Causeway

Broken Mirror: Better Times Ahead for Emerging Markets Equity?

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> NEWSLETTER

Emerging markets equities have certainly cracked from a valuation perspective and trade at a price-to-earnings ratio over 30% lower than developed markets – the largest valuation gap since mid-2005.

After six cumulative years of lagging returns versus the MSCI World, MSCI EAFE and the S&P 500 Indices, one might ask, why bother with emerging markets? What will break the spell and reverse the post-2007 overall period of underperformance? Emerging markets equities have certainly cracked from a valuation perspective and trade at a price-to-earnings ratio over 30% lower than developed markets – the largest valuation gap since mid-2005. Some of the performance drag reflects a loss of investor confidence, as several emerging markets are burdened by economic and/or political setbacks. However, the current economic travails of many emerging markets are not unusual. These countries have spawned domestic private and public sector credit excesses in prior cycles, leading to substantial – albeit temporary - market volatility. Political tensions, such as the recent conflict in the Ukraine, are typically buying opportunities, not reasons to abandon the asset class.

Despite the recent outflow of funds from emerging markets, Causeway currently favors an increasingly larger allocation to the asset class in its global opportunities strategy. We use the MSCI All Country World Index, with its 10% emerging markets weight as a starting point. In a global context, Causeway's allocation model favors emerging markets as a result of attractive relative valuation and earnings growth characteristics versus developed markets, improving macroeconomic factors and the rising level

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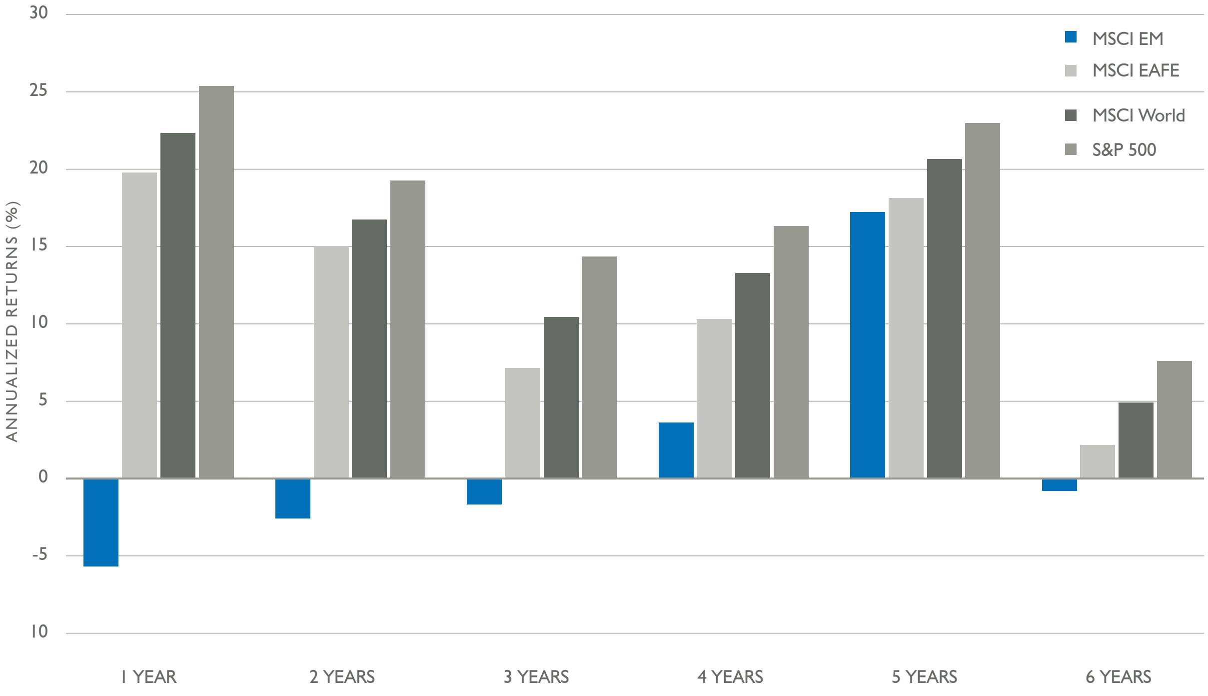
FIGURE 1: EMERGING MARKETS HAVE LAGGED DEVELOPED MARKETS FOR SIX YEARS

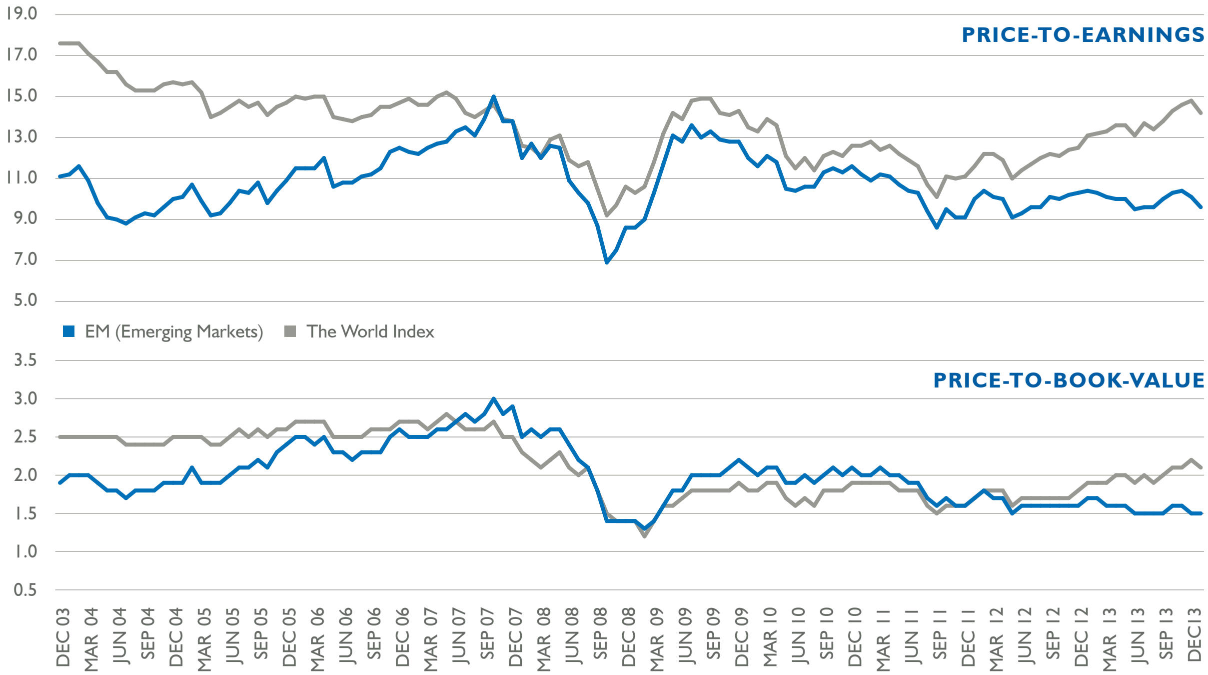


Source: FactSet; Data as of 2/28/2014

of global risk aversion (measured by the CBOE Volatility Index (VIX) and the emerging market bond index yield spread over US Treasury bonds). Admittedly, we are adding emerging markets exposure very gradually to client portfolios in our global and international opportunities strategies. Due to the importance of the "top-down" asset allocation decision, we must answer the following questions: How much of the decline in relative real gross domestic product (GDP) growth rates (emerging versus developed markets) is cyclical versus structural? To what degree can we rely on historical valuations of these markets– especially if structural changes are occurring?

Emerging markets achieved their best performance on record from 2002-2007 when the MSCI Emerging Markets Index rose by a cumulative 361%. The developing regions boasted

FIGURE 2: EMERGING MARKETS ARE TRADING AT A MULTI-YEAR VALUATION DISCOUNT TO DEVELOPED MARKETS



Source: FactSet; Earnings are one-year forward estimates

improving external and fiscal balances, as well as rapid growth in sales and earnings.

Since then, imbalances have widened again for several emerging countries due to rapid credit-fueled domestic demand growth and weak domestic demand in the United States, Europe and Japan. As the overall trade surplus in the developing countries has fallen, much of the emerging bloc has receded into current account deficit (importing more than they export), with a few countries suffering from serious external imbalances (Turkey, South Africa, Brazil, and India, for example). To add insult to injury, foreign investors aren't waiting to see how it all pans out. When investors get nervous, they run for the exits. Emerging markets are paying the price for exchange traded fund (ETF) liquidity—suffering volatility inflamed by the ability of

Remember that stock markets discount future events well in advance. Markets will reflect any economic recovery in the emerging countries several quarters before we see the improvement in the data.

investors to sell ETFs quickly. Of the 22% drop in the net assets of the iShares MSCI Emerging Markets ETF in 2014 to date, only 6.5% is due to the total return of the fund. Outflows explain the bulk of the shrinkage in net asset value. We estimate that two prominent emerging markets ETFs lost $25 billion—more than 20% of their net assets—to outflows in 2013 and this year to date, combined.

To explore the cyclical versus structural question in emerging markets, we spoke to Causeway portfolio managers Arjun Jayaraman, Duff Kuhnert, and Joe Gubler.

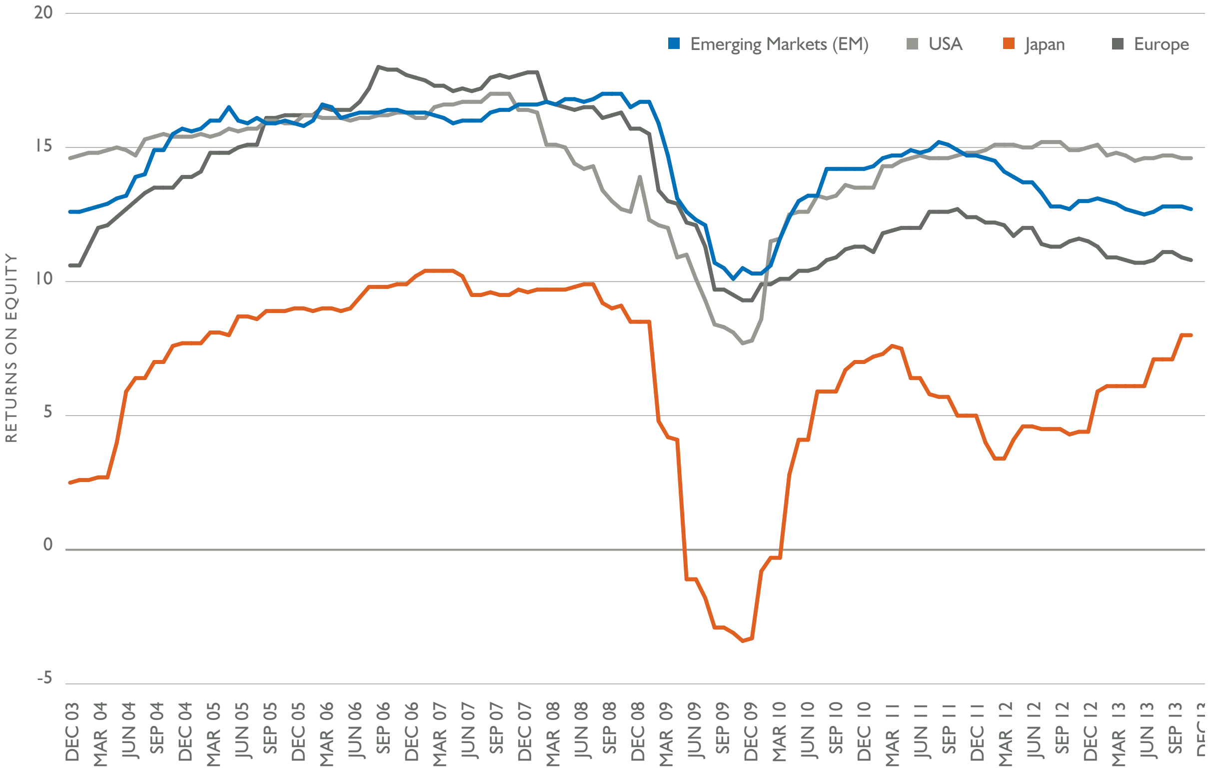
Arjun, at what point will emerging markets become cheap enough to warrant a more aggressive allocation than you currently advocate for Causeway's international and global opportunities clients?

AJ: The valuation discount, plus the earnings momentum and increasing global risk aversion factors, have tipped our asset allocation model to favor an overweight in emerging markets. As with any economic down cycle, adjustments invariably occur. To cure for credit excesses, central banks in the inflation-plagued countries have started a phase of monetary and credit contraction—and that dampens economic activity. The tight credit conditions should ultimately force companies to boost productivity and enhance returns on capital to re-attract foreign investment. With inherent growth advantages versus the developed world, the emerging countries are magnets for foreign capital. In a few years, asset prices should increase again as credit expands. That's the cycle. Remember that stock markets discount future events well in advance. Markets will reflect any economic recovery in the emerging countries several quarters before we see the improvement in the data.

But what has changed about the emerging markets since 2007 that explains their disappointing cumulative returns?

DK: Some critics claim that many emerging markets currently suffer from low and declining returns on capital, a byproduct of unsustainably fast growth. Inefficient investment typically leads to sinking returns on investment, triggering capital flight (from a low-return region) to one offering better returns. We do not expect this situation to persist. Although returns on equity (ROEs) in emerging markets have not recovered to pre-2008 levels, they are still above longer-term averages, and are superior to ROEs in Europe and Japan. Narrowing profit margins have played the key role in the depressed emerging market ROEs in the past few years, as tight labor market conditions prompted wage increases. We believe this trend is cyclical, not structural. Some of the larger emerging markets countries, such as Brazil and China, avoided the worst of the 2008 financial crisis and subsequently boomed, creating upward wage pressure. In the meantime, the slow recovery in the developed world led to large productivity gains and weak wage gains (causing developed market margins to expand). For those companies competing on a global scale, the natural selection of markets will favor those firms achieving increases in productivity, allowing them access to low-cost capital. Over the next few years, we expect the profit margin difference between emerging and developed markets companies to narrow. Regardless, emerging markets companies retain a clear advantage versus developed peers in terms of revenue growth. Overall, financial leverage is also significantly lower in emerging markets relative to the developed world. As capital markets continue to develop and strengthen in emerging economies, leverage should increase, providing further support to ROEs of companies in emerging markets.

FIGURE 3: DESPITE CYCLICAL PRESSURES, EMERGING MARKETS COMPANIES EARN COMPETITIVE RETURNS ON EQUITY



Source: FactSet

AJ: As economies mature, low return investments naturally attract less capital than those with high returns. This is a normal path of development, and we believe not a structural flaw with emerging markets.

JG: Many emerging country currencies have devalued versus the US dollar over the past three years. This should help reverse the negative current accounts and improve the competitiveness of these countries. Indonesia, for example, has seen a fall of 17% in the rupiah versus the dollar over the past year, coinciding with a narrowing of the country's trade deficit. Brazil's trade account is roughly in balance, although its current account is slightly negative. In contrast, South Africa and Turkey each have a steeper road ahead economically. However, they also have some of the most favorable demographics.

You haven't yet mentioned China. Are its problems also cyclical – and temporary?

AJ: The changes in the Chinese economy, including the shift from export-driven to consumer led- are structural, and will take many years. The country still has a positive current account balance. I admit that the rising levels of public and private sector debt are concerning. The question we ask ourselves is whether China has a probability of experiencing a collapse of its financial system. China's rapidly expanding shadow banking sector includes trust (savings) products, which will likely experience debt defaults. But problems in the shadow banking sector don't appear large enough to topple the country's planned economy and disrupt its (closed) capital account.

JG: According to data from BCA Research, the total size of assets managed by various Chinese financial institutions has risen from RMB8 trillion in 2008 (less than 40% of household bank deposits) to RMB36 trillion in 2013 (77% of household savings deposits). To put that in perspective, at about 30% of the formal banking sector, the Chinese shadow banking system is far smaller than in most other major economies.

DK: We are watching this situation carefully. China has enjoyed tremendous growth in household wealth. The Chinese have invested their savings in all sorts of domestic projects in real estate and infrastructure, as well as directly in domestic companies. When investments sour, especially the local government infrastructure projects, we expect the central government to backstop the credits. Our confidence in the valuations of Chinese stocks is closely linked to the fiscal strength of the nation.

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 wealth 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 International Value Equity Composite ("International Composite") includes all U.S. dollar denominated, discretionary accounts in the international value equity strategy, which do not apply a minimum market capitalization requirement of $2.5 billion or higher ($5 billion or higher prior to November 2008), permit investments in South Korean companies after October 2003, do not regularly experience daily external cash flows, and are not constrained by socially responsible investment restrictions. The international value equity strategy seeks long-term growth of capital and income through investment primarily in equity securities of companies in developed countries located outside the U.S. From June 2001 through November 2001, the International Composite included a non-fee-paying account with total assets of approximately $2 million. This was the sole account in the International Composite from June through September 2001. The account was included in the International Composite at account inception because it was fully invested at inception. The benchmark is the MSCI EAFE Index.

The Global Value Equity Composite ("Global Composite") includes all U.S. dollar denominated, discretionary accounts in the global value equity strategy which are not constrained by socially responsible investment restrictions. Through March 30, 2007, Causeway managed the Global Composite using research and recommendations regarding U.S. value stocks from an unaffiliated investment advisory firm under a research services agreement for an asset-based fee. The global value equity strategy seeks long-term growth of capital and income through investment primarily in equity securities of companies in developed countries located outside the U.S. and of companies located in the U.S. The benchmark is the MSCI World Index.

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.

The International Opportunities Composite includes all U.S. dollar denominated, discretionary accounts in the international opportunities strategy. The international opportunities strategy seeks long-term growth of capital through investment primarily in equity securities of companies in developed and emerging markets outside the U.S. using Causeway's asset allocation methodology to determine developed and emerging weightings, and using Causeway's international value equity strategy or Causeway International Value Fund for the developed portion of the portfolio and Causeway's emerging markets strategy or Causeway Emerging Markets Fund for the emerging markets portion of the portfolio. The benchmark is the MSCI All Country World Index ex U.S.

The Global Opportunities Composite includes all discretionary accounts in the global opportunities strategy. The global opportunities strategy seeks long-term growth of capital through investment primarily in equity securities of companies in developed and emerging markets outside the U.S. and of companies located in the U.S. using Causeway's asset allocation methodology to determine developed and emerging weightings, and using Causeway's global value equity strategy or Causeway Global Value Fund for the developed portion of the portfolio and Causeway's emerging markets strategy or Causeway Emerging Markets Fund for the emerging markets portion of the portfolio. The benchmark is the MSCI All Country World Index.

The Global Absolute Return Composite" includes all discretionary accounts in the global absolute return ("GAR") strategy. The GAR strategy seeks long-term growth of capital with low or no correlation to the MSCI World Index through investment in long and short exposures to common and preferred stocks of companies in developed countries located outside the U.S. and of companies located in the U.S. The benchmark is the BofA Merrill Lynch 3-Month U.S. Treasury Bill Index. The GAR strategy takes long and short positions in securities directly and/or using swap agreements. The strategy will use leverage up to four times total assets. The use of leverage is speculative and will magnify any losses. Short positions will lose money if the price of the underlying security increases, and losses on shorts are therefore potentially unlimited. The strategy involves significant expenses including financing charges and transaction costs which will reduce investment returns and increase investment losses. To the extent swap agreements are used, the strategy risks loss of the amount due under a swap agreement if the counterparty defaults. To the extent assets are held by a prime broker, recovery will be limited in the event of the prime broker's insolvency. The strategy involves liquidity risks since a portfolio may not be able to exit security exposures immediately, particularly during periods of market turmoil.

New accounts are included in the Composites after the first full month under management, except as noted for the International Composite above. Terminated accounts are included in the Composites 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 Composites 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 EAFE Index is an arithmetical average weighted by market value of the performance of approximately 1,000 non-U.S. companies representing 22 stock markets in Europe, Australasia, New Zealand and the Far East. The MSCI World Index is a free float-adjusted market capitalization index, designed to measure developed market equity performance, consisting of 24 developed country indexes, including the U.S. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index, designed to measure equity market performance in the global emerging markets. The MSCI All Country World Index ex U.S. is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets excluding the U.S. The MSCI All Country World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The BofA Merrill Lynch 3-Month U.S. Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. Each month the index is rebalanced and the issue selected is the outstanding Treasury Bill that matures closest to, but not beyond 3 months from, the rebalancing date. The Treasury Bills comprising the Index are guaranteed by the U.S. government as to the timely payment of interest and principal. While accounts in the GAR strategy may invest a portion of their assets in Treasury Bills, accounts will primarily be exposed to securities that will not be similarly guaranteed by the U.S. government. The Indices are gross of withholding taxes, assume reinvestment of dividends and capital gains, and assume no management, custody, transaction or other expenses. It is not possible to invest directly in these indices. Accounts in the Composites may invest in countries not included in their benchmark indices.

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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

The market commentary expresses the portfolio managers' views as of 2/28/2014 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.