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INTERVIEW

Volkswagen, China Mobile, and Other Far-Flung Bargain Stocks

Causeway Capital's Sarah Ketterer explains how the firm keeps beating its peers—and what it's buying now.

By Leslie P. Norton

For more than 15 years, Causeway Capital Management has reliably provided investors with disciplined exposure to out-of-favor foreign large-cap stocks. Co-founded by Sarah Ketterer and Harry Hartford, the Los Angeles–based firm has an excellent long-term track record, even though recent results have been weaker, owing to the vogue for growth.

Its flagship fund, Causeway International Value (ticker: CIVVX), has beaten its peers over one, three, five, 10, and 15 years, as well as this year. Many on the tight-knit team, including managers Jamie Doyle and Jonathan Eng, have been with the firm since its founding.

We asked Ketterer, 56 and Causeway's CEO, to take the pulse of the foreign stock markets, which have stormed higher this year. She emphasized the critical need for risk management today, and then supplied a number of cheap, financially sound contrarian plays that could weather a downturn. To learn of the charms of Volkswagen (VOW.Germany) and others, read on.

Barron's: What is value, Causeway-style?

Ketterer: Our definition often centers around unpopularity. Most companies can't sustain earnings growth indefinitely. They encounter a product lapse, or a macroeconomic issue, or complacency. You can point to a number of companies in the U.S. now whose industries attract more and more capital, which brings about a lot more competition. Suddenly, the returns start to go down. We like to find stocks that are falling apart, where the research analysts say there's no catalyst to be found, where revenues are shrinking or stalling and margins are contracting. As long as the balance sheets are strong, as long as there is significant financial strength versus peers, we're interested. What distinguishes Causeway is this fundamental research—understanding where a stock is in its valuation cycle—combined with quantitative risk management.

You co-founded Causeway in 2001. What's the biggest management-style adjustment you've made since then?

Back in 2001, we had a quant team of two people, and built on that. Coming out of the extraordinary mother of all financial crises in early 2009, we realized we needed more risk management. We put even greater emphasis on incorporating quantitative tools. Today, we have 31 investment staff members, including me, and nine are dedicated to quant research and portfolio management. One of the major byproducts of quant risk management is diversification. You might think that having stocks listed in different countries and different industries would take care of it, but it doesn't. Quant can see into a level of risk that's very difficult for a fundamental manager to gauge without those statistical tools.

Our funds attract investor attention because of our discipline and stability. We recognize that there are industries where research is evolving, and we are careful to avoid those with severe structural impediments. For example, we are very careful about media, that we don't get caught in companies that will have to spend a fortune just to survive.

We had a resurgence in value last year.

Then it reversed dramatically. It's not bad for us in international—we're keeping up with the benchmark, which I think is a victory, given that growth has clobbered value, year to date. The U.S. is a totally different story. If you're a value manager, you have a noose around your neck and the table was kicked out from under you. People really want growing revenue and will pay indiscriminately for it. There's a fair amount of passive money out there. So our quant tools ensure that we're not way out on the edge of a cliff. Taking a lot of risk right now, whether it be cyclical risk or any one of several quantitatively measured risk factors, is somewhat unwise, given the high level of markets and where we are in the monetary-policy cycle. We have to be fully invested, so we take risk off through intense diversification.

We've taken off quite a bit of European bank exposure over the past several months. Financials are almost always high-beta stocks, so they are a logical place to cut exposure after good performance. This is one of the most challenging times I can recall for us to ensure clients' downward protection. Yet we've been forced to own a disproportionately large number of cyclicals because they're more undervalued than the economically defensive stocks, which still trade at almost a 50% premium to their cyclical peers in the MSCI World Index. You see the conundrum.

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Where are the opportunities today?

At the end of 2016, Europe was one of the most undervalued markets anywhere in the developed world. That changed this year. Europe trades at 15 times next year's earnings, versus the Standard & Poor's 500 index, which is about 18. European companies have been restructuring and cost-cutting over the past several years. The activist investor has reached Europe—not just indigenous activists, but the Americans are there, too, and they smell blood.

The only sector anywhere in the world that really is cheap is energy. Many of these stocks are part of passive sell programs. The good old exploration-and-production companies are considered dead. We're interested in those that have strong balance sheets, excellent management, and, most importantly, really good-producing assets. I cannot say this at cocktail parties in California, but we will be using fossil fuel for years.

One smaller-cap U.S. company we like is PDC Energy [PDCE], which operates in the Wattenberg Field in Colorado and in the Delaware Basin. Like other well-managed U.S. shale peers, they can drill longer laterals, getting more yield. It trades at six times cash flow. We think production will grow 30%-plus a year between 2017 and 2019. They've hedged 72% of production at almost $54 a barrel. We also own Encana [ECA], which has a $10 billion market cap and operates in the Permian and the Eagle Ford and in the Montney section of Canada. Both PDC and Encana currently trade as if crude were at $30 a barrel, not $50. Encana has excellent capital discipline. Its valuation is remarkably low, and we don't need much in the way of oil price increases. This is like Causeway buying into pharmaceutical stocks two years ago, when prices meant you weren't paying for the research-and-development pipeline.

What else looks cheap?

Telecommunications. We like the Asian telecoms, particularly China Mobile [CHL], the gigantic state-owned beast. The minute I mention it, clients fall on the floor with boredom. It just paid a special dividend. The yield is now 7%. They're the dominant operator in China, with 800 million subscribers and the largest 4G network. There is so much free-cash generation that their balance sheet is brimming with cash. And they have money left over to build out their 5G mobile, which begins in 2019 and will be in full service by 2020. The one negative is you have to be in there with the Chinese government. Mobile penetration still has room to go in China. We think revenue growth will be greater than gross domestic product, which means that China Mobile's dividend can grow 5%-plus a year or more. It's in the $80s now and could trade into the hundreds. It could return in the low teens per annum—very attractive.

What's your investment thesis for Akzo Nobel [AKZA.Netherlands], the chemicals company?

Nothing gets us more excited than when we discover undervaluation and another entity affirms this with a bid. In this case, PPG Industries [PPG] became a suitor for Akzo Nobel. A combination would have led to cost and revenue synergies that Akzo couldn't recreate on its own. Akzo's management spurned the offer. But now, the CEO has abruptly resigned, due to health reasons. PPG can't make another bid [under Dutch market rules] until November. Akzo has to have a plan to create shareholder value equivalent to what they've turned away. We don't think they can come close to doing it. The stock trades at nine times enterprise value to earnings before interest, taxes, depreciation, and amortization for 2018 and has a free-cash-flow yield of 5%.

Let's say PPG says it isn't interested anymore. If there is any type of significant slowdown, there may be another bid.

Akzo has excellent financial strength and attractive market share, particularly in paints and coatings in the emerging world, and removing its nine billion euro specialty-chemical business and returning the proceeds to shareholders would be very good. The stock is up 30% this year. We're looking at returns in the high-single digits over the next couple of years. That may not sound astonishing, but the downside protection is of interest. There's room for more income, and the stock will likely hold its value.

You doubled down on Volkswagen after Dieselgate. Why?

Volkswagen is one of our largest holdings. The stock trades at five times next year's earnings, while Europe trades in the mid-to-high teens. Where is cheap enough? That's a question. We bought the stock in the first quarter of 2015 on the thesis VW would show progress on its bloated cost base. Unfortunately, Dieselgate happened in September 2015. The share price went down 35% over two days. We huddled and looked carefully at past recalls and got estimates of possible damages and other costs. There was enough margin of safety. So we decided to own a lot more of it. Our financial-strength criteria make a big difference.

Ketterer's Picks

Company / Ticker	Recent Price
PDC Energy / PDCE	$43.59
Encana / ECA	10.44
China Mobile / CHL	51.93
Akzo Nobel / AKZA.Netherlands	€77.83
Volkswagen / VOW.Germany	139.36

Source: Bloomberg

The business is now showing a lower cost base and better profitability. Operating and profit margins in the mass VW brand had been half that of its peers. Dieselgate accelerated the need for restructuring. They were late in launching SUVs. Now, in the big markets—Europe, China, and Brazil—VW is launching all-new SUVs. Dieselgate cost €20 billion to €25 billion. But people forget VW went into the crisis with €22 billion of net cash. They had the financial strength to take on the setback. And because diesel is now a technology of the past, they're racing to be ahead of the pack with a good array of electric-vehicle offerings in 2019-20. Again, you are not paying much for that.

What is it worth?

VW owns fantastic luxury automotive brands—Porsche, Audi, Bugatti, Lamborghini. The premium brands are worth €110 per share, or about 80% of the current share price. So you are getting the other parts of VW—the valuable Chinese business, the thriving commercial-vehicle makers Man and Skoda, the mass-market VW brand, and the financial-services business—almost for free.

What are you reading these days?

I read Michael Lewis' The Undoing Project, about the collaboration between two brilliant academic psychologists, Daniel Kahneman and Amos Tversky. That led me to the book I'm reading now, Kahneman's Thinking, Fast and Slow, about his collaborative work on human judgment and decision-making, highlighting common errors of the human psyche. Thanks to Kahneman, I approach meetings differently, asking colleagues to express their opinions before they enter the room and can get overwhelmed by dominant personalities.

Thanks, Sarah.

Important Disclosures

To determine if a Fund is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors, charges and expenses before investing. This and other information can be found in the Fund's full or summary prospectus, which may be viewed and downloaded by visiting http://www.causewayfunds.com/ or by calling 1-866-947-7000. Read it carefully before investing.

Investing involves risk including loss of principal. 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. Investments in smaller companies typically exhibit higher volatility. Diversification does not prevent all investment losses. There is no guarantee that risk can be managed successfully or that the fund will achieve its stated objective.

As of June 30, 2017, the top 10 holdings in the Causeway International Value Fund were: Volkswagen AG 4.3%, Royal Dutch Shell Plc 3.2%, British American Tobacco Plc 2.9%, Schneider Electric SE 2.8%, China Mobile Ltd. 2.8%, ABB Ltd. 2.8%, KDDI Corp. 2.7%, Novartis AG 2.7%, Barclays Plc 2.7%, UniCredit S.p.A. 2.6%. Holdings are subject to change. Current and future holdings are subject to risk.

For performance data current to the most recent month-end, please call 1-866-947-7000 or visit our website at www.causewayfunds.com. As of 6/30/17, the Causeway International Fund Investor Class returned 20.49% (one year), 0.22% (three year), 7.99% (five year), 1.62% (ten year) and 7.41% (since inception). Inception is October 26, 2001. Performance greater than one year is annualized.

The performance quoted represents past performance. Past performance is not an indication of future results. Investment return and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth less than their original cost and current performance may be lower than the performance quoted. Total annual fund operating expenses for the Institutional Class are 0.91%. Total annual fund operating expenses for the Investor Class are 1.16%. Investment performance may reflect fee waivers in effect. Without the fee waivers, total return would be reduced. Total returns assume reinvestment of dividends and capital gains distributions at net asset value when paid. Returns greater than one year are average annual total returns. Investor Class shares charge up to a 0.25% annual shareholder service fee. The Fund imposes a redemption fee of 2% on the value of shares redeemed less than 60 days after purchase. Your return will be lower if a redemption fee is applied to your account

Beta is a measure of the volatility of a security or a portfolio in comparison to the market as a whole.

Dividend Yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price. A company may reduce or eliminate its dividend, causing losses to the fund.

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Causeway International Value Fund-Investor Class (CIVVX) was rated against 268 (three years ended 6/30/17) and 218 (five years ended 6/30/17) and 133 (ten years ended 6/30/17) Foreign Large Value funds and received a Morningstar rating of 4 stars for the three year period, 4 stars for the five period and 4 stars for the ten period.

CIVVX was ranked 166 out of 326, 99 out of 268, 77 out of 218 and 16 out of 133 Foreign Large Value funds for the 1, 3, 5, and 10 year periods ended 6/30/17.

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