



CAUSEWAY CAPITAL MANAGEMENT LLC  
NEWSLETTER

# Navigating Market Cycles

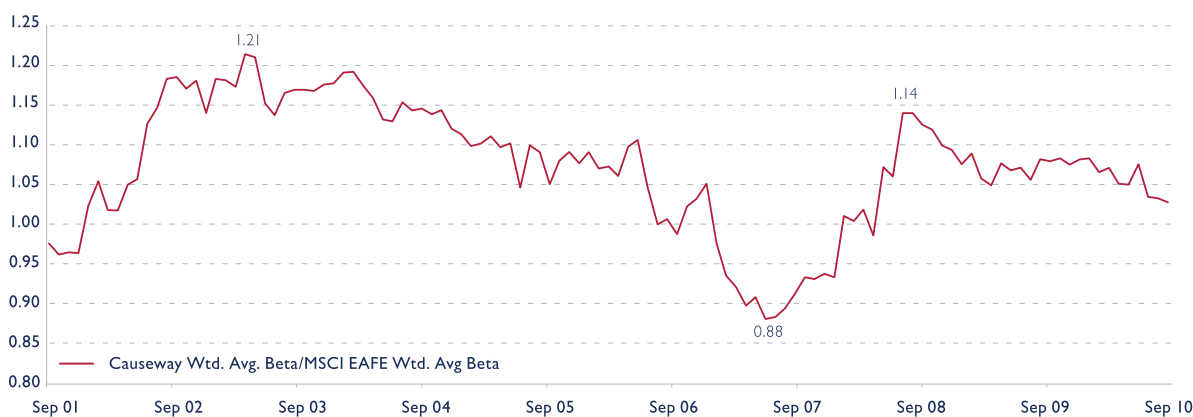
## Risk – And Its Rewards

Dust off the cobwebs and take a look at William Sharpe and Gordon Alexander’s renowned textbook, *Investments* (Prentice-Hall, 1990). The authors begin with the most basic definition:

Investment, in its broadest sense, means the sacrifice of certain present value for (possibly uncertain) future value. Two different attributes are generally involved: time and risk. The sacrifice takes place in the present and is certain. The reward comes later, if at all, and the magnitude is generally uncertain.

What if we could be more certain about the magnitude of the reward? Sensibly, we would likely take more risk. But most investors have little tolerance for wide price swings—and even less for loss. In our fundamental, long-only mandates, our clients expect us to be fully invested, and to mitigate the likelihood and magnitude of any declines in portfolio market value. The 10- and 20-year annualized performance (net of management fees, as of end of March) for Causeway’s International Value Equity strategy of 309 basis points (bps) and 404 bps over the MSCI EAFE Index isn’t enough. Clients ask us to generate that alpha consistently, and have little tolerance

Causeway Deliberately Increased Portfolio Risk During Bear Markets  
Historical Weighted Average Beta (Trailing 48 Month) of Causeway International Value Equity versus MSCI EAFE



**Source:** Factset, MSCI. Data prior to June 2001 is that of Mercury HW International Value Fund Class I shares. See important disclosures at end of presentation. The beta shown is the weighted average beta of the holdings in the Causeway portfolio relative to the weighted average beta of the constituents of the MSCI EAFE Index. Beta is a measure of a stock’s market sensitivity.

### CONTACT INFORMATION

**SALES AND MARKETING – Mark Cone**      **CLIENT SERVICE – Eric Crabtree**  
 email: cone@causewaycap.com              email: crabtree@causewaycap.com  
 phone: (310) 231-6108                          phone: (310) 231-6145

Risk – And Its Rewards continued

for negative returns. In Sharpe’s eponymous return-to-risk measurement, Causeway also scores considerably better than benchmark. Yet, there’s no escaping the physical laws of investing. Within the parameters of fully invested, long-only mandates, only a magician could disconnect the portfolio return from equity market fluctuations. We expect our clients to be paid handsomely for taking on both individual equity and market risk. But, how much should we take- and when? In the two bear markets of the last decade, Causeway portfolio managers shifted our global and international portfolios to high-quality companies with plenty of financial flexibility. We used our own quantitative multi-factor risk model to add risk (defined as the standard deviation of portfolio returns) — to seek a specific commensurate return. With share prices collapsing, the sky was falling, yet we were able to generate

**“We expect our clients to be paid handsomely for taking on both individual equity and market risk. But, how much should we take – and when?”**

a 46% annualized net-of-fees return in our global value composite in the two years from end March 2009 to end March 2011\*. We made our clients 1,375 bps over the MSCI World Index annualized, but we had to amplify portfolio beta (i.e., sensitivity to the benchmark index) to reap that reward. We spoke to our portfolio managers, Jonathan Eng and Duff Kuhnert, for more insight into how Causeway views the optimal mix of risk and return.

**Q:** How has your view of risk changed over the years for Causeway’s global and international value portfolios?

**JE:** My colleagues and I think of risk as a tool to amplify returns or to protect the performance we’ve already generated. The recession of 2002, capped by the global SARS outbreak in early 2003, seemed fairly pedestrian relative to the near

\* There is no guarantee that any strategy will protect against market loss. Past performance is no guarantee of future performance. Performance prior to June 2001 is that of Mercury HW International Value Fund Class I share. See important disclosures at end of presentation.

Causeway Fundamental Strategies Will Take Greater Volatility to Seek Greater Returns



Past performance is no guarantee of future performance. Performance prior to June 2001 is that of Mercury HW International Value Fund Class I share. See important disclosures at end of presentation.

## Risk – And Its Rewards *continued*

collapse of the financial system in 2008. However, we used a similar set of risk tools to guide client portfolios through both periods. During the worst of the market sell-off in each of these bear markets, we added well-managed market leaders to client portfolios, taking on the increased risk for the promise of greater returns.

Some of the best performing stocks held in Causeway portfolios in 2003 consisted of companies we purchased just after the technology, media, and telecommunications bubble burst. These included economically cyclical businesses, such as a Netherlands-based specialty staffing company. Such an operationally geared company can produce record profits when revenues rebound. The stock added demonstrably to portfolio risk, but our analysis showed its share price had the potential to increase dramatically (in fact, the stock rose 180% in US dollars in 2003). A few more years slipped past, with equities soaking up the massive liquidity. By 2006-7, we struggled to find undervalued stocks. We had to hold more companies and diversify as much as possible. The expected returns we calculated on the investable universe seemed paltry for the associated equity risk.

By late 2008, however, the economically cyclical companies had sunk the most, and the buy opportunities brightened considerably. Companies we had wanted to own for years – the world class industrial franchises – became value stocks. My colleagues and I explained to our clients that we were trading out of companies vulnerable to public spending shrinkage. We wanted low-risk gearing into economic recovery. This led us to reduce exposure to the healthcare, consumer discretionary and utilities sectors. In the equity meltdown, we were able to buy financially indomitable firms in the industrials, materials and consumer discretionary sectors. The global economy eventually would recover; it was simply a question of when. Our strategy was to purchase these top-quality stocks at decade-low valuations. Out went a high-risk UK defense contractor and beneficiary of the recent (but unsustainable) surge in defense spending; in went a UK manufacturer of civil aerospace engines with the stability of a growing installed

base of 13,000 engines, accounting for 60% of total sales. At its nadir, the engine manufacturer sold for 8x earnings, had a net cash position of 15% of its market cap, and paid its investors to wait for share price recovery– with a dividend yield of 4%.

**Q:** How did Causeway’s multi-factor risk model guide portfolio construction in the credit crisis – and what type of influence does it have at present?

**DK:** While our fundamental portfolio managers were circling deeply undervalued cyclical stocks in late 2008 and early 2009, we ran several iterations of our risk model. The financial sector stocks scored very poorly in our model, and their opaque balance sheets further tempered our enthusiasm from a fundamental perspective. The model also steered us away from concentrations in any one area, or in any one currency.

**“In effect, our multi-factor risk model is helping Causeway make the right active decisions, and avoid those that don’t pay off.”**

You wouldn’t recognize the quantitative risk characteristics of our international and global value portfolios today versus the worst months of the credit crisis. We have reduced the forecast risk (i.e., beta). The forecast beta for both our global and international portfolios has settled at one or less, and prospective volatility (standard deviation) has receded to benchmark levels.

**Q:** What types of active decisions are you making?

**DK:** Each week, all of our portfolio managers meet to discuss equity holdings and our risk model. We are well aware of the explicit exposures to any one risk factor. In our international value strategy, we have negative exposures (compared to a broad universe of global equities) to volatility, momentum, growth, cyclical, and value factors, with positive exposures to size and exchange rate factors. We also track portfolio sensitivity to factors we created for additional insight, such as China, crude oil, and a commodity index. In the portfolio construction process, we weigh the marginal contribution to risk we anticipate for a candidate versus its return potential. If the risk-adjusted return does not compete with our other choices, we select the next candidate.

Risk – And Its Rewards continued

**JE:** In effect, our multi-factor risk model is helping Causeway make the right active decisions, and avoid those that don't pay off.

**Q:** What stocks have the ideal risk/return characteristics for the current environment?

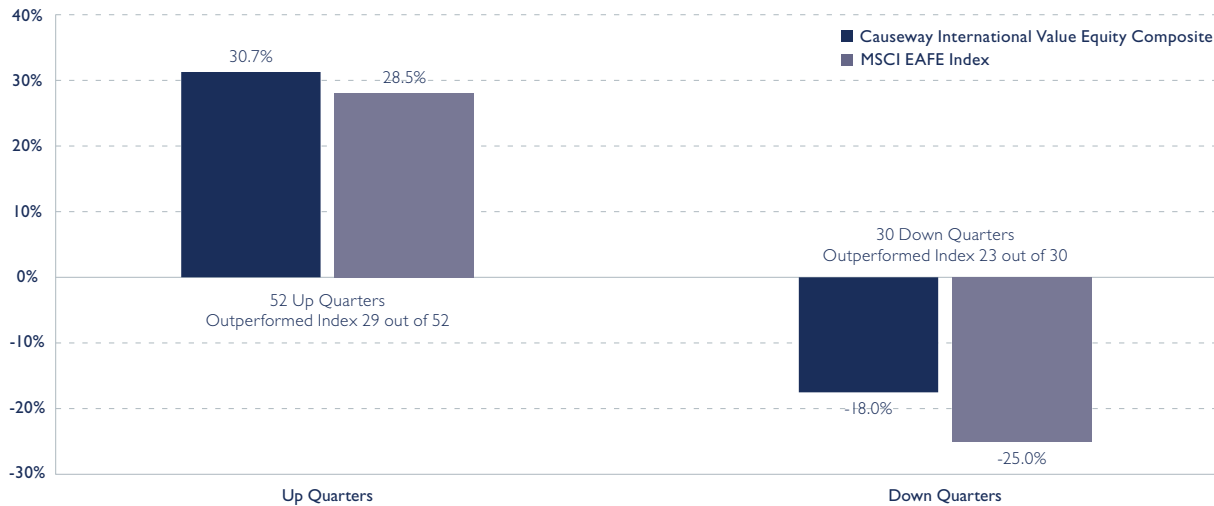
**JE:** In 2010, investors wanted cyclical stocks. Now the focus is shifting to more resilient companies that can offer growth, earnings visibility and an annuity-like stream of cash flow. Our quantitative models also reflect this shift. The industrial gas companies – with their take-or-pay contracts, expansion into emerging markets, and industry oligopoly – offer all these attributes. This industrial gas global oligopoly prices rationally, and passes on raw materials costs to customers. They have very diversified revenue streams with a wide array of customers representing global industries such as electronics, healthcare, energy, food and several more. Also in the materials sector, our long-term holding in a European

specialty chemical company has continued to reward our clients. The company also has the ability to pass on raw material costs to its customers, generate attractive surplus cash, and pay its shareholders for their patience. We like its global growth aspects, with 40% of revenues in rapidly expanding emerging countries, and a duopoly position in paints and coatings. For fully invested portfolios, we seek to own these great, durable franchise businesses to lower portfolio risk. Conversely, we will amplify risk when (and if) the time is right, during the next period of investor despondency. This may explain, in part, why Causeway usually does even better versus the benchmark in bear versus bull markets.

**“We will amplify risk when (and if) the time is right, during the next period of investor despondency.”**

For long-only, un-hedged investors, there's nowhere to hide in a market selloff. But we have the tools to mitigate the downside. We emphasize careful stock selection made with the benefit of both fundamental valuation and quantitative modeling. We make our stocks compete on risk-adjusted returns, the most effective roadmap to portfolio construction.

**Causeway Has Captured More Alpha in Bear Markets**  
Annualized Total Return Performance in USD  
Net of Fees 10/1/1990 to 03/31/2011



Past performance is no guarantee of future performance. Performance prior to June 2001 is that of Mercury HW International Value Fund Class I share. See important disclosures at end of presentation.

## **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 value equity, global value equity and emerging markets equity assets for corporations, pension plans, public retirement plans, Taft-Hartley pension plans, endowments and foundations, mutual funds, charities, private trusts and funds, wrap fee programs, and other institutions. The firm includes all accounts managed by Causeway.

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

The International Value Equity Composite ("International Composite") includes all international value equity, U.S. Dollar denominated, discretionary accounts, which contain typically 50 to 80 holdings, do not apply a minimum market capitalization requirement of \$2.5 billion or higher (\$5 billion or higher prior to November 2008), include investments in South Korean companies after October 2003, do not experience significant regular 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 (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. Portfolios in the International Composite invest in Canada and South Korea, which are not included in the MSCI EAFE Index.

Contact Sarah Van Ness at 310-231-6127 or [vanness@causewaycap.com](mailto: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 5/31/11 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.