

Causeway Emerging Markets Fund Class Institutional | CEMIX

A quantitative strategy that delivers.

Analyst Research | 03-20-17 | by John Fei

Causeway Emerging Markets continues to do a fine job applying quantitative models to emerging markets, earning it a Morningstar Analyst Rating of Bronze.

Emerging markets throw up a number of hurdles for quantitative fund managers. Macroeconomic events can swamp company fundamentals, accounting rules are different, and value traps abound. But Causeway's quantitative team has an answer for each of those challenges.

Causeway's quantitative team is largely separate from the fundamental team that runs well-known Causeway International Value CIVVX. The team is headed by Arjun Jayaraman. MacDuff Kuhnert has comanaged the fund with Jayaraman since its March 2007 inception, and Joe Gubler was promoted to comanager in 2014.

The team has built an array of models that generally have helped steer it on the right path. First are valuation models that give the fund a clear value tilt relative to most emerging-markets funds. The emphasis on modest valuations is tempered with earnings quality as well as share price and analyst rating momentum in order to keep the fund out of value traps. The other are top-down models that factor in macroeconomic and currency data. The fund also adjusts position sizing in order to get maximum return for minimum risk.

Jayaraman and his team have regularly recalibrated their models since inception to deliver less variable returns. The fund's valuation emphasis led it to some cheap but vulnerable stocks that got crushed in 2008 then rebounded to huge gains in 2009. In light of the fund's extreme performance in 2008 and 2009, they modified price momentum factors in 2009 to adjust for volatility. In 2010, they increased their bottom-up weighting to the current 75% from 66%, and decreased the top-down weighting to 25% from 33%.

The fund has modestly outperformed peers and benchmark on a total return and risk-adjusted basis since inception and since it completed the second modification to its strategy in 2010. It remains a solid source of emerging-markets exposure for fans of quantitative strategies.

Process Pillar: Positive I John Fei, Ph.D. 03/20/2017

The fund blends a number of quantitative strategies to come up with a value-tilting portfolio of about 136 stocks. The combination of models leads to a fair amount of trading as evidenced by the fact that annual turnover has ranged from roughly 70% to 110% over the years.

The models look at valuation, earnings growth, and technical factors. The strategy also incorporates top-down factors to help it move to the right sectors, countries, and currencies because top-down issues often overwhelm bottom-up factors in emerging markets. The top-down models aim to identify the most attractive countries based on valuation, financial strength, macroeconomics, earnings growth, and risk/reward profile.

Because the models spur a lot of trading, there are limits on strategy capacity. Causeway estimates that the strategy can be run up to around \$8 billion under management. The current total is about \$6 billion with separately managed accounts included. So far, though, we haven't seen signs that asset growth has had an impact on the portfolio. The fund hasn't moved up in market cap, and its total number of holdings is only up about 15 since it launched.

Although this is a quantitative strategy, it does make use of Causeway's fundamental analysts to vet potential additions to the portfolio. The idea is for the analysts to catch any unusual issues that the models might miss, such as pending litigation.

The fund hews fairly closely to its MSCI Emerging Markets Index in sector, country, and Morningstar Style Box weightings, and it has limits on bet size in each case. When it does diverge, it is to take advantage of low volatility stocks that are very cheap.

For example, the fund made a contrarian bet in energy in 2015, and has stuck with it. At the end of 2016, the portfolio was overweight in energy, at 13.3% versus its benchmark's 7.4%. Lead manager Jayaraman noted that holdings such as Lukoil, Gazprom, and Sinopec have compelling valuations.



Other holdings in the portfolio reflect the model's predilection to pick value over price momentum within risk/reward constraints. The fund took small positions in Turkiye Halk Bankasi and Turkiye Vakiflar Bankasi given their low valuations despite political risk in Turkey. Overall, the portfolio is mildly overweight in Turkey because of attractive valuations.

The fund tends to be more concentrated than most quantitative funds, though 136 holdings isn't very focused when compared with the entire Morningstar Category.

Performance Pillar: Positive I John Fei, Ph.D. 03/20/2017 The fund has outperformed its average peer and its benchmark, the MSCI EM GR Index, since opening in 2007. From April 1, 2007, through Feb. 28, 2017, the fund had a 3.5% annualized return compared with 1.7% for its typical rival and 2.8% for its benchmark. Its five-year rolling returns since inception have also been strong, beating its index 98% of the time, and its typical peer 100% of the time. The fund's Sortino ratio since inception of 0.35 bests its benchmark's 0.31 and typical peer's 0.21.

Since Arjun Jayaraman and his team took multiple steps to refine the quantitative model in 2009 and 2010, performance has improved. For the period January 2011 through February 2017, the fund returned an annualized 0.4% compared with negative 0.9% for the benchmark and negative 0.7% for its typical peer. The fund's Morningstar Risk-Adjusted Return for the same period was negative 3.0%, relative to the index's negative 3.7% and its typical peer's negative 4.1%. The fund's Sortino ratio for January 2011-February 2017 period was 0.15, greater than the 0.07 of the benchmark, and negative 0.01 of its typical peer. Given that it has efficiently delivered returns, this fund earns a Positive Performance Pillar rating.

People Pillar: Neutral I John Fei, Ph.D. 03/20/2017

Causeway's quantitative team is headed by lead manager Arjun Jayaraman. MacDuff Kuhnert has comanaged the fund with him since its March 2007 inception, and Joe Gubler, who joined Causeway in 2005, was promoted to comanager in 2014. Prior to his promotion, Gubler had supported the Emerging Markets fund since its inception as a senior research analyst.

Jayaraman had previously served as manager of international and global strategies for Putnam and PanAgora. His Putnam strategies moved with him to PanAgora, so we have a record from 2000 through

2005. Both his global-equity and international-equity funds were middling performers over that time. Kuhnert worked on risk models for Hotchkis & Wiley from 1996 to 2001 and has been at Causeway since then.

The quantitative team also runs Causeway International Small Cap CVISX, Causeway Global Absolute Return CGAVX, and Causeway International Opportunities CIOVX. The three funds have outperformed their peers since their inceptions in 2010, 2011, and 2014, respectively.

Kuhnert and Jayaraman both have invested between \$100,000 and \$500,000 of their own money in the fund, while Gubler has invested between \$10,000 and \$50,000.

The managers demonstrate skill in delivering results, but Jayaraman's prior record tilts the People Pillar rating to Neutral.

Parent Pillar: Positive | 12/23/2016

This employee-owned firm has a strong investment culture. The two founders, Harry Hartford and Sarah Ketterer, left Hotchkis & Wiley, a former Merrill Lynch subsidiary, in 2001, along with two other current comanagers, Jamie Doyle and Jonathan Eng. Causeway has done an excellent job of retaining talent. During the past 15 years and across six strategies, the firm has lost only one portfolio manager, in 2016.

This near-perfect retention record owes in good measure to the breadth of employee ownership. The majority of the firm's investment professionals have some equity ownership in the firm. Plus, Hartford and Ketterer have proactively spread the wealth. In 2014 and 2016 they sold some of their own shares back to employees; they plan to do so again in 2018.

The investment team is divided between fundamental and quantitative strategies. The fundamental team is responsible for about 80% of firm assets across four strategies, with the quant team managing two. The two teams work together in complementary fashion. For instance, the quant team provides a risk overlay on the fundamental strategies while the fundamental team provides a check on the quant models.

Although the firm may launch a new strategy in the coming years, it has been judicious in this regard. It has launched only one new strategy in the past five years, Causeway International Small Cap, in October 2014.



Price Pillar: Positive I John Fei, Ph.D. 03/20/2017

Fees have been trending downward over the past four years for both the institutional and investor share classes. The institutional share class, which has 81% of the total assets, has an expense ratio of 1.18%. That expense ratio is 6 basis points lower than the median for institutional emerging-markets funds, and the share class has a Morningstar Fee Level of Below Average.

The investor share class, which has the rest of the assets, has an expense ratio of 1.43%. That expense ratio is 4 basis points higher than the median for no load emerging-markets funds, and the share class has a Morningstar Fee Level of Average.

This fund receives a Positive Price Pillar rating because the majority of its assets are in an attractively priced share class.

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 obtained by calling 1-866-947-7000 or visiting www.causewayfunds.com. Read it carefully before investing.

Mutual fund investing involves risk, including possible loss of principal. In addition to the normal risks associated with equity investing, international investing may involve risk of capital loss from unfavorable fluctuations 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 involve additional risks and typically exhibit higher volatility. Diversification does not prevent all investment losses. There is no guarantee the Fund will meet its stated objectives. The Fund may invest in derivatives, which are often more volatile than other investments and may magnify the Fund's gains or losses.

Holdings are subject to change. As of 3/31/17, the top 10 holdings in the Causeway Emerging Markets Fund are: Samsung Electronics Co., Ltd. (4.7%), Tencent Holdings Ltd. (3.3%), Taiwan Semiconductor Manufacturing Co., Ltd. (3.2%), Alibaba Group Holding (2.9%), Bank of China Ltd. (2.6%), Hon Hai Precision Industry Co., Ltd. (2.3%), China Petroleum & Chemical Corp. (2.2%), PTT Public Co., Ltd. (2.1%), Lukoil (1.9%), Investimentos Itau (1.9%).

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As of 3/31/17, the Causeway Emerging Markets Fund Institutional Class returned 14.27% (QTD), 19.91% (one-year), 2.08% (three-year), 2.51% (five-year), 3.98% (ten-year) and 3.95% (since inception). Inception is 3/30/2007. Performance greater than one year is annualized. The Causeway Emerging Markets Fund Institutional Class expense ratio is 1.18. The fund has a 2% redemption fee on shares held less than 60 days.

The MSCI Emerging Markets Index (Gross) is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The Index is gross of withholding taxes, assumes reinvestment of dividends and capital gains, and assumes no management, custody, transaction or other expenses. It is not possible to invest directly in an index.

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As of March 31, 2017, the Causeway Emerging Markets Institutional Class (CEMIX) was rated against 629 diversified emerging markets funds based on risk adjusted returns over a three year period, 429 funds over a five year period and 177 funds over a ten year period and received 4 stars, 4 stars and 3 stars respectively. There are additional Fund share classes that may have been ranked differently. Past performance is no guarantee of future results.

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