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ValueInvestor INSIGHT

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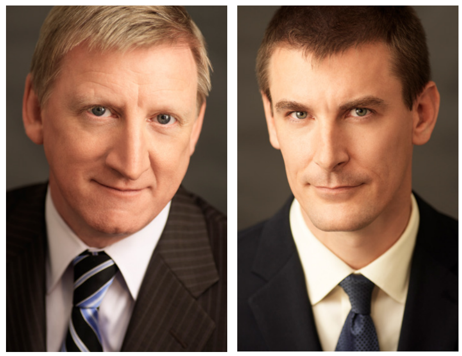
Seeking Validation

Identifying cheap stocks is much easier than uncovering those that are truly mispriced. Harry Hartford and Causeway Capital have proven highly skilled at both.

While the significant majority of the more than $44 billion in assets managed by Causeway Capital are invested in non-U.S. securities, firm president and portfolio manager Harry Hartford considers that fact a distinction without a difference. With big firms in particular, "what matters is where and how the company competes," he says. "Where it's listed is increasingly irrelevant."

Causeway's clear-eyed global view has paid off nicely for investors. Its flagship Global Value Equity strategy has earned a net annualized 10.2% since its 2001 inception, vs. 7.2% for the MSCI World Index. Among areas Hartford and fellow portfolio manager Conor Muldoon find interesting today: defense systems, banking, auto manufacturing and steel.

INVESTOR INSIGHT



Causeway Capital Management
Harry Hartford *[l]*, Conor Muldoon *[r]*

Investment Focus: Seek companies with quantitatively cheap stocks that upon analysis also appear significantly mispriced for fixable or otherwise temporary reasons.

Inside this Issue

Investor Insight: Causeway Capital

Harry Hartford and Conor Muldoon of Causeway Capital Management describe where around the globe they're seeing unwarranted differences in valuation, how they risk-adjust their return expectations, where they're investing in their firm's capabilities, and what they think the market is missing in Volkswagen, UniCredit, ArcelorMittal and Cobham.

You cast a wide net for bargains – how do you start out to cull the wheat from the chaff?

Harry Hartford: The starting point for us is always valuation. Using computer-driven tools we've refined over many years, we're identifying stocks that optically appear cheap on the basis of earnings, cash flow and/or dividend yield. Because we don't want to exclude industries at this point, our screening is on both an absolute basis as well as relative to the industry.

From that initial list we're digging into the first level of detail to determine first if the stocks really are cheap, and then beyond that the degree of mispricing we believe exists. To us the key issue is the validation of that mispricing. We have to have a view that is different at the company level or at the industry level, and a well-defined rationale for how that differentiated view coming true will help correct the mispricing.

What situations that create mispricings are of most interest?

HH: Companies and industries go through cycles, so it might be the cycle. We're not going to articulate the case that ArcelorMittal [MT:NA] is a great company, and it's a stretch of the imagination to say that the steel industry is a great industry. But there are points in the cycle in our view when a stock like this can become mispriced. We'll try to take advantage of that, as we are today with Arcelor.

Our largest position is in a large well-known German manufacturer of autos that has been in the news of late. We're cognizant that Volkswagen [VOW:GR] has issues, and that those issues have imposed an enormous financial penalty on the company. But therein lies the opportunity. It's not that we love the auto industry, with its high capital intensity and especially at this point in the cycle for companies with large U.S. exposure. But we'd argue there are reasons to believe, which we can detail later, why Volkswagen's actual prospects are not being well priced today by the market.

As far as situations go, it's often a combination of things. ABB [ABBN:VX], the Swiss-based industrial conglomerate that was long a stock-market darling, started underperforming because of what we considered cyclical issues in key markets such as energy, resolvable product issues in selling to the utility sector, and due to a cost base that in the boom years had expanded beyond what was necessary and reasonable. In our due diligence we came to appreciate that there was an earnings recovery at hand that was not adequately priced into the stock. With self-help and an improvement in the industry backdrop in a few key areas, we saw an earnings boost that would lead to a higher share price without relying on multiple expansion. We're starting to see that play out.

ON PROCESS:

We're identifying stocks that optically appear cheap and first dig in to determine if, in fact, they really are cheap.

Conor Muldoon: I'll give you one more example where multiple issues can be at play. We had followed insurer Prudential PLC [PRU:LN] for years, and while we admired the company we always thought the stock traded expensively, primarily because of the company's high-growth and profitable business in Asia.

What fueled a derating in the stock was concern over two primary issues. First was the planned introduction of the fiduciary rule in the U.S. and the impact that might have on the sale of variable annuities and other products sold by the company's Jackson National subsidiary. Second was concern that increasingly strict capital controls would impact Prudential's Hong Kong insurance subsidiary, which does a lot of business with mainland-Chinese customers who like buying assets outside of mainland China to diversify risks.

We looked at both of those regulatory issues, making what we considered conservative assumptions about how the fiduciary rule would impact Jackson National, and concluding that the Hong Kong issue would have very little impact on the in-place book of business the company already had. In addition, the new Chinese regulations wouldn't ultimately impact the underlying growth story for the company in Asia, which is driven by powerful demographic trends and still-small market-penetration levels for most life- and health-insurance products.

Our initial purchase came in early 2016, and then of course came Brexit, which we used as an opportunity to add to our share position on the view that it wouldn't have nearly the effect on Prudential – which does maybe 25% of its business in the U.K. – that the market so quickly priced in.

With the stock now at £16.90, near its 2015 highs, has the story played out?

CM: We don't think so. The stock is back to its peak, but today at that price you get a company that has almost 30% more earnings and cash-flow power than it had two years ago.

How often, as with Brexit, is the opportunity created when the proverbial baby gets thrown out with the bathwater in a particular country or region?

CM: It certainly happens. Prudential, for example, trades at a significant discount to a peer like AIA Group [1299:HK], which is listed in Hong Kong. Even if we apply local multiples to Prudential's U.S. and U.K. businesses, we're paying much less for an Asian franchise whose quality is as good if not better than AIA's.

One of our holdings in the U.K. is Lloyds Banking Group [LLOY:LN], which is basically a regional retail and corporate bank with excellent market shares that in the medium term can generate 12-15% returns on tangible equity, has a great capital position and pays a nice dividend. If you look at a comparable or even inferior regional bank in the U.S., it would trade at closer to 2x tangible book value. Lloyds trades at only 1.2x tangible book. Obviously a U.S. bank doesn't have the overhang of Britain's exit from the European Union, but we're comfortable with Lloyds' financial strength to weather any tough periods and believe in the medium term a bank of its quality should trade with a significantly higher valuation.

Your global portfolio today is heavily overweight in Europe and underweight in the U.S. Is that further evidence that you're finding regional differences in how stocks are priced today?

HH: That's part of it – in Europe, earnings and equity markets have lagged relative to other developed markets around the world and we definitely see more value there relative to the U.S.

But I would point out that what's really relevant is what the company does and where it does its business, not where its shares are listed. In our International portfolio, for example, 70% of the companies are listed in Europe, but those companies derive less than 40% of their revenues from activities in Europe, with 25% from North America, which has zero representation in the MSCI EAFE index, and 15% from emerging markets. We own British American Tobacco [BATS:LN], which is listed in the U.K. but it actually doesn't sell cigarettes in the U.K. Its single-largest market is Brazil.

We spend a considerable amount of our research time, whatever the sector or geography, in trying to understand business models and industry dynamics. We own four telecom service providers – KDDI [9433:JP] in Japan, SK Telecom [017670:KS] in Korea, China Mobile [941:HK] in Hong Kong and Vodafone [VOD:LN] in the U.K. – and the primary reason three of the four happen to be in Asia is because those markets tend to have three primary cellular service providers and exhibit much more rational competition and revenue stability. (Vodafone is based in Europe, but a significant part of its business is elsewhere.) In markets with four service providers the smallest one ends up setting the pricing low for everyone, and that's even worse when there are five or more. As I said earlier, our starting point is valuation, but understanding industry dynamics and fundamentals is equally important.

ON JAPAN:

At the margin things are changing, but true change from the Abe administration's efforts has been very slow.

When we last spoke [*VII*, February 29, 2012] you mentioned having been underweight Japan since you started. Has that changed with the arrival of "Abenomics"?

HH: We have only been close to a benchmark weight in Japan coming out of the financial crisis in 2009. The benchmark today is about 24% Japan, and our international portfolio is roughly 15% invested there.

Japan to us is a two-tiered market. It has some well-managed businesses with great balance sheets and good underlying global industry exposures. Then you've got a large number of companies that are poorly managed, where management doesn't understand how to allocate capital. The problem with the good capital allocators is that everybody recognizes them as good companies, scarcity value is attached to them, and it's only after something like a huge crisis that we find them cheap enough to buy.

CM: At the margin things are changing in Japan. There's now an index for which part of the criteria for inclusion is strong returns on capital. But true change from the Abe administration's efforts has been very slow to take hold. What's going on with Toshiba [6502:JP] is a great example. If this company were in the West it would very likely be going through bankruptcy proceedings and restructuring. But instead they're pursuing a "Japanese solution" with banks and certain competitors having to step up to help out. The whole process doesn't speak to a positive shift in governance in Japan as a whole.

Based on its position as the largest holding in your global mutual fund, why is Citigroup [C] your top U.S.-based holding?

CM: Citi is more of a global bank in nature. In the U.S. it's primarily a credit-card business and an investment bank, but it also has a global consumer business that has strong market positions in Asia and Latin America. The stock is very cheap, on a relative and absolute basis, partly because it has run up less than others because it's perceived to be less exposed to the post-Trump changes anticipated in U.S. interest rates and regulatory reform. But given the strength of its capital position, we think it actually has the most to gain from any increased flexibility in returning capital to shareholders. We just don't believe Citi has the profile of a bank today that should trade below book value.

Describe generally how you approach valuation.

CM: In a majority of cases we're trying to determine whether the company is facing permanent or temporary issues, with the goal of arriving at an estimate of more normalized earnings in the future that we can value. The second part of the equation is taking into consideration the time value of money. If we're investing in a steel company and we think the industry is going to be in the doldrums for 10 years, a cheap price may very well be appropriate because there is no timely upturn. Of course, we're trying to separate the value opportunity from the value trap.

To expand on that a bit: When you do the bottom-up analysis to build out your financial models – trying to determine if profits and profitability can revert – you obviously have to be very cognizant of the revenue drivers. At one time we owned a number of mobile telephony providers operating in Western Europe whose stocks looked cheap at 9-10x earnings and had big dividend yields. But at this point market penetration levels were close to 100%, so the volume angle wasn't there. At the same time, regulators were still encouraging new entry, so pricing power was likely decreasing rather than increasing. We ended up concluding that our original assumptions about cash-flow growth and increasing dividends no longer held and some of these cheap stocks were more than likely to stay that way.

You had good company in getting caught in the value trap that was giant U.K.-based retailer Tesco. Lessons from that?

HH: The stock indeed looked very cheap. We missed a few things that ended up invalidating our original investment thesis. The core of it was that we failed to recognize how the company's expansion by adding enormous amounts of square footage to diversify beyond traditional food retailing to a broad range of hard goods and clothing made it that much more vulnerable to new competition. When that new competition hit, both from online sellers and from predominantly German discount grocery retailers, that had a negative impact on sales per square foot. In a business where margins are tight to begin with, that's extremely bad news.

CM: Tesco was a classic case where we thought it was dealing with cyclical or operating issues that could be fixed, when in fact the issues turned out to be more structural in nature. The good news is that we have a formal review process when a stock goes against us by 10% or more, and in this case we were able to exit before the shares fell another 50%. It wasn't a good investment, but it could have turned out a lot worse.

ON VOLATILITY:

Price volatility correlates with how accurately we can predict what's going to happen with the business.

You tend to build positions slowly. Why?

HH: As value investors we're confident in our ability to calibrate what a business is worth, but we think the idea that we can bottom-tick the stock price is just wishful thinking. We're inevitably likely to be early, so we've learned from bitter experience not to shoot all at once. Of course if the stock continues to fall after you buy it, it's important to constantly assess whether your original thesis remains valid. But as long as the thesis holds, we're happy to have not been in a hurry to buy all of it at once.

Why are you typically fully invested?

HH: We also don't believe we have the skill set to time the market. The benchmark we're compared to is a 100%-invested benchmark, so we accept the task we are charged with, which is to actively invest in equities. We feel it's appropriate for our clients to make other allocation decisions themselves.

You speak a lot about quantitative tools you use to manage portfolio risk. Describe how those tools are employed.

HH: The culmination of our research process on a security is to arrive at the value we believe the market will ascribe to the business within the next two years. Then using a risk model that has seven style factors and 80 region/sector factors, we take the absolute expected return and risk-adjust it to determine how the allocation of capital to that security would impact the overall volatility of the portfolio. That process then allows us to rank stocks on a risk-adjusted-return basis, which we use in making buy/sell decisions. Our objective is to have a level of portfolio volatility at or below the benchmark, with return expectations that beat the benchmark.

Say Conor is looking at banks. Without the risk model he wouldn't have a good understanding of how his stocks are interacting with everything else in the portfolio. If you manage the portfolio in a siloed, return-only framework, you won't be able to see the correlation or lack thereof between banks and the rest of the portfolio. We tie it into a single framework.

Why the emphasis on volatility?

CM: You're right that as long-term equity investors we shouldn't be so concerned about price volatility if we're right on valuation. But we believe volatility does correlate with our ability to accurately predict what's going to happen with the business. A business whose stock has a higher beta than the market generally is more volatile and there's a greater range of outcomes for it and its industry. We want to take that into consideration in determining how attractive the return profile is.

The number of stocks in your International Value mutual-fund portfolio tends to move between 50 and 80 over time. What drives that?

HH: We talked about our not attempting to time the market from a cash perspective, but one natural result of the way we adjust for risk is that when stocks are cheap and we're being paid to take more risk, we will typically have fewer, larger positions. That would be when we're around 50 or so holdings. When stocks are less cheap we should be reducing portfolio volatility because we're not being paid to take on that risk, which results in diversifying by increasing the number of securities usually to the 70-80 range. Today in the International Value fund we had just under 60 stocks in the portfolio at the end of the year. That says we're finding stocks to be OK from a valuation perspective. The absolute level of valuation maybe isn't that compelling, but we're able to find an opportunity set in both an absolute and relative sense that is fairly attractive.

Your interest in Volkswagen initially predated the emissions scandal. Describe what put it on your radar.

HH: Our original thesis was that investors were excessively penalizing the company on the expectation on a slowdown in China, where it earns about €3 billion in annual cash flow from its joint venture there. In addition, there was new management and we thought there was considerable upside for improvement in overall operating margins that were less than half those of a comparable global company like Toyota. When we ascribed what we considered fair values to the company's quite-profitable businesses like Audi and Porsche and trucks, we thought the Volkswagen and other European mass-market brands were deemed worth next to nothing, which we didn't consider reasonable.

We took a position and then along with everybody else find out the company has been cheating on diesel-emission tests and the share price tanks. We did what we always do in such cases, which is a lot of due diligence, specifically on what happened and how much it could cost to rectify the situation. Our fair-value estimate upon doing that went down, but because the share price had fallen so much the stock was still near the top of our ranking on risk-adjusted return, so we added more capital.

Is the rest of your thesis still intact?

HH: Despite all the noise around the company, when we assess the various nameplates we find a very impressive lineup of new models coming out around the world over the next three years. To give just one example, VW has 13 new SUV models coming to the market by 2020.

These new vehicles represent capital investments that have been made but not yet monetized, and should result in higher free cash flow going forward. Margins should also benefit as new models typically require fewer incentives to sell, and as management works to rationalize costs in manufacturing and in the supply chain. It's mind-boggling, for example, the number of VW Golf derivations manufactured around the world today, which is the type of thing the drives up average unit costs. All these operating initiatives are the key part of our investment thesis and we believe they're being largely ignored by the investment community because of the scandal.

Are you assuming little to no lasting brand damage from the cheating?

HH: We've found with auto manufacturers that damage to brand value from operational issues tends to wane over time. In fact, there is clear evidence that is already the case with Volkswagen, as the VW brand was the global leader in unit sales in 2016 for the first time ever.

What's your total estimate of liability from the scandal?

HH: The deceptive software was installed in 11 million vehicles globally and we

INVESTMENT SNAPSHOT

Volkswagen
(Xetra: VOW:GR)

Business: Global automobile manufacturer with a 12% share of the global car market, through brands including Volkswagen, Audi, Porsche, Bentley, Lamborghini and Skoda.

Share Information
(@3/30/17, Exchange Rate: $1 = €0.936):

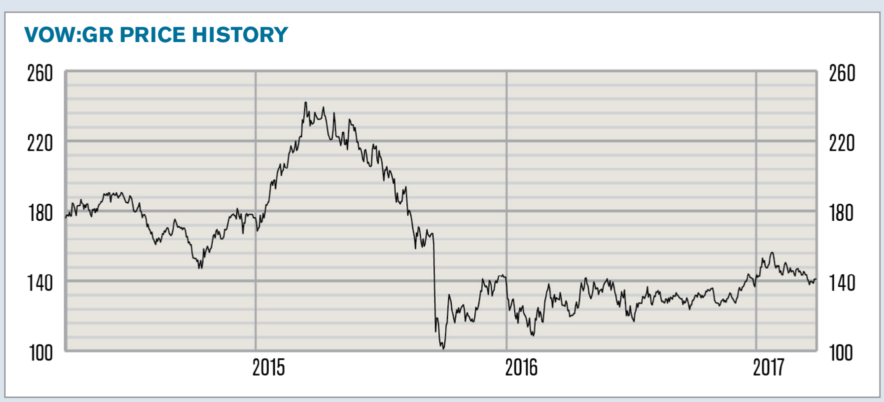
Price	**€140.95**
52-Week Range	€116.05 – €157.40
Dividend Yield	0.0%
Market Cap	€70.15 billion

Financials (TTM):

Revenue	€217.27 billion
Operating Profit Margin	6.9%
Net Profit Margin	2.5%

Valuation Metrics
(@3/30/17):

	VOW	S&P 500
P/E (TTM)	13.7	24.5
Forward P/E (Est.)	6.2	18.3



THE BOTTOM LINE
The company's emissions-cheating scandal has diverted attention away from an impressive global pipeline of new models and the potential to rationalize costs in manufacturing and in the supply chain, says Harry Hartford. Assigning a high-single-digit multiple to his 2018 earnings estimate he arrives at a fair value for the shares today of around €200.

Sources: Company reports, other publicly available information

estimate the total liability related to that at €28 billion, €20 billion of which is in the U.S. and €8 billion outside the U.S. (The issue is a bit less serious outside the U.S. because the company has not been charged with fraud.) These estimates combine already agreed upon settlements, our assumptions of the cost to support brand residual values globally, and our assumptions of the cost of shareholder claims in Germany. This will be a long legal process and we think the company's large net-cash position and its free-cash-flow generation should be sufficient to not only meet future claims, but also to continue to fund the roll-out of new models and their requisite financing.

What upside do you see in the shares, now trading around €141?

HH: We estimate the company can double its mass-market-brand margins to about 4% by 2020, driven by new models and reductions in manufacturing, labor and R&D costs. Coupled with modest revenue-growth assumptions and assuming only a high single-digit earnings multiple on our 2018 earnings estimate, we believe the stock today has a fair value of about €200 per share.

People worry about the potential peaking of the auto cycle in the U.S., but VW should be somewhat insulated from that. The much bigger market for it is Europe, which is still in recovery mode.

In our last interview you characterized the downside of Italian bank UniCredit [UCG:IM] as "incalculable." Seeing that you now own it, what's changed?

CM: This is the largest bank in Italy, where it derives 40% of its revenues, and it also has broad commercial, retail and investment-banking exposure in 16 other countries across Western, Central and Eastern Europe. The stock for some time passed our valuation screens but we avoided it for just the reason you mentioned. Unlike in the U.S., there has been an unwillingness in parts of Europe – and especially in Italy – to correctly mark non-performing loans to market, which has resulted in a severe drag on economic growth. Banks have been restrained in lending and the capital available to do so hasn't been readily available.

What appears to have changed is that European regulators and the banks themselves have finally begun to address restoring the health of the banking system. In Italy, for example, the government recently created a €20 billion fund to assist smaller Italian banks that don't have enough capital to properly mark bad loans. We believe this step will facilitate lending capacity and improves the overall prospects for the Italian economy.

UniCredit, under new CEO Jean Pierre Mustier, is also shoring up its balance sheet. The company raised €20 billion in capital from a rights issue and the sale of non-core assets. This allowed it to significantly mark down its non-performing assets while lifting capital ratios about 200 basis points above regulatory minimums. It also securitized a large portion of the assets subject to markdowns, selling about half of the resulting tranches to Fortress Investment Group, an experienced buyer of distressed loans. While UniCredit must still work through these bad loans over the next few years, we think the Fortress transaction helps validate the bank's net asset value.

These changes haven't gone without notice by the market. At a recent €14.25, how are you looking at the potential for the stock today?

INVESTMENT SNAPSHOT

UniCredit
(Milan: UCG:IM)

Business: Italian-based provider of commercial and retail banking services located in 17 countries across Europe, and of investment banking operations that extend globally.

Share Information
(@3/30/17, Exchange Rate: $1 = €0.936):

Price	**€14.28**
52-Week Range	€8.53 – €18.32
Dividend Yield	4.4%
Market Cap	€8.70 billion

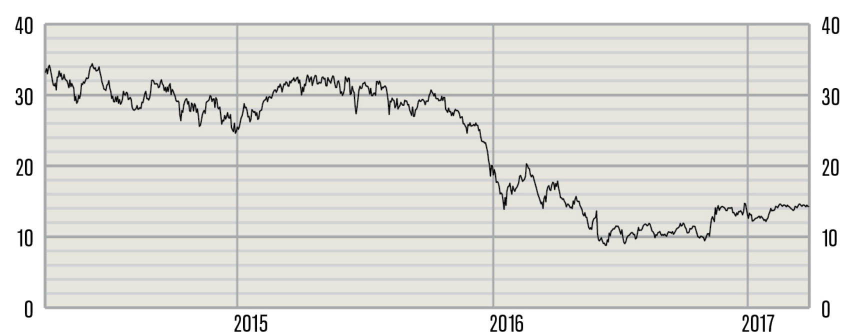
Financials (TTM):

Revenue	€5.69 billion
Operating Profit Margin	(-155.7%)
Net Profit Margin	(-207.4%)

Valuation Metrics
(@3/30/17):

	UCG	S&P 500
P/E (TTM)	n/a	24.5
Forward P/E (Est.)	n/a	18.3

UCG:IM PRICE HISTORY



THE BOTTOM LINE

Conor Muldoon believes that both European regulators and the bank itself – finally – are taking the right steps to restore collective and company-specific financial health. Even if the company falls short of its return-on-tangible-equity goal, he sees 15% upside for the stock. If it hits the goal of a 9% ROTE, he'd expect another 25% rise in the share price.

Sources: Company reports, other publicly available information

CM: We value the stock by assigning a multiple of book value that is appropriately aligned with our estimate for return on equity. Management's stated goal is through cost cuts and operating improvements to attain a 9% return on tangible equity, which we believe is roughly in line with the bank's cost of capital of 10%. If that goal is achieved – and compensation for the bank's top 120 employees is heavily dependent on it – we think that would justify a stock valuation of 0.9x to 1x tangible book value.

We think management's cost-reduction estimates, primarily through branch closures and reductions in headcount, are credible and will enable profitable operations in a low-revenue-growth environment. We aren't as optimistic as management is on rate hikes in Europe, however, so we've tempered our revenue assumptions relative to the company's. As a result we're looking more at a 7-8% return on tangible equity, which supports a valuation of 70-80% of tangible book value. That would yield a roughly 15% total return from the current share price. If management meets its 9% ROTE goal, there's maybe an additional 25% upside from that. We also believe that if the bank's recovery progresses over the next few years its cost of capital could decline 100-200 basis points, which would justify multiple expansion beyond what we expect today.

Describe in more detail the cyclical appeal you see in ArcelorMittal.

CM: ArcelorMittal is the world's largest steel company with roughly 110 million tons of annual production capacity. It is also vertically integrated in producing iron ore and coking coal, the two main ingredients for steel. Arcelor was the product of European steel-industry consolidation, while Mittal was a combination of U.S. steel-manufacturing assets that came out of bankruptcy. The two companies have been together since 2006.

There is a global glut of steel supply, driven by excess capacity in China, which in the last 17 years has evolved from consuming very little steel to now being the world's largest producer and consumer of steel. As growth in Chinese consumption waned in recent years, Chinese producers began dumping product on the global market, helping drag Arcelor's EBITDA per ton down to $40, compared to historical levels of $70-$80. That put stress on its balance sheet. In early 2016 the company completed a rights offering to reduce leverage and announced a plan to improve its operating-cost profile in order to withstand a very tough revenue environment. That led to our initial investment.

Since then we've seen trade policy action targeted at insulating U.S. and European steel producers from the effects of excess Chinese supply. Tariffs as high as 250% are being imposed on Chinese steel for the next five years. Steel prices as a result of that and of better demand in China have since recovered, pushing Arcelor's run-rate EBITDA per ton back to around $75 at the end of 2016.

Does your optimism on the stock, now around €8, rest on improvements in the operating-cost profile from here?

CM: We think the shares reflect increased steel prices to date, but they don't price in the company delivering on its restructuring plan, which targets EBITDA per ton of greater than $85. Part of that comes from anticipated labor-cost reductions, but also through emphasis on more attractive end markets like the auto industry, which require premium-grade steel and a standard of quality control that helps protect Ar-

INVESTMENT SNAPSHOT

ArcelorMittal
(Amsterdam: MT:NA)

Business: Largest steel producer in the Americas, Europe and Africa, with operations in 18 countries; vertically integrated, producing both iron ore and coking coal as well.

Share Information
(@3/30/17, Exchange Rate: $1 = €0.936):

Price	**€7.98**
52-Week Range	€3.79 – €8.84
Dividend Yield	0.0%
Market Cap	€24.40 billion

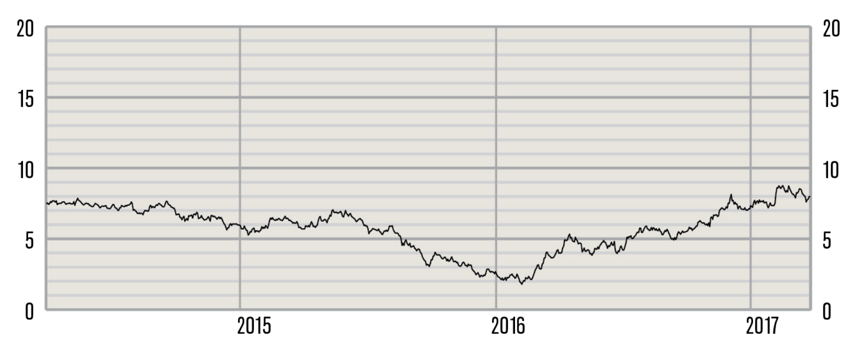
Financials (TTM):

Revenue	€56.79 billion
Operating Profit Margin	5.5%
Net Profit Margin	3.1%

Valuation Metrics
(@3/30/17):

	MT	S&P 500
P/E (TTM)	12.9	24.5
Forward P/E (Est.)	9.1	18.3

MT:NA PRICE HISTORY



THE BOTTOM LINE

While its shares reflect recent steel-price increases, Conor Muldoon believes there's further upside as the company delivers on its restructuring plan, emphasizes higher-value-add markets, and if China follows through on reducing redundant production capacity. He believes a 20% increase in EBITDA per ton could result in a share price of €11.

Sources: Company reports, other publicly available information

celor from cheap imports. The unit economics would improve further if China follows through on announced plans to mothball some redundant capacity, which would likely take steel prices higher. If that happens, Arcelor's EBITDA per ton could move closer to $100 and signal increased health in the industry that might lead to multiple expansion.

Because of financial and operational leverage, we estimate that a 20% increase in EBITDA per ton from $75 to $90, coupled with some recovery in volumes, would increase normalized EBITDA by closer to 30%. With no multiple expansion, that would result in a stock price closer to €11.

U.K. defense contractor Cobham [COB:LN] hasn't exactly been firing on all cylinders. What's your contrarian take?

HH: The company produces systems focused on aerial refueling, navigation and communications for both defense and commercial original-equipment aircraft manufacturers. About two-thirds of its revenue is related to defense, primarily in the U.S. and the U.K.

Cobham has extensive, deep relationships with U.S. Department of Defense suppliers to provide things like supplier hoses for Boeing refueling tankers and communications equipment that connects a range of aircraft, ships and guided missiles. But the company has stumbled through five profit warnings in the last 15 months and is behind schedule and over budget on several contracts, including a key one for Boeing refueling tankers.

There have also been balance-sheet issues, largely the legacy of a poorly timed acquisition by the previous management team of a communications-equipment firm called Aeroflex at the peak of the market in 2014. That $1.5 billion acquisition was funded with dollar-denominated debt, which has become more expensive and threatened a covenant breach thanks to the 20% decline in the value of the British pound vs. the dollar. In response, the company raised capital last year but simultaneously issued a dividend, which was a total head-scratcher to us.

The thesis in this case is fairly straightforward. We believe the company's new management team is addressing the balance sheet and operational issues, which will allow it to fully benefit from anticipated increases in defense spending in the U.S. and Europe.

Is there evidence of progress yet?

HH: The company is in the process of raising additional capital and it has eliminated the dividend. We're also encouraged by the aggressive focus being placed on the problem contracts and by the fact that the company has taken provisions to better account for cost overruns. It's still early, but we think it's very much on a path to improved profitability.

From today's £1.35, how do you see that translating into upside for shareholders?

HH: If the company can recover to two-thirds of its historical peak operating margins, revenues stabilize, and the shares receive a reasonable 12-13x earnings multiple, we estimate fair value at around £1.80. That doesn't include any generalized increase in military spending, but just assumes already committed programs basically proceed as planned.

Speaking generally again, how do you process the rhetoric around global trade?

HH: First off, I scratch my head when I hear a lot of it. The world is better off as a consequence of trade and will be worse

INVESTMENT SNAPSHOT

Cobham
(London: COB:LN)

Business: Provides to defense and commercial original-equipment manufacturers equipment and systems focused on aerial refueling, navigation and communications.

Share Information
(@3/30/17, Exchange Rate: $1 = £0.801):

Price	**£1.35**
52-Week Range	£1.02 – £1.85
Dividend Yield	0.0%
Market Cap	£2.29 billion

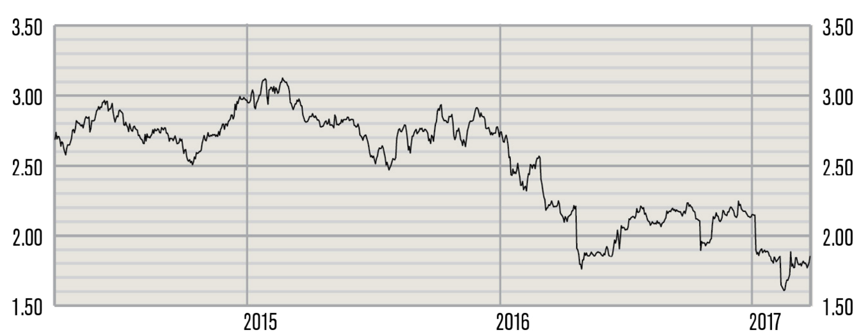
Financials (TTM):

Revenue	£1.94 billion
Operating Profit Margin	(-39.8%)
Net Profit Margin	(-40.9%)

Valuation Metrics
(@3/30/17):

	COB	S&P 500
P/E (TTM)	n/a	24.5
Forward P/E (Est.)	16.3	18.3

COB:LN PRICE HISTORY



THE BOTTOM LINE

While the company has stumbled through multiple profit warnings, operational mishaps and poor financing decisions, Harry Hartford believes it is righting its ship and can benefit from anticipated defense-spending increases. Assuming it can earn two-thirds of historical peak margins with stabilized revenues, he estimates fair share value at around £1.80.

Sources: Company reports, other publicly available information

off if we get into trade wars. There will be winners and losers in any event – our job is to interpret the information available to us in a way that allows us to gain exposure to the winners and avoid the losers. The ultimate loser if we clamp down on free trade is going to be the consumer.

We expect the ongoing discussions to create volatility, which can create opportunity. For example, the significant rhetoric around the free flow of trade between the U.S., Canada and Mexico has adversely affected the shares of Kansas City Southern [KSU], a monopoly-type railroad franchise with routes connecting the three countries. We're going to look at everything on a case-by-case basis and try to take advantage when we think the market is getting it wrong.

To what extent do you think the rise of passive investing has changed the game for fundamental active investors?

HH: The biggest challenge from a business perspective, of course, is that passive options tend to be extremely cheap. You always had to generate competitive returns, but the threat to your business model if you don't has never been greater.

Because so much passive money is valuation indifferent, there should be greater opportunity down the road for the active manager. That clearly doesn't work in our favor when markets are going up and up, but valuation-indifferent sellers when that's not the case should provide an extraordinarily rich opportunity set for us.

ON PASSIVE INVESTING:

It's leading to money moving in and out more quickly over short time horizons. That volatility can be helpful to us.

CM: In general we find that the increased prevalence of factor-based and industry-specific equity-investment strategies is leading to money moving in and out more quickly over short time horizons, often for macro reasons. That may not be quite so evident at the index level, but if you drill down to the security and industry levels you see very significant swings. With utilities and REITs, for example, they tend to all move together very quickly when the market decides interest rates are going up or down. That type of volatility based on macro factors can be helpful to us as value investors looking at fundamentals and sensitive to valuation.

Is there now an even greater premium on being prepared to act?

HH: We would agree with that. That's a key reason we have continued to invest in our research capability both on the fundamental and quantitative sides. When we get these mispricings due to valuation-agnostic or macro-factor-based investing, we need to have done the due diligence and be prepared to respond. VII

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 investing 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. Diversification does not prevent all investment losses. There is no guarantee that the Causeway Funds will meet their stated objectives.

Holdings, country and industry allocations are subject to change and current and future holdings are subject to risk. The top 10 holdings for the Causeway Global Value Fund may be viewed by visiting http://www.causewaycap.com/fund/global-value/ and for the Causeway International Value Fund by visiting http://www.causewaycap.com/fund/international-value-fund/

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As of 3/31/2017, the Causeway Global Value Fund Institutional Class returned 5.42% (QTD), 15.69% (one-year), 2.90% (three-year), 7.94% (five-year) and 4.64% (since inception). Inception is 4/29/2008. The expense ratio for Institutional Class shares is 1.05% and 1.04% after adviser fee waiver. Contractual fee waivers are in effect until 1/31/18. As of 3/31/2017, the Causeway International Value Fund Institutional Class returned 7.79% (QTD), 13.58% (one-year), -0.52% (three-year), 5.68% (five-year), 2.07% (ten-year) and 7.46% (since inception). Inception is 10/26/2001.The expense ratio for Institutional Class shares is 0.91%. Performance greater than one year is annualized. The Funds have a 2% redemption fee on shares held less than 60 days.

The MSCI World Index (Gross) is a free float-adjusted market capitalization index, designed to measure developed market equity performance. The Index is gross of withholding taxes, assumes reinvestment of dividends and capital gains, and assumes no management, custody, transaction or other expenses. The Fund's value discipline may prevent or restrict investment in major stocks in the benchmark index. Indices are unmanaged and it is not possible to invest directly in an index.

The MSCI EAFE ® Index (Gross) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada. The Index is gross of withholding taxes, assumes reinvestment of dividends and capital gains, and assumes no management, custody, transaction or other expenses. The Fund's value discipline may prevent or restrict investment in major stocks in the benchmark index. Indices are unmanaged and it is not possible to invest directly in an index.