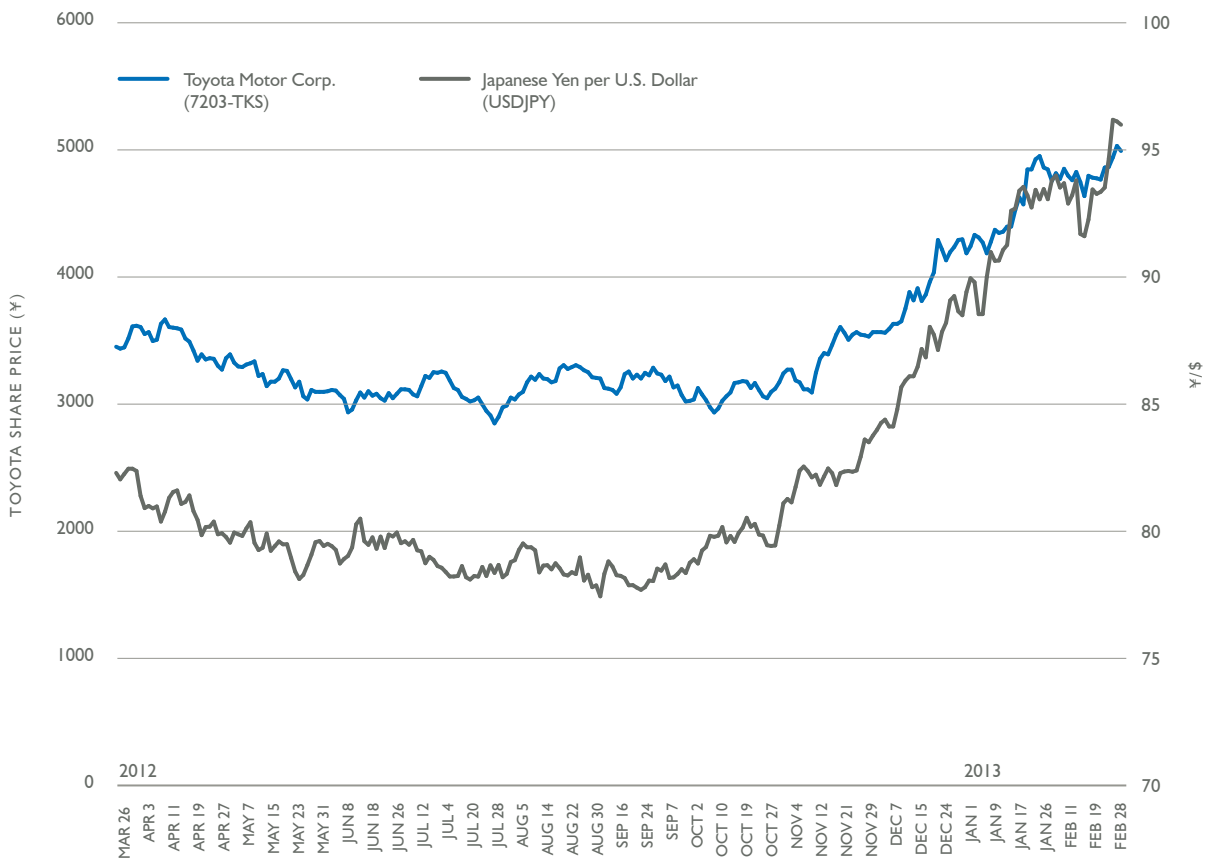
Source: FactSet; *GDP data for Developed Europe and Greece is for calendar year 2011, most recent available

Other than the (now expensive) banking stocks, what other examples can you give of big movers in the Japanese market – especially those benefiting from the weaker yen?

The exporters- for example in autos, tires, and electronics - have enjoyed a huge three months of performance. We reject the notion that a weaker yen will cause consumers outside of Japan to buy more Toyota cars, more Canon cameras, or more Sony televisions. Sony's stock is up 87% in local terms from its 52-week low in mid-December. The company trades at 0.7x price-to-book value, a favored valuation methodology by Japanese analysts because Sony has generated losses the past few years. Asset sales (such as its headquarters building) this fiscal year turned what would have been another loss into a very modest gain. Using optimistic assumptions about a dramatic turnaround in its loss-making mobile products

and home entertainment segments, the stock trades on a two-year forward price-to-earnings ratio of 18x. But what about the low price-to-book value ratio, you ask? The most generous of analysts' next year's earnings estimates, including anticipated benefits from yen weakness, project that Sony will generate a 3% return on equity, validating the low multiple. Unfortunately, weak orders from Europe, as well as restructuring charges, are eroding forecasted currency gains. This is the fundamental challenge facing many Japanese firms. Yes, these companies will have higher levels of yen-denominated profits, but competition

JAPANESE EQUITIES HAVE SURGED WITH YEN WEAKNESS, NOT FUNDAMENTALS



Source: FactSet

from more innovative companies and cheaper products elsewhere pressure their businesses.

What would change your mind on Japan?

The current surge in Japanese equities is a consequence of the yen's decline and the anticipation of aggressive monetary policy from the BoJ. What is really required for Japanese equities to sustain their momentum is deep-seated structural reform, including fiscal and tax reforms, liberalization of trade and labor markets and de-regulation. Absent meaningful reform that leads to sustainably higher returns on capital employed, today's Japanese equity market rally may prove to be a warm weekend in a long winter, and again disappoint investors.

We remain committed to investing in stocks globally based on valuation and the fundamental underpinnings of companies' operating profitability. To the extent that we can convince ourselves that management of Japanese companies will improve meaningfully, causing higher returns on capital to accrue to minority shareholders, we will willingly participate. Absent that reform, we will not take the risk of investing in a momentum-led rally that appears unsustainable over the long-term.

Market Commentary

The market commentary expresses the portfolio managers' views as of 3/31/13 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. Causeway began operations in June 2001; its international value equity strategy was founded at a prior firm in 1990.