CONSUELO MACK | WEALTHTRACK

Program #1318
Broadcast: October 21, 2016

On this week's show, highly-rated global investor, Sarah Ketterer, Portfolio Manager of Causeway International Value Fund explains why there is still plenty of value to be found in overseas markets.

SARAH KETTERER
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CONSUELO MACK: This week on WEALTHTRACK, where is a top rated global investor finding value these days? Causeway international fund's Sarah Ketterer describes the treasures she is finding among the rubble of restructurings and scandals next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
For those of us looking for income from our investments, and who isn't, the latest report from veteran investment strategist Sam Stovall is sobering. Stovall warns income-oriented equity investors to expect *"…pincer-like pressure from rising short- term interest rates and the reduction in stock dividend increases."*

That latter prediction caught my attention. At this point most of us yawn at forecasts of higher interest rates. We have been waiting for years for them to happen. But until this year dividend oriented investors have been benefitting from five years of double digit increases in dividend payouts. According to Stovall the latest indications are that *"…dividend net increases",* -those are increases less decreases,- *"for U.S. domestic common stocks totaled $6.0 billion during Q3 2016."* This was a decrease from both the quarter before and the same quarter a year ago.

And here's the kicker! "*For the 12-month period ending Sept. 2016, net increases fell nearly 56% to $20.8b vs. a $47.1b increase ending September of 2015."*

Ouch! If you can't continue to look forward to robust dividend increases where will positive stock returns come from? When all the third quarter reports are out, Wall Street analysts expect S&P 500 earnings will have experienced their fifth consecutive quarterly decline.

This week's guest is not discouraged by these trends. She is a global value investor with a superb long term track record. She is Sarah Ketterer, Chief Executive Officer of Causeway Capital Management which she co-founded in 2001 and now has more than 40 billion dollars in assets under management. She is Portfolio Manager for the firm's Fundamental and Absolute Return Strategies including five of Causeway's six mutual funds.

She and her team at the flagship Causeway International Value Fund were nominated for *Morningstar's* International Stock Fund Manager of the Year Award for 2013. The fund which has a *Morningstar* analyst rating of gold is a perennial favorite of the research firm.

Since this is Ketterer's first WEALTHTRACK appearance I started with the basics. What does value mean at Causeway?

SARAH KETTERER: It means not overpaying, and a value investor doesn't overpay for anything. We don't overpay for household goods and cars and TV sets. We are very oriented around getting the bargain.

CONSUELO MACK: How would you describe your investment philosophy?

SARAH KETTERER: Fundamentally we invest from the bottom up. So rather than being slaves to an index, we identify stocks that we believe will outperform markets by using a bottom up, fundamental, active approach. So the philosophy is very much active investing to identify undervaluation in companies that have superior financial strength that are often in the process of returning increasing amounts of capital to shareholders.

CONSUELO MACK: What are the kinds of tools that you bring to the task of identifying companies that you think have tremendous potential?

SARAH KETTERER: What sets Causeway apart in my mind is that we are an amalgam of fundamental and quantitative investing. Most people like to put everything in buckets. It's simpler to think about the world as fundamental and analysis of financial statements or quantitative using computer models. We're convinced that the fusion of the two leads to a much better outcome; that you could have fundamental analysts. I work with a whole team of individuals who tear apart financial statements. We meet with company managements. We make an assessment of the business fundamentally, and we arrive at what we think the share price should be. If the stock's undervalued, where should it be trading? But our quantitative colleagues are experts at determining how much risk a stock will add to the portfolio, and it's having that risk information early in the process that allows us to identify companies and stocks, ultimately stocks that will outperform their markets with much less risk.

CONSUELO MACK: What is it that the quantitative approach brings to the table that you think enhances your job and also performance?

SARAH KETTERER: I will go so far to say, Consuelo, that if a manager doesn't have quantitative tools, I think that manager will suffer.

CONSUELO MACK: Why is that? They don't ...

SARAH KETTERER: Well, for one thing quantitative allows us as fundamental managers to understand how much incremental volatility a stock will add to our portfolios. Years ago when I began in the business it was, where is this company listed? In what country, what market and what currency does it trade in? What industry is it in? Oh, well, let's just diversify. Let's have a certain amount in consumer staples and a certain amount in health care, and those old rules haven't applied for years. Now in order to understand diversification, the critical way to do that is to know how much volatility a stock will add to the portfolio.

CONSUELO MACK: This is what a computer can do, right, is to look at past history.

SARAH KETTERER: The computer can do the number crunching. It's really just statistics. It's just basic mathematics, understanding how stocks, their share prices compare with each and the past. How they compare in a statistical construct has a lot of bearing on how they'll trade relative to each other in the future, and if a company has changed its stripes, if it's no longer the business it used to be ... for example, most of the major banks globally post the 2008 global financial crisis have raised over twice as much capital as they had prior to the crisis. They're much stronger institutions, more heavily regulated. They may in fact be much lower risk going forward than they were in the past, so a backward-looking risk model that's resonated in computers might overestimate risk. So it's up to us fundamentally to temper the risk model. I think the arrows go both directions; that fundamental analysts have a good sense of what risks we should anticipate in the future, and quantitative analysis is very backward-looking that extrapolates that information into the future.

CONSUELO MACK: Let me follow up on the bank issue because banks are different businesses now just like you've said. I mean they've had to become much more conservative. You've owned a number of banks through this period. What's the attraction of banks now, considering all of the negatives that we're all extremely aware of?

SARAH KETTERER: Well, our international fund and our global fund are both overweight European banks, and now you're going to throw me out, but the reason why is because they're some of the cheapest financials in the global investable universe, and why now? Because interest rates have reached a floor. We're convinced both in the U.S. as we've begun this tapering process implemented by the Federal Reserve, as well we're seeing this in the Bank of Japan's actions to keep their long-term bond yields at least at zero, not to drop below.

CONSUELO MACK: Not negative.

SARAH KETTERER: The European Central Bank is also running out of options. All these central banks are begging the various governments to complement the monetary policy with more aggressive fiscal policy, but there's not much more to do monetarily and, as a result, all the concerns that swirled around the banks about a never-ending period of squeezed profit margins because as you know banks take money in and typically have to pay their depositors. Things have changed these days, and then they lend it out and that difference, that net interest margin, is critical for bank profitability. If there's no margin, there's no profitability, so you can understand the consternation of investors, but we're convinced that situation has changed. Since banks – especially European and the good ones, the Barclays, BNP Paribas, Lloyds Bank in the U.K. – they trade if not at book value, at discounts to their book even if you take out goodwill, big discounts to tangible book value, and that assumes they'll never earn their cost of capital, that they'll never recover. That's what we do well as value managers. We buy early in the cycle when everyone is pessimistic, and then the cycle turns.

CONSUELO MACK: So early in the cycle. I mean that really is a hallmark, and it's a curse almost to being a value investor because we've been waiting for a long time for interest rates to go even a little bit higher, and we've been waiting a long time for banks to start making more money. Do you have any more confidence now that that's going to happen sooner rather than later? I mean could we still be a year or two out as far as ... ?

SARAH KETTERER: You can hear the drumbeat. It's coming, this turn in the cycle because just a really small change in interest rates, almost minuscule, can make a big difference on bank profitability. Banks are very leveraged entities by their very design. That means that you've got to own them now. You want to own the higher quality banks, the ones that when it comes times, say a year or two, they will have built up enough surplus capital, and the regulators will give them the green light, and they'll return that to shareholders and that's the big reward is higher dividends and share buybacks.

CONSUELO MACK: I see. So you just mentioned three, so Barclays, HSBC and Lloyds I think. So are those basically the three if you were to give examples of banks that are going to really be able to capitalize on even a gradual and a very small rise in interest rate? Are those the three primary candidates?

SARAH KETTERER: If you want to get to that great intersection between most undervaluation and the return potential and quality, I would say those banks are in the U.K. because the U.K. ...

CONSUELO MACK: Oh, in the U.K.

SARAH KETTERER: U.K. is considered blighted. Remember we're in a Brexit.

CONSUELO MACK: Post-Brexit.

SARAH KETTERER: Actually we're post the referendum but we're pre the pain. All we're seeing now is a plunge in pound sterling. Great time to go to London as a tourist but a lousy time to own British stocks. However, all this pessimism we believe is unfounded because the British population did not vote for unemployment. They didn't vote for becoming poorer or having their public service deteriorate or having their purchasing power sharply lowered. They voted for prosperity, so given it's a very service-oriented economy, we think there's really very little latitude that the government has. They could talk a big game about closing the borders and ...

CONSUELO MACK: They are taking the big game, the Prime Minister.

SARAH KETTERER: But it's talk. We're convinced it's talk and that no government, no sane government unless it's completely suicidal votes for a worse economic situation or will implement a worse economic situation. So let's just say the U.K. can manage to arrange a few really good trade agreements, and they have some control over immigration but not to the point they close their borders. It's a low corporate tax economy. It's generally pretty open, lots of international workers. It's a great place to do business, and now it's 17 percent cheaper.

CONSUELO MACK: So you're betting that the politicians will see the light and actually act rationally.

SARAH KETTERER: I know that does sound almost impossible.

CONSUELO MACK: Are you kidding?

SARAH KETTERER: Yes. They will always vote to keep themselves in office, and in order to do so, they’ve got to make sure they protect people’s pocketbooks.

CONSUELO MACK: Because one of the things that you told me in a pre-interview was that you look for disasters at Causeway, and so I mean a disaster could be the British government to a certain extent at this point.

SARAH KETTERER: That’s definitely a fair representation of what they’re doing.

CONSUELO MACK: Yes, of what they’re doing exactly right now, but you also look for companies that are perceived as being disastrous but again that you think the underlying businesses are really solid.

SARAH KETTERER: Well, let’s get out of banks and go to industrials. Regrettably we owned some Volkswagen before the September 2015 revelation of fraud and Dieselgate as it’s known.

CONSUELO MACK: So you owned it on its fundamentals before that.

SARAH KETTERER: Exactly, exactly.

CONSUELO MACK: Before the scandal.

SARAH KETTERER: It was one of the worst run but potentially most promising global automotive manufacturers, meaning bloated expense base, lots of room for cost cutting, lots of room for reorganization of the business and consolidation of models, lots of very, very valuable brands. Outside of the Volkswagen brand we’ve all heard of, the company also owns Porsche and Audi and commercial trucks such as MAN and Škoda. They have Bugatti. They have all sorts.

CONSUELO MACK: Really luxury items.

SARAH KETTERER: Absolutely. So they’re much more diversified than most investors realize, and another one of Causeway’s important screening criteria is that we only invest in companies with superior financial strength. So prior to the revelation of Dieselgate, Volkswagen had 24 billion euros of net cash on the balance sheet, so they had lots of room, no net debt to maneuver, but we never expected fraud. I’ve only seen that twice in my entire long career, so that was a surprise. So it took us about 48 hours post the revelation of the crisis to decide this was a bet worth taking to buy more. Just when all investors were selling, we were buying mainly because so much upside in that stock, so much latent value, and we knew in a crisis management would have to implement the restructuring that we were anticipating.

CONSUELO MACK: You knew they had the financial strength to withstand the kind of financial hit ...

SARAH KETTERER: Exactly.

CONSUELO MACK: ... that they were going to take to do that.

SARAH KETTERER: Exactly.

CONSUELO MACK: Again this takes a tremendous amount of patience on your part and also patience on your shareholders' part. How has that worked out? The last two years you've underperformed your benchmark, and this year it looks like you're still underperforming your benchmark. So how do you explain this to shareholders? Are they withdrawing funds like a lot are from other actively managed funds?

SARAH KETTERER: Well, ours aren't.

CONSUELO MACK: They aren't?

SARAH KETTERER: I find that encouraging, and maybe somebody's learned about the value cycle, but I think part of this has to do with the need we all have to save more in a low interest rate environment and take more risk. The fixed income ...

CONSUELO MACK: To get better returns.

SARAH KETTERER: Exactly, exactly. So we're seeing a number of fund shareholders contribute or add more to their holdings, and I think they understand that the value cycle is turning.

CONSUELO MACK: It's a big if for that to happen, but you sound like you're much more confident in it. Another area that you also mentioned to me, and aside from disasters such as Volkswagen, but also when you were describing Volkswagen before the Dieselgate that you also look for companies that you called self-help companies. What does that mean?

SARAH KETTERER: Well, let's just say that even though rates may bottom, there may be no further down we go, we're not really looking for much of an uplift. The world is not in a vigorous economic cycle. So if there's not a lot of revenue growth for companies out there, how do we get profitability growth? Well, the only other way is through cost cutting. So it's an expense reduction, efficiency type story, and there are many companies implementing that approach, and they're listed in the U.S. market, in Europe, in Japan, and a good example I would give you is Japan Airlines. We are normally a little nervous about airlines because they're very heavy fixed cost businesses.

CONSUELO MACK: Very cyclical.

SARAH KETTERER: Asset intensive, but like so many airlines that one came out of bankruptcy and now it has an absolutely stellar balance sheet, so great financial strength. Other than the fact that Japan suddenly got expensive because their currency has risen 17 percent or 15 while the pound has fallen just the other direction, the stock trades at like five times earnings. They have net cash on the balance sheet. They have really good management. They're managing capacity, and because they know how to do this, we watch them. They've been very clear with us about capacity reductions where needed. They're not running it the way they used to. That sense of self, that understanding of how to help themselves get to higher levels of efficiency without the revenue improvement is really important. That will lead to the re-rating upward. Hitachi is another example in Japan, a company that has been this sprawling conglomerate, everything from rice cookers to software, and what we want to see is a company that takes that enormous disparate set of industries and then starts to get rid of those that are low return, and they are doing that now. Every time they announce another disposition of a poor return business that improves their mix, they get re-rated upward by the market.

CONSUELO MACK: You like income at Causeway. So talk to me about what you look for. What kind of income do you like? What do you look for?

SARAH KETTERER: Usually it's cheap income. You're talking to a value manager, but an example would be Royal Dutch Shell. This is one of the world's largest global integrated oil and gas companies, and they ...

CONSUELO MACK: Not popular in the sustainable investing crowd.

SARAH KETTERER: But I'm convinced based on discussions with these oil and gas companies and talking to our lead portfolio manager in energy that the solution or the successor to fossil fuels is actually resident in these energy companies. They have the cash flow and are spending the money on discovering alternatives. So I wouldn't count them out, but in the next 20 years we'll still need them at least. So in the interim it's very useful to find those that are generating enough cash. The reason why Royal Dutch is so interesting is that they've been very careful not to spend more than they have. It's called keeping their capital expenditures within operating income, and then making sure shareholders get well rewarded. So between a combination of cash and what's called script or additional equity, there's a six percent dividend yield on that stock when you're taking very little in the way of financial strength risk if any, and we think that oil and gas especially Brent Crude prices are going to continue a gradual march upward not to levels that would kill demand but somewhere in the 60 to 70 dollar range which bodes very well for companies like Royal Dutch.

So there's income that's sustainable, and there's financial strength and possibly capital gains as well. It doesn't get better than that.

CONSUELO MACK: One of the things that's happened in the U.S., there are two things that have happened with the S&P 500 companies for instance, and one of them is that this is the fifth consecutive quarterly decline in earnings that S&P 500 companies are experiencing. Also for the first time in several years actually their dividend increases have decreased pretty substantially over the last year. So there are two trends that little warning flags kind of go up. How concerned are you about the decrease in profitability and also in payouts?

SARAH KETTERER: In our global fund, we are underweight the U.S. market, but it's not a top-down decision. It's through the bottom-up process. We just find more undervaluation with the prospect of earnings improvement, the change being better overseas than the in the U.S. It's not an indictment of the U.S. market. The U.S. market is enormous. There are always stocks to buy in the U.S., and I can think of many situations of companies that will buck that trend, but overall as a market we've been seeing peak earnings…

CONSUELO MACK: How would you rank the opportunity set at this point? Are you fewer, more, about the same as you always have? I mean what opportunities is the global market presenting to you? Is it pretty rich?

SARAH KETTERER: Yes, and from a value perspective. If for example we were the tactical types who raised cash, I wouldn't hold any cash at all, not even a penny.

CONSUELO MACK: Wow.

SARAH KETTERER: I'd put it all into equities, value-oriented, because we're at the turn of that value cycle. It's been two plus years of pain as the value manager, and now with a floor under interest rates and with a little bit of life in the U.S. economy and some improvement abroad, that's the time when this type of stock that's been downtrodden – but again we're looking at very high-quality companies – this is their moment to shine.

CONSUELO MACK: What are you analyzing that's going wrong in your portfolios now that you're sticking with?

SARAH KETTERER: I'd say the deepest undervaluation and the one that's most sensitive to this bottoming of interest rates are the financials both banks and insurance stocks. They could ultimately, over the next three to five years, be the biggest returners of capital. There could be the most significant improvement in dividends and share buybacks, so we got to keep the faith in those. We have a disproportionately large amount of European financials in both funds, International and Global, but we're convinced buying these stocks at such large discounts to book value, there are so few times in one's career you can do that, and this is one of them.

CONSUELO MACK: All right, final question, the one investment for a long-term diversified portfolio. What would you have all of us own some of in a diversified portfolio?

SARAH KETTERER: Well, we have a stock in our global portfolio. It's U.S. listed, called United Healthcare, and the reason why I mention it is my colleagues and I we've argued about. Is it too expensive? Can they continue to do well? This is a managed care organization which is, by the way, an industry entirely unique to the U.S.. The government pays elsewhere, but we're not going to be in a government pay situation. We've dabbled with it. We've decidedly put it in the hands of the private sector with a public sector component being Medicare and Medicaid, but United Healthcare has reinvented themselves, and the more we talk about this company, the more interested we get for the next ten, 20, 30 years to have this optimum care within their business, to be the source both in terms of information technology and efficiency for hospitals and doctors. This idea that you'll be wearing some sort of semiconductor-related device that will tell your physician exactly if you're taking your medication and how often and how are you doing, all of that being monitored by a really efficient organization like United Healthcare, and that's the future of medicine. This whole idea of fee for service is going out the window. Now it's pay for value.

CONSUELO MACK: Fascinating. So Sarah Ketterer, lovely to have you on **W**EALTHTRACK for the first time. Thanks so much for joining us.

SARAH KETTERER: Thank you for having me.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point comes to us courtesy of a WEALTHTRACK guest and noted financial thought leader, Burton Malkiel, author of the classic, *A Random Walk Down Wall Street*.

Malkiel recently wrote an op-ed in the wall street journal extolling the virtues of preferred stocks for retirement accounts. Under his leadership one of the firms he advises, Rebalance IRA just allocated 25% of its income growth portfolio to preferred stock. So this week's Action Point is: consider some preferred stocks for your portfolio.

Preferred stocks are a kind of hybrid security that sits between bonds and common stocks in a company's capitalization. They are junior to bonds, but senior to common stocks.in their claims on assets. They currently yield considerably more than investment grade bonds.
And unlike interest which is taxed at regular personal income tax rates, preferred dividends are usually taxed at the much lower long-term capital gains rate.

Malkiel points out that investment- quality preferred stocks with attractive dividend streams are relatively stable and only moderately more volatile than bonds. His advice: Preferreds, which are available in mutual funds and ETFs are worth considering, especially for retirees in these income starved times.

Next week we will have a rare interview with a great global growth investor, Mark Yockey Head of the highly rated Global Equity Team at Artisan Partners where he runs The Artisan International Fund among others. Where is he finding growth in this low growth world?

In the meantime to see this interview again and hear our EXTRA interview with Sarah Ketterer go to our website wealthtrack.com. Also feel free to reach out to us on Facebook and Twitter.

Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.