Causeway

Income – at the Right Price

> MAY 2013
NEWSLETTER

Stocks in the energy sector currently offer significantly better valuations and dividend income than those in consumer staples, especially in the non-US developed markets.

To supplement the vanishing income from fixed income securities, investors have gravitated towards stable income-paying stocks in sectors such as consumer staples, utilities and telecommunication services (especially in the US market). This migration of selective equity buying has driven a wedge between economically sensitive "cyclical" stocks and those with earnings more insulated from global growth cycles. Causeway's fundamental research has identified a wide array of undervalued cyclical stocks, including a high representation in the energy sector. Currently, Causeway's international and global portfolios' exposures to energy are among the strategies' largest sector overweights versus the MSCI EAFE and World Indices. Our fundamental value portfolios are overweight energy versus their benchmarks by about the same magnitude as they are underweight consumer staples.

The yawning valuation gap underpins our weighting emphasis. Stocks in the energy sector currently offer significantly better valuations and dividend income than those in consumer staples, especially in the non-US developed markets. In MSCI EAFE countries, the average dividend yield of companies in the energy sector is 4.2%, 1.5x higher than the yield of consumer staples stocks. Yet, energy trades below 10x price-to-earnings, while EAFE's consumer staples sector trades at over 20x.

To shed some light on energy stocks in the global equity markets, we spoke to Causeway fundamental portfolio manager, Kevin

INSIDE THIS ISSUE

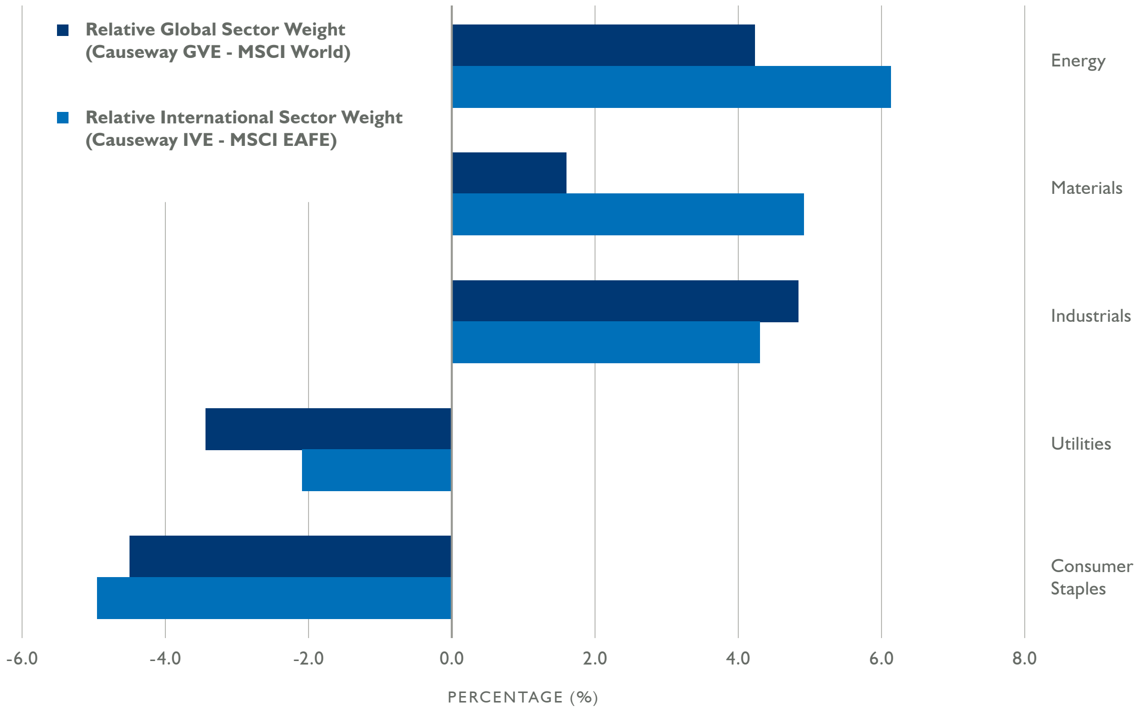
CONTACT INFORMATION

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

Income – at the Right Price

UNDERVALUATION HAS LED TO CAUSEWAY OVERWEIGHTS TO CYCLICAL SECTORS



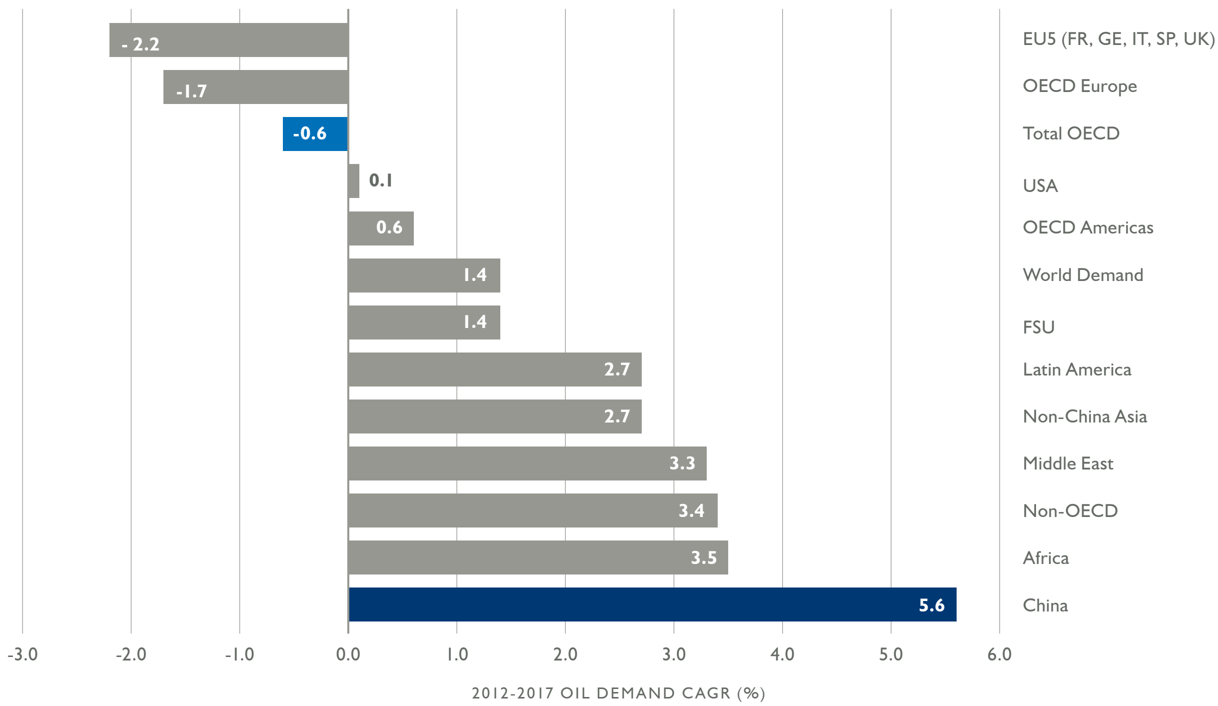
Source: : Representative international and global accounts; FactSet; as of 5/10/13

Durkin. Kevin has led Causeway's energy sector research from our firm's inception. Quantitative portfolio managers, Arjun Jayaraman and Duff Kuhnert, and senior quantitative analyst, Joe Gubler, provide a quantitative context for today's valuation gap between stable income-paying and cyclical stocks.

Why does Causeway own energy stocks in this period of contracting Chinese economic growth?

KD: I can't dispute that the greatest portion of marginal global demand for crude oil comes from China. But China's position in oil is different than in other commodities. China only accounts for 10% of global crude demand, versus 20-45% for most other commodities. The country's crude "intensity" (demand versus gross domestic product growth) has declined fairly consistently since 2000 (steel and copper intensity accelerated over the same

ENERGY: STEADY INCREASE IN EMERGING MARKETS OIL DEMAND



Source: Bernstein Analysis & Estimates

period). According to consensus estimates, gasoline demand will accelerate going forward, due to the large increase in passenger car parks, as well as continued income and urbanization gains. As a result, the "drive" portion of oil demand will become more significant. However, I believe China's role as the global factory won't end anytime soon, so the "burn" portion of oil demand will not disappear. Chinese consumer balance sheets remain healthy and consumer spending should continue to rise. Yes, we have evidence of capital misallocation – but the country has the financial wherewithal to absorb credit excesses and bad debts and continue to grow. In fact, economists forecast that the compound annual growth rate (CAGR) for Chinese oil demand will be 5.6% from 2012 – 2017, compared to a –0.6% decline in Organization for Economic Co-operation and Development (OECD) nations.

Even with wage increases, China's export sector remains hugely

The market is placing a higher value on earnings certainty than in the past, driving up the premium for defensive stocks.

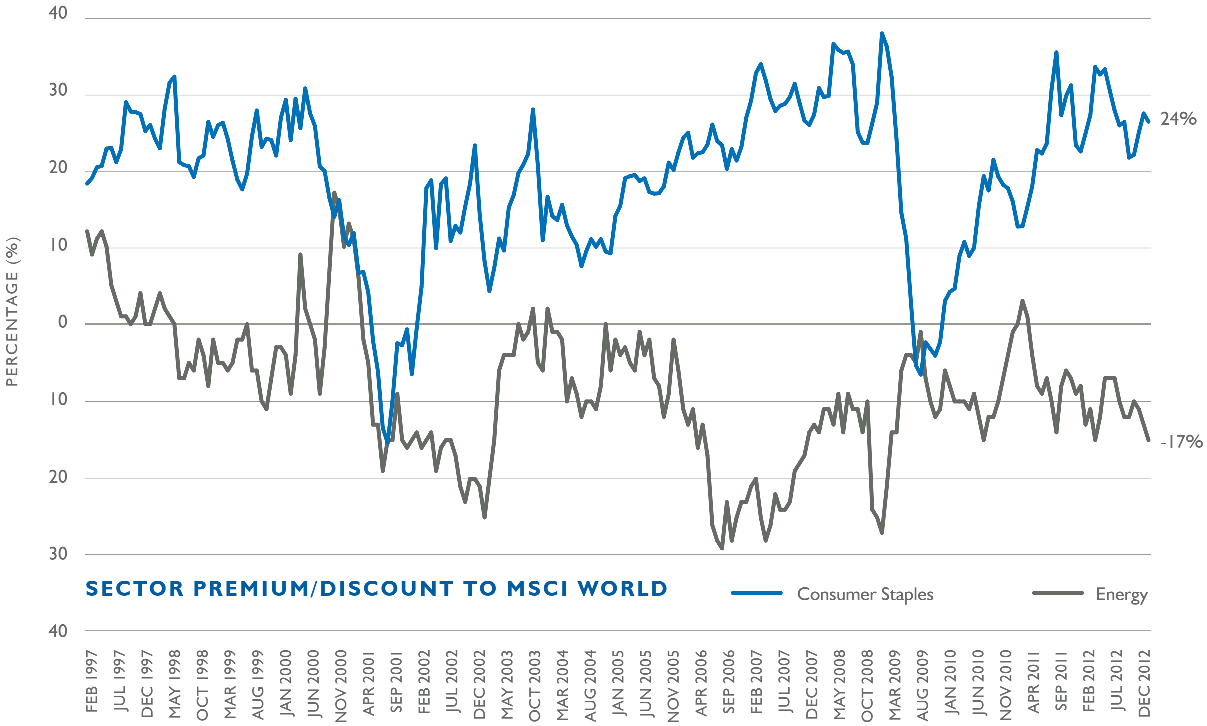
competitive. Given the efficiency of supply chains in China, we do not expect the country's global export market share to shrink significantly in the near term. Most likely, China will continue to generate a large portion of national income from global trade.

Arjun, Duff, and Joe, how do we view energy from a quantitative perspective?

AJ: Worldwide, we see companies in the energy sector trading at a significant valuation discount to companies in sectors more resilient to economic downturns. In developed markets, the 24% premium of the CAPE (cyclically-adjusted price-to-earnings ratio) of the consumer staples sector versus the CAPE of the MSCI World Index is near all-time highs, and has been climbing steadily since the market bottom in early 2009. Conversely, the energy sector's CAPE is trading at a 17% discount to the CAPE of the MSCI World Index, the steepest discount currently of all sectors. With risk aversion most acute in Europe, the valuation dispersion between these sectors in those markets is also at a 10-year high.

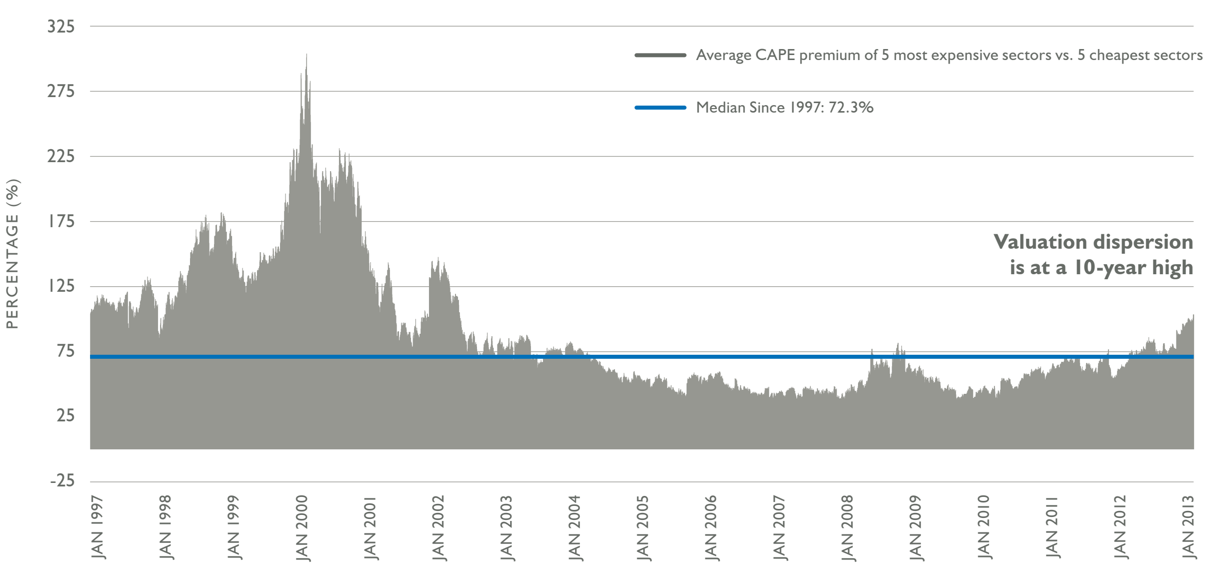
DK: In emerging markets, some of this discount is justified. Energy companies in China and India trade at valuation discounts to global averages because those countries subsidize consumer gas prices. Russian energy companies trade at a discount because of the country's inferior corporate governance. However, cyclicality likely also explains some of the sector's low valuation. At the margin, there has been improvement on these fronts: the Chinese and Indian authorities have reduced gas price subsidies, and in Russia, the finance ministry pressures state-owned companies to boost dividend payouts, which should reduce value-destructive activities like expensive acquisitions and capital expenditures. These actions, in part, have led sell-side analysts to upgrade their numbers. Recent upgrades, coupled with the cheap valuations, have resulted in an energy sector overweight for Causeway emerging markets portfolios. After 18 months of having an underweight to emerging markets in our all-country (developed

ENERGY CURRENTLY TRADES AT A STEEP DISCOUNT TO MSCI WORLD; CONSUMER STAPLES AT A PREMIUM



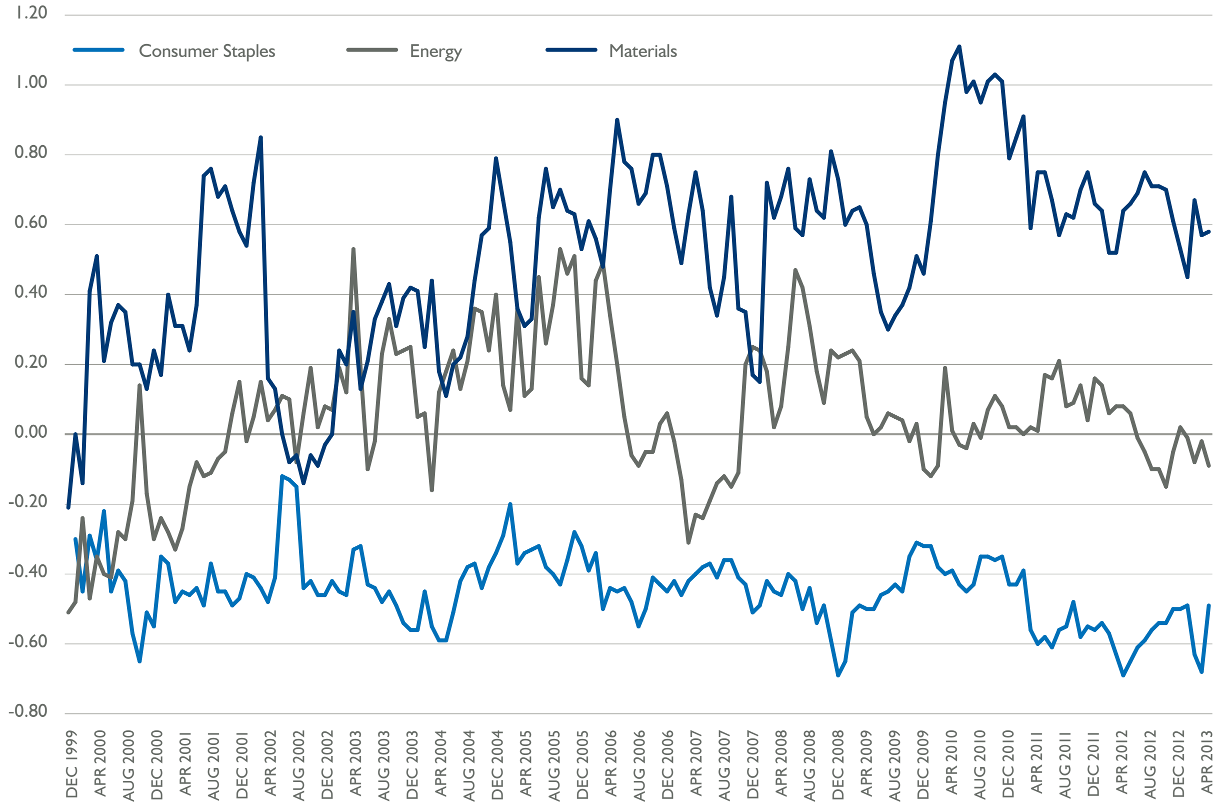
Source: MSCI, FactSet, Bloomberg, Causeway Analytics

VALUATION DISPERSION IS AT MULTI-YEAR HIGHS
MSCI EUROPE CAPE PREMIUM: 5 MOST EXPENSIVE SECTORS VS. 5 CHEAPEST SECTORS



Source: FactSet; CAPE

EARNINGS ESTIMATES DISPERSION IN ENERGY AND MATERIALS HAS DECLINED
MSCI EM INDEX: WEIGHTED AVERAGE EPS DISPERSION BY SECTOR



Source: MSCI, FactSet, Bloomberg, Causeway Analytics

plus emerging markets) International Opportunities strategy, this cyclical stock discount has started to tip the scales in our allocation model in favor of increasing our weighting to emerging markets.

JG: Another metric we track is earnings estimate dispersion within sectors. Dispersion within the cyclical energy and materials sectors has decreased at the margin, while dispersion within consumer staples is unchanged. However, the market is placing a higher value on earnings certainty than in the past, driving up the premium for defensive stocks. This preference even extends to emerging markets, where investors generally have had a greater risk tolerance. Companies in the emerging markets consumer staples sector are trading at an unprecedented 30% premium to their developed market peers. Emerging markets investors are currently willing to pay a very high price for peace of mind.

Kevin, we've discussed broad energy themes, but Causeway's stock selection process is bottom-up. Which energy companies have you selected for Causeway's fundamental value portfolios?

KD: Our energy holdings fit into three broad categories: integrated oil & gas companies, energy services, and independent exploration & production companies. In all three categories, we have identified attractively valued companies with advanced technologies or long-life, low-cost resource bases that allow them to "win" under our conservative hydrocarbon price scenarios. The energy services companies have large and growing addressable markets. These companies assist customers in oil as well as gas, and national government controlled oil companies as well as private companies. Deep water drilling has generated 50% of recent oil discoveries, yet represents only 7% of total oil production. The portfolios of our developed markets clients hold an industry-leading deep water oil services company with a structural advantage to grow cash flow at rapid rates as production increases. We also hold a well-managed Japanese energy plant construction company. This company has a competitive advantage in its design and construction expertise producing the highly complex processing units necessary to freeze natural gas for export, a growing market. We are anticipating a multi-year liquefied natural gas (LNG) shortage in energy-hungry Asian markets, in particular. Our integrated holdings are stable companies with solid balance sheets and high shareholder returns that trade at significant discounts to the market. We believe cash flows for all of our integrated holdings will be meaningfully higher by 2017. These exploration and production companies have amassed sizable resource bases and have the ability to discover oil in the most profitable way – with the drill bit. These stocks trade at lower cash flow multiples than they deserve, in our view, making them a haven in fairly valued global markets.

Market Commentary

The market commentary expresses the portfolio managers' views as of 5/20/13 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.