Beyond Boundaries: The Case for Global Equity

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"*When a man has put a limit on what he will do, he has put a limit on what he can do.*"
– Charles M. Schwab

From Causeway's inception in 2001, we embraced global equity as an alternative to the constrained international equity mandates requested by the vast majority of our clients. We recognized the benefits of screening globally for undervaluation among the world's best-run companies. The developed global investable universe is comprised of over twice the number of companies in the developed international universe. As a result, global has the potential to deliver significant performance advantages versus international. However, when we first launched global value equity over 12 years ago, we did not fully anticipate the potential of investing in global versus international developed markets. Although more efficient, on average, than its foreign peers, the US equity market invariably offers opportunities to exploit mispricing. The breadth and depth of the US equity market lends itself well to a developed markets portfolio without geographic limits. Unlike a dedicated US equity portfolio, a global portfolio may hold varying amounts of US-listed stocks. From a bottom-up

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perspective, we compare the risk-adjusted total return potential of the US-listed stocks to non-US alternatives. If given the choice, we prefer global equity mandates over international for their flexibility and their greater number of potential investment candidates.

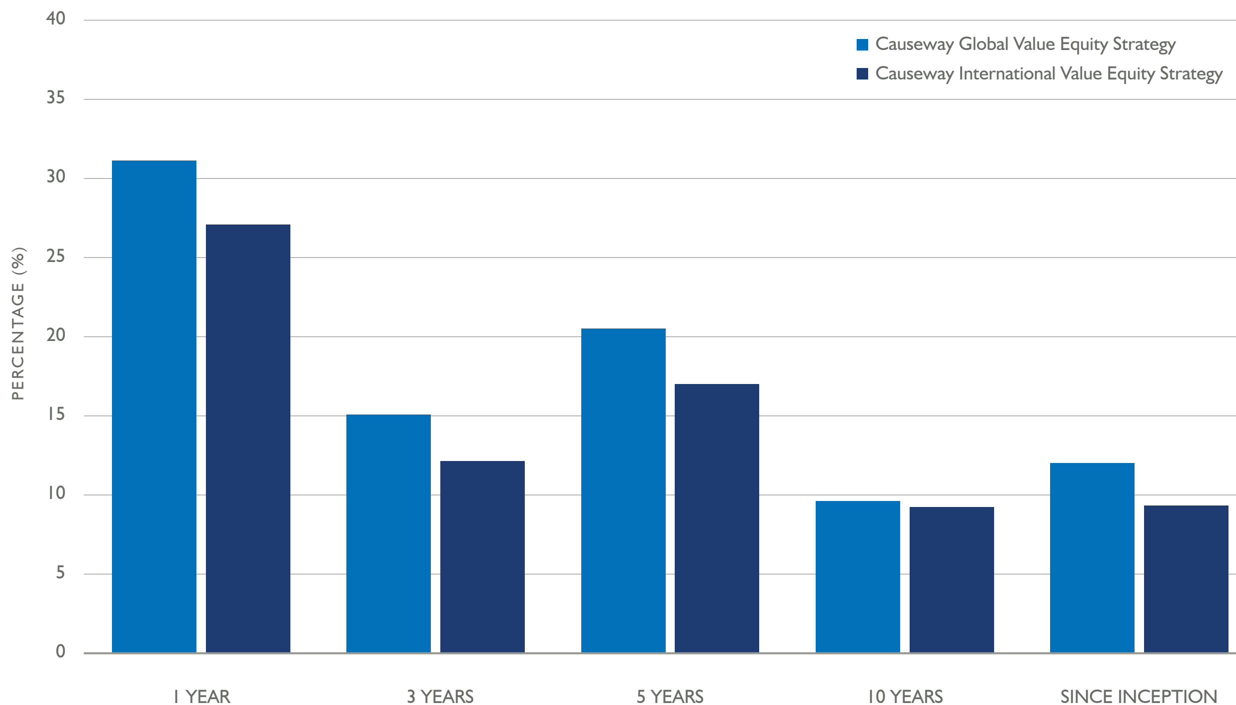
The arguments for separating US and non-US equities typically revolve around a misguided notion of diversification. Today, many US-domiciled investors still think of their US equities as "core," and international equities as something different, unrelated to the US market. We argue just the opposite. High (and increasing) correlations of US and non-US equity returns imply that global factors eclipse local factors in driving developed market returns. Over the past 20 years, we have observed that industry-specific valuation differences in the developed markets have narrowed – and often vanished – across borders. Multi-national and/or exporting companies in the same industry, regardless of geographic domicile, share similar opportunities for growth. Efforts by investors to partition US from non-US developed markets also stemmed from a notion of specialization. How could an expert in non-US developed markets also succeed in the US market – and vice versa? Yet, we note, if research analysts do not span the globe, how can they ever understand fully their industries and the competitive environment? We believe that our analysis must compare political, regulatory and social changes impacting companies in one country/region, and weigh the possible contagions to other regions.

To explore this comparison of global versus international, we spoke to Causeway fundamental and quantitative portfolio managers, Jamie Doyle and Joe Gubler.

Jamie and Joe, what evidence do you have in favor of giving an asset manager geographic discretion?

JD: I always start with Causeway's own track record. Our global value equity strategy has delivered an annualized 12%, net of fees, and returned 4.5% in excess of the MSCI World Index (to 12/31/13). This compares favorably with Causeway's international value equity strategy, which does not invest in the US, with an average annual return since inception of 9.4% and alpha of 3.1% versus the MSCI EAFE Index. For a bigger picture, we compared a universe of global portfolios to their international and US peers. The comparison corroborated our own positive experience with global equity.

FIGURE 1: CAUSEWAY GLOBAL AND INTERNATIONAL VALUE COMPOSITE RETURNS (NET OF FEES) AS OF 12/31/2013



Causeway Global Value Composite Inception: 9/30/01; Causeway International Value Composite Inception: 6/11/01. Annualized for periods greater than one year. Past performance is no guarantee of future performance. See end of newsletter for important disclosures. This information supplements the composite presentation at the end of this report.

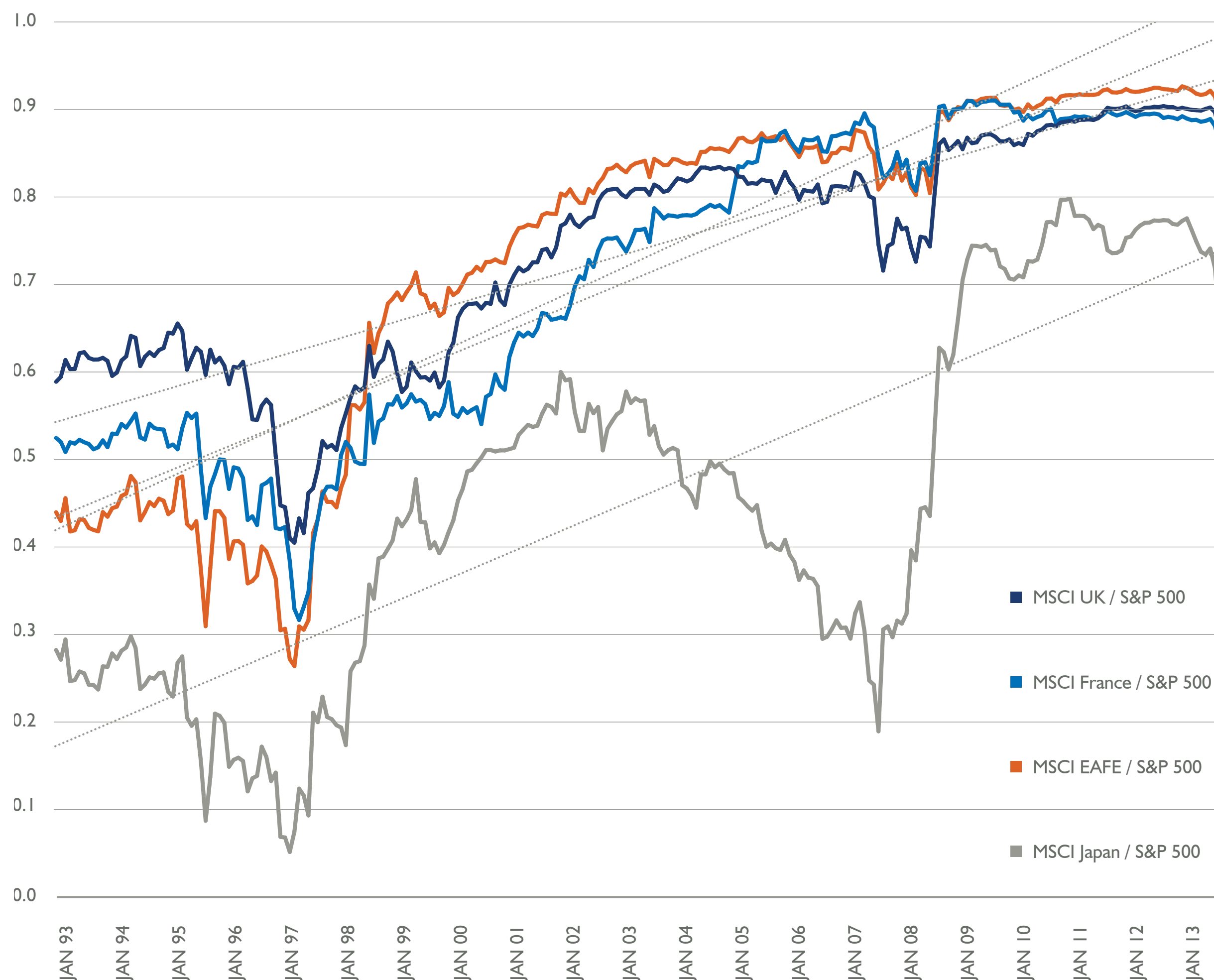
FIGURE 2: A BROADER GEOGRAPHIC MANDATE HAS TRANSLATED INTO MORE ALPHA

10 YEAR ALPHA BY MANAGER UNIVERSE

	GLOBAL LARGE CAP	FOREIGN LARGE CAP	US LARGE CAP
25th Percentile	2.4%	1.1%	2.0%
Medians	1.2	0.4	1.0
75th Percentile	0.1	-0.5	0.1
Number of Porfolios	122	121	791

Source: eVestment. Returns are gross of management fees. Data as of September 30, 2013. Excess returns are presented before fees. The Global Large Cap universe returns are benchmarked to the MSCI World Index, the Foreign Large Cap returns to the MSCI EAFE Index, and the U.S. Large Cap returns to the S&P 500 Index.

FIGURE 3: DEVELOPED MARKET CORRELATIONS HAVE INCREASED STEADILY ROLLING 60-MONTH CORRELATIONS, JANUARY 1993-NOVEMBER 2013



MSCI and S&P 500 Indices. Data source: FactSet

JG: As for the benefit of separating non-US and US equity exposures to reduce volatility, only the Japanese market still appears to provide some element of diversification in a rolling 60 month analysis. If we shorten the regression to the past decade and past five years, we see that benefit of adding Japanese stocks eroding. As the diversification benefit of investing across developed markets diminishes, it becomes more important for managers to make intelligent risk/return tradeoffs within the portfolio across other dimensions of risk. A manager with a single global mandate has more flexibility to do this than multiple managers with separate US and non-US portfolios.

JD: For our clients who want maximum equity diversification, we can also combine our global developed markets equity with our emerging markets strategy (what we call the Causeway global opportunities strategy), benchmarked to an all-country benchmark, such as the MSCI All Country World Index (ACWI). In a 2011 paper by Bekaert et al, the authors reveal the convergence of earnings yields of stocks in developed countries relative to the yield of the MSCI World Index from the early 1970s to 2005. Emerging markets, however, have not exhibited the same integration, and they continue to offer diversification benefits versus developed markets.

Jamie, how can clients understand their portfolios' geographic exposures?

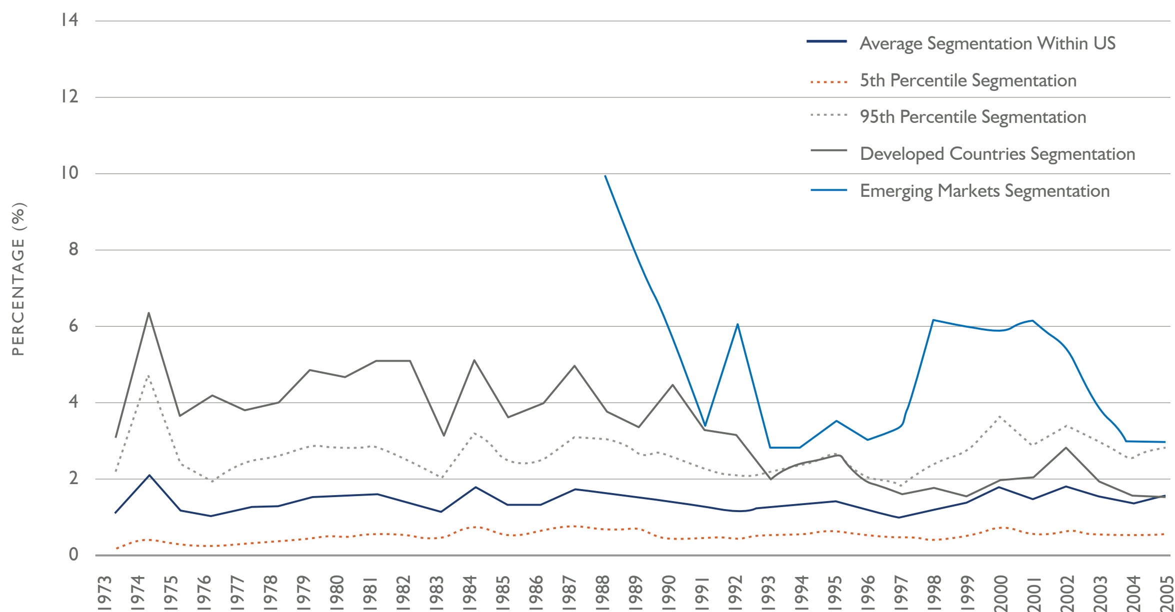
JD: Causeway uses a proprietary multi-factor risk model to help our fundamental portfolio managers use diversification as a tool to lower prospective volatility of returns. However,

Over time, we expect that many of our clients will desire the benefits of a geographically-limitless portfolio, one that takes full advantage of all of Causeway's detailed research and experienced stock selection.

few clients want to dive into the statistics and evaluate the region and currency factors in our model. As an alternative, we provide clients with the revenue breakdown of the companies that comprise their international and global portfolios. It might be surprising for clients to realize that their "international" portfolio is filled with companies generating 23% of sales in North America and 15% in emerging markets. Even though the EAFE Index appears somewhat similar in revenue split, this revelation can be disquieting for clients who place their equities in geographic silos.

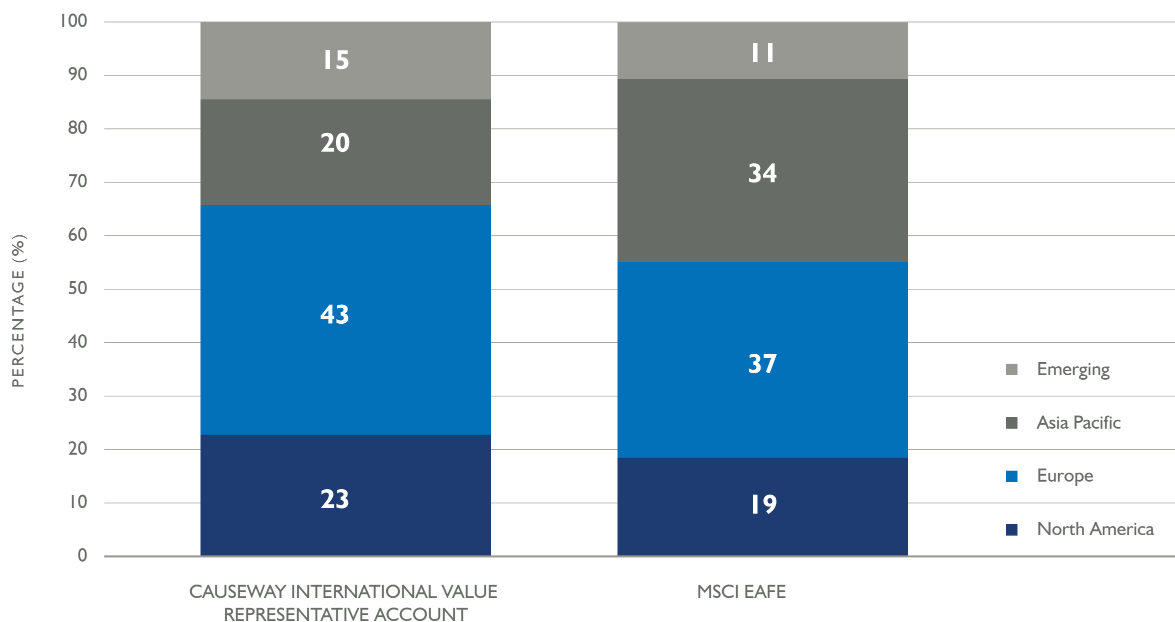
Confidence in our global research allows us to concentrate the number of stocks in our global portfolios. With such a large investable universe, global provides the potential to achieve lower levels of volatility than in international equity. As a research team, we are not surprised by the borderless nature of many companies. The better-managed companies will continue to expand wherever they can benefit their shareholders. In response to this corporate diaspora, we must continue to measure our portfolio's ever-changing geographic risk. Over time, we expect that many of our clients will desire the benefits of a geographically limitless portfolio, one that takes full advantage of all of Causeway's detailed research and experienced stock selection – and one that does not restrict us to less than half of the developed markets universe. US versus non-US segmentation can constrain performance and may not achieve the diversification goal. As for a New Year's resolution, we suggest, "Go Global."

FIGURE 4: RESEARCH FINDS DEVELOPED COUNTRIES EFFECTIVELY INTEGRATED SINCE 1993
EARNINGS YIELD DIFFERENTIALS (RELATIVE TO WORLD LEVELS)



Source: Bekaert, Geert and Harvey, Campbell R. and Lundblad, Christian T. and Siegel, Stephan, What Segments Equity Markets? (February 1, 2011). The authors define "segmentation" as the market capitalization-weighted sum of the differences between local and global industry earnings yields for companies domiciled in each geographic region. The U.S. market is used as a relative benchmark for integration due to its position as the world's largest. The 5th and 95th percentiles represent confidence intervals to account for random effects of earnings differentials within the U.S. market.

FIGURE 5: REGIONAL BARRIERS HAVE COLLAPSED IN THE BUSINESS WORLD
REGIONAL REVENUES



Data source: FactSet, Bloomberg, Causeway Analytics. Causeway estimates are based on latest available revenues reported by companies in the portfolio on 9/30/13, proportionate to holding weights. Israel is classified as emerging.

Market Commentary

The market commentary expresses the portfolio managers' views as of 12/31/2013 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.