Causeway

Emerging Markets: Shoot First; Ask Questions Later?

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INSIGHTS

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The calls by brokers to "reduce emerging markets exposure" are deafening. If you are a day trader or market timer, this commentary doesn't apply to you. For serious institutional investors (those who recognize that markets are often remarkably inefficient at pricing risk), read on. As outlined below, emerging markets have plenty of challenges, but valuations most likely already discount this sobering environment. Ultimately, revitalized US and European economies will do much good for the emerging countries, stimulating demand globally.

The one, three, and five-year underperformance of the MSCI Emerging Markets index versus the developed markets index (MSCI World) reflect both a de-rating of underlying stock prices and a stampede out of several emerging markets currencies in the past year. The 2013 year-to-date devaluation of the Indian rupee and the Brazilian real (each down 15% versus the US dollar) appear symptomatic of a classic emerging markets crisis, typically linked to US Federal Reserve policy and the US dollar. According to BCA Research, "The 1994-95 Mexican crisis, the 1997 Thai baht fallout and the crises in Brazil, Argentina and Turkey between 1998 and 2002 were all heavily influenced by Fed monetary tightening, rising US bond yields and/or strengthening US. dollar." BCA notes that, "Recent US dollar strength, the sharp rise in US Treasury yields and the Fed's 'taper' talk have had much to do with the sudden deterioration in liquidity conditions in emerging markets in general and in India's financial system in particular, creating the catalyst for capital flight and turmoil in foreign exchange markets."

Deceleration of Chinese growth is the other major wet blanket weighing on emerging markets' performance. In the wake of two decades of massive expansion, as well as a post-2008 borrowing binge, Beijing appears committed to restructuring the domestic Chinese economy. The central government has set itself the challenging goal of reducing the economy's reliance on credit- and government-led capital spending. Deleveraging – or digestion of a credit binge – has definitely taken away the Chinese punch bowl. Both the provincial

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governments and Chinese corporates (those dependent on investment-led spending) may have inadequate levels of cash flow to service their debt. We believe the Chinese central government wants domestic credit conditions to tighten. With slowing credit growth (from a currently unsustainable 20% per annum), the Chinese economy will barely deliver the prescribed 7% plus annual growth over the next several years. Accordingly, Chinese stocks have underperformed the World Index for two of the past three calendar years, and for 2013 to date, trail the World Index by over 21%.

Unconventional and expansionary monetary policy in the US and in Europe not only helped revitalize the west, but also added rocket fuel to emerging markets capital inflows. We are reminded of the European Central Bank's efforts to help the "Sick Man of Europe" (Germany) in 2000-2008 that sent the more vital Ireland and Spain into asset price inflation. One single monetary policy definitely doesn't fit all. Ultimately, borrowing binges come to an end, and over-investment reverses. Countries with the largest current account deficits usually incur the greatest magnitude of domestic currency depreciation to rectify the imbalance, with rising productivity and enhanced export competitiveness. The emerging markets currencies presently under siege include the Indian rupee, Indonesian rupiah, South African rand, and Brazilian real. In the post-2008 period, these countries became dependent on inflows of foreign capital. Interest rates must rise in these profligate countries to re-attract capital inflows, and stabilize foreign exchange (FX) rates.

We take some comfort in the fact that most of the affected emerging countries have considerably larger stores of FX reserves than in the Asian crisis of the late 1990s. In that period, the Thai baht and the Malaysian ringgit plunged 40-50%, while real interest rates shot well above levels seen currently. According to Bloomberg data, today, Brazil has reserves of $373 billion, more than 7.5 times its reserves in the late 1990s. India and South Africa also show high FX reserve levels compared to historical levels. Indonesia has seen the greatest depletion of its reserves (approximately 25% off the late-2011 peak), but still holds about $93 billion, compared to around $20 billion in the late 1990s. These significant reserves can be used to combat currency volatility. In places like Brazil where inflation is a concern, central banks also will be inclined to increase rates, providing additional currency support. Although interest rate increases can suppress near-term growth, governments may choose to deploy abundant FX reserves to convert a dramatic currency scare into a modest growth scare. Furthermore, real effective exchange rates, determined by a country's trading partners and adjusted for inflation, show that most emerging

markets currencies (except China) remain undervalued versus the US dollar on a purchasing power parity basis.

What the blaring broker "sell" calls don't mention is the following: cyclical stocks (or markets) reach a floor many months before even the slightest hint of recovery becomes apparent. In other words, one must buy early to reap the lowest-risk portion of the equity up cycle. Never lose sight of valuation, because – at some sustainable valuation floor – the risk of investing early becomes modest. Preferably, early purchases bring dividend income, paying investors to wait until the beleaguered markets return to popularity.

Where are we in late August in terms of emerging markets valuations? A simple comparison of valuation characteristics of the emerging markets versus US stocks should raise a few eyebrows. Let's start with price-to-book value, now 2.5x for the US market, and 1.5x for emerging markets. As for trailing 12-month price-to-earnings, the ratio for the United States is 17x, versus 12x for emerging. We can also compare analysts' forecast long-term earnings growth rates: the emerging markets offer 12% per annum over the next business cycle, versus 11% for the United States. Yes, that's correct. The emerging markets offer more growth (based on industry analysts' forecasts) at a considerably lower price. What magnitude of emerging markets rebound might we expect, you ask? From the three most recent emerging bear markets, we have seen the following:

	8/31/1998	9/30/2001	2/27/2009	CURRENT (7/31/2013)	MONTHLY AVERAGE SINCE 12/31/1995
EM UNDERPERFORMANCE					
(MSCI EM-MSCI USA, 1-Year Trailing)	-60%	-6%	-13%	-23%	-
PRICE/BOOK					
EM	0.9x	1.2x	1.3x	1.5x	1.8x
US	4.0x	3.0x	1.5x	2.5x	3.1x
PRICE/EARNINGS					
EM	12.5x	10.8x	7.9x	11.9x	15.5x
US	22.7x	27.8x	11.9x	17.4x	21.0x
FORECAST LONG-TERM EARNINGS GROWTH					
EM	17.0%	16.9%	10.3%	12.2%	16.6%
US	14.0%	14.8%	10.3%	11.2%	12.8%
USA YIELD CURVE SLOPE	15	222	276	254	164
(10 yr- T-Bill, basis points)					
SUBSEQUENT EM OUTPERFORMANCE					
(MSCI EM-MSCI USA, 3-Year Cumulative)	+11%	+88%	+35%	?	-

Source: FactSet; EM=MSCI EM Index, US= MSCI US Index

Causeway's International Opportunities clients currently remain underweight versus the emerging markets weight in the MSCI All Country World Index ex US. However, recent weeks have brought more encouraging factors for boosting that emerging allocation, such

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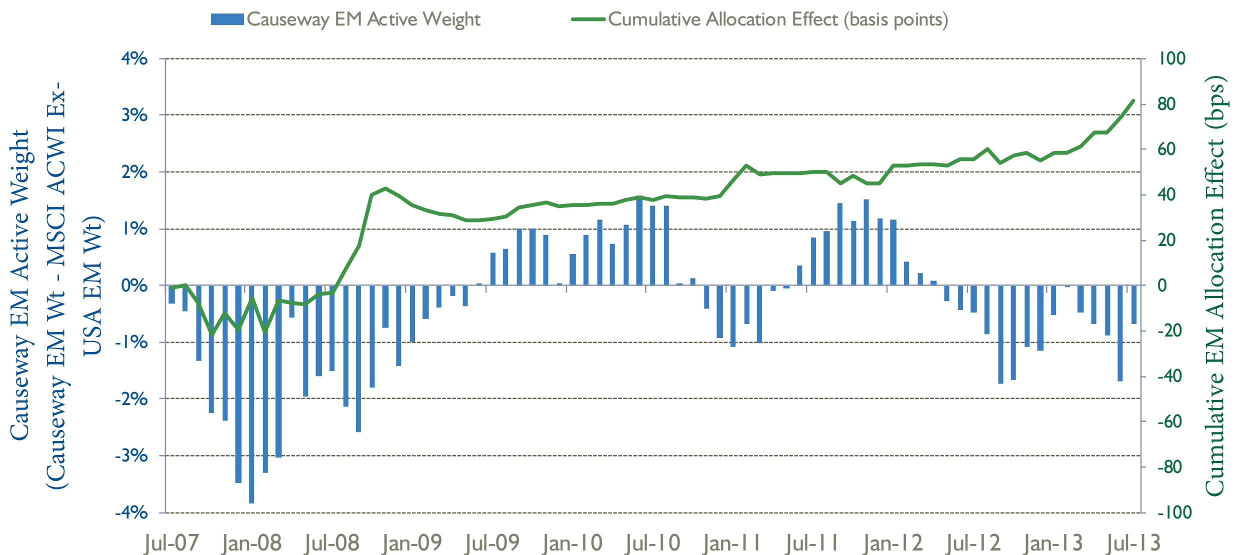
as an improvement in earnings updates for emerging stocks, and a more attractive valuation versus developed. An upward sloping global yield curve is another positive for emerging markets, as global growth may have a rosier period ahead. Causeway uses this allocation model as a tool of gradualism, allowing indicators to settle and establish a sustainable pattern.

CAUSEWAY'S EMERGING MARKETS ALLOCATION HAS ADDED VALUE

EMERGING MARKETS ACTIVE WEIGHT AND CUMULATIVE EMERGING MARKETS ALLOCATION EFFECT:
International Opportunities Composite, Inception* -July 31, 2013



**Inception date June 30, 2007. Source: Causeway analytics. "Cumulative Allocation Effect" is the percentage added to or detracted from overall composite performance, gross of fees, attributable to the strategy's emerging markets active weight.*

Well-timed allocation decisions have augmented the performance of our International Opportunities strategy. Our dynamic approach to weighting the emerging markets exposure allows us to take greater advantage of emerging markets opportunities, or scale back our exposure when emerging markets appear overvalued and high risk. At present, we like what we see in the numbers underpinning our allocation model. In addition, with a 2.8% average weighted dividend yield in emerging markets, the payment to wait looks reasonable relative to 2.1% for the US and 2.6% for the developed world. With that in mind, we can be even more patient anticipating recovery while collecting a significant portion of the return up front. If these encouraging relative valuation and macro-economic trends continue, we will thumb our noses at the calls to "sell." History and today's data support our instincts that it is too late to sell, and may be just the right time to buy.

Causeway Emerging Markets Equity

STRATEGY HIGHLIGHTS

Philosophy

- Actively managed, tracking-error oriented, quantitative emerging markets strategy
- Combines bottom-up and top-down factors in security selection
- Risk control:
  -Constrain country/sector weights versus benchmark
  -Use proprietary quantitative tools

Process Highlights

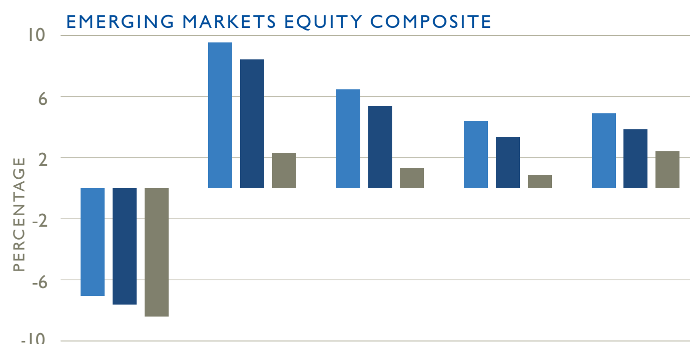
- 24 emerging markets
- 1,200 stock universe
- Employ stock ranking and risk models designed for emerging markets
- Use optimization to maximize expected return per unit of risk

Portfolio Managers

- Arjun Jayaraman, MacDuff Kuhnert

PERFORMANCE *(as of 7/31/13)*

Annualized for periods greater than one year



	YTD	1 YEAR	3 YEARS	5 YEARS	INCEPTION*
Causeway gross	-7.1	9.5	6.5	4.4	4.9
Causeway net	-7.6	8.4	5.4	3.3	3.8
MSCI EM	-8.4	2.3	1.3	0.9	2.4

*Inception: April 30, 2007

Important Disclosures

The Firm, Causeway Capital Management LLC ("Causeway"), is organized as a Delaware limited liability company and began operations in June 2001. It is registered as an investment adviser with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940. Causeway manages international, global, and emerging markets equity assets for corporations, pension plans, public retirement plans, sovereign welath funds, Taft-Hartley pension plans, endowments and foundations, mutual funds, charities, private trusts and funds, wrap fee programs, and other institutions. The firm includes all discretionary and non-discretionary accounts managed by Causeway.

Causeway claims compliance with the Global Investment Performance Standards (GIPS®).

The Emerging Markets Equity Composite includes all U.S. dollar denominated, discretionary accounts in the emerging markets equity strategy. The emerging markets equity strategy seeks long-term growth of capital through investment primarily in equity securities of companies in emerging markets using a quantitative investment approach. The benchmark is the MSCI Emerging Markets Index.

New accounts are included in the Composite after the first full month under management. Terminated accounts are included in the Composite through the last full month under management. Account returns are calculated daily. Monthly account returns are calculated by geometrically linking the daily returns. The returns of the Composite are calculated monthly by weighting monthly account returns by the beginning market values. Valuations and returns are computed and stated in U.S. dollars. Returns include the reinvestment of interest, dividends, and any capital gains. Returns are calculated gross of withholding taxes on dividends, interest income, and capital gains. The firm's policies for valuing portfolios, calculating performance, and comparing compliant presentations are available upon request. Gross-of-fees returns are presented before management, performance-based and custody fees, but after trading expenses. Net-of-fees returns are presented after the deduction of actual management fees, performance-based fees and all trading expenses, but before custody fees. Causeway's basic management fee schedules are described in its firm brochure pursuant to Part 2 of Form ADV.

Past performance is no guarantee of future performance. In addition to the normal risks associated with investing, international investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index, designed to measure equity market performance in the global emerging markets. MSCI has not approved, reviewed or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. You may not redistribute the MSCI data or use it as a basis for other indices or investment products.

Contact Sarah Van Ness at 310-231-6127 or vanness@causewaycap.com to request a complete list and description of firm composites and/or a presentation that adheres to the GIPS® standards.

Market Commentary This market commentary expresses Causeway's views as of 8/28/13 and should not be relied on as research or investment advice regarding any stock. These views are subject to change. There is no guarantee that any forecasts made will come to pass.