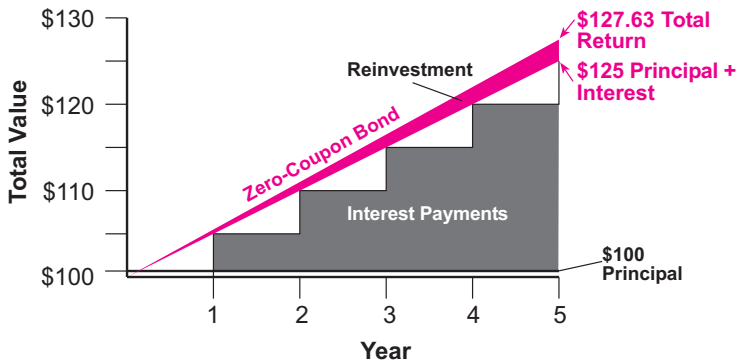


Capital Visions

ZERO-COUPON BONDS

We like zero-coupon bonds! Such a fixed income security is one which does not pay coupon interest. Instead, the bond is sold at a discount to its maturity value. The difference between its maturity and offering prices is nearly the same as the value of the accumulated interest payments on similar coupon-paying bonds. It's the word "nearly" that draws us to the coupon-less security. The following chart exemplifies our point.

Total Value of a Bond



Source: Internal
Simplifying assumptions include: Stable market interest rates, stable credit rating and credit spreads, annual interest payments, principal payment at maturity and a coupon reinvestment rate equal to the initial yield.

This chart shows the total value of a five-year 5.00% bond over the course of its life. The blue shaded area is the \$100 of initial principal plus the \$5 annual coupon payments. At the end of year five when the bond matures one will have received the initial principal plus \$25 (5x\$5) worth of interest. But wait, there's more! The red shaded area is the interest earned on the interest as it is paid out in yearly installments. For example, after the first year, the bond holder will receive an interest payment of \$5. These funds may be invested (we assume at the same rate as the bond) to earn 25¢ annually (5% of \$5). The first of the interest payments earns this 25¢ four times until the bond matures so one would receive an additional \$1. The next payment may be invested for three years to earn 75¢ and so on. Of course the interest earns interest too, which also earns interest, etc. Putting this all in one lump sum results in a total value at year five of \$127.63 with \$2.63 of the \$27.63 total return coming from the reinvestment of the interest payments. This is 9½% of the total return and thus is quite significant.

The reason we prefer the zero-coupon bond over the standard bond is because it is priced to result in the same return as the coupon-paying instrument. Thus, if we paid \$100 for such a bond and held it

for its five-year maturity, we would receive back \$127.63. [NOTE: Zero-coupon bonds are typically issued at a discount to par – \$78.35 for this example – and paid off at \$100, but we assumed the issuance at \$100 in this case to make the returns easier to see.] What we don't have with the zero-coupon bond is **reinvestment risk**. That is, we as holders of the security do not have the burden of reinvesting the coupon payments; it compounds for us "automatically" as part of the zero-coupon bond. So the \$2.63 is a certainty.

Please keep reading as we will now explain the relevance of this example to equity investing.

Reinvesting FREE Cash

The reinvestment income (red shaded area in the chart) is somewhat analogous to the choices a company may face in reinvesting its FREE cash flow. As VALUE investors we often look at the FREE cash flow generating ability of companies as one measure of intrinsic net worth. FREE cash is defined as reported earnings plus noncash charges (including depreciation, amortization, accruals for deferred taxes, etc.) less required cash expenditures (mostly dividend payments, changes in working capital and capital expenditures). What's left over (if positive) may be used to pay dividends, repurchase shares, make capital expenditures, acquire other businesses or it can just sit in the bank. Each of these choices for excess cash deployment carries with it **reinvestment risk** – similar to our bond example above.

If a company is growing rapidly and uses all its cash flow for operational purposes (leaving none in excess), the returns may be more predictable, like a zero-coupon bond. If a company makes "coupon" payments to its shareholders (dividends), we as investors must then reinvest the funds at a rate as least as attractive as can be accomplished by the company or our returns will be diminished. If the company does not pay out its excess capital, but chooses to deploy it on acquisitions or increased spending, shareholders then have the risk of nonproductive investments.

Take, for example, **Federated Department Stores**. We sold this stock earlier this year because we believe they "threw away" more than \$1 billion on the ill-fated acquisition of Fingerhut. In this case the reinvestment risk of the company's excess capital was extraordinarily high. The company may have been better served to return the excess cash from its slow-growing department store business to its shareholders via share repurchases or dividends.

What we have learned (through many years of investment experience) is that the analysis of **how** a company employs excess capital could be even more critical than the determination of **if** they generate such cash. Because unlike bonds, the unwise reinvestment of corporate excess capital could be very costly. Furthermore, as VALUE investors, we do not require that potential investments generate excess capital. If, like a zero-coupon bond, we can find good quality companies that reinvest back into their own business for a favorable return, that's great. **Molex** is a connector company that has always had many more ideas for new products and markets (within its own well-known and highly favorable industry) than it could exploit. So it reinvests most of its excess capital into research & development and small acquisitions. The same can be said for our holdings of **MMM**, pharmaceutical company **Aventis** and energy company **Enron**.

But other companies in which we invest know they cannot fully deploy their excess capital and so choose to enact large share repurchase programs. **IBM** has been doing this for more than five years under the stewardship of Louis Gerstner (he was recently knighted, so we may call him **Sir Louis!**) and has bought back more than 25% of its outstanding shares. The same can be said for others including **ITT Industries**, **Trigon Healthcare** and financial services company **Washington Mutual**. Each company has choices. It is the proper shareholder-oriented selection from these choices that make great companies, those in which we choose to invest.

Now let's discuss recent economic and financial market events.

VALUE EQUITIES STRATEGY

Unlike the steady returns of zero-coupon bonds, equity returns can at times be volatile. The trade-off is that with lower *predictability* of returns sometimes comes higher absolute long-term performance. One of our jobs at MetWest Capital is to position portfolios with the optimal combination of risk versus reward to get the best of both worlds.

The first half of 2001 was a subpar period for many financial markets. The dramatic slowing in economic activity (worldwide) has "spooked" many investors out of equities and sent them clamoring for more assured fixed income investments. Thus, after declining by -11.85% in 2001's first quarter, the S&P 500 Stock Index (including income) recovered only half the lost ground and remains nearly 7% lower year-to-date. Value-oriented indices have fared better due to their lower exposure to technology stocks, but have still declined thus far in 2001.

The U.S. economic slowdown has been somewhat unusual. Typically, by this point in a downturn, consumer spending would be weakening. But to the contrary, growth in real consumer spending has remained strong. Neal Soss, Chief Economist at Credit Suisse | First Boston put it well: ". . . *the latest retail sales figures suggest U.S. consumers are continuing to do what they do best, spend. That's been the difference between the economy experiencing a slowdown and a recession.*" Not only has consumer spending held up, but the most cyclical of consumer purchases – big-ticket durable goods – has actually accelerated. Purchases of

cars (down, but not by much), houses, furniture, appliances, personal electronics & computers and even luxury items like boats and jewelry have held up well. What is going on?

While Dr. Soss has argued that consumer spending will remain robust and keep the U.S. out of recession, we are a bit less sanguine. It could be that the consumer has gone on one last shopping "spree" before taking a normal cyclical breather. Robert Mellman at JP Morgan Chase points out that the "*explanation for the strength of consumer spending seems to lie with interest rates that are historically low and falling, in an environment of still modest unemployment and rising real wages.*" Also helping out is a flurry of home-equity lending and refinancing, a strong U.S. dollar (making imported goods appear to be "on sale") and a promised Federal tax refund.

Later this year we expect interest rates to level out. This could reduce home refinancing and the increased spending that typically follows. We also remember that labor trends lag economic activity and thus the unemployment rate could continue to rise, thereby dampening consumer confidence. The tax cut will run its course but could be a onetime "kicker," not a sustaining element of expenditures. Finally, the U.S. dollar could fall over the coming quarters and cause import prices to rise (or at least stop falling). On this last point, we shall explain our rationale in the International Strategy section.

Given our views, we have been positioning portfolios to weather the modest consumer slowdown we are expecting. Thus, we trimmed consumer stocks and purchased select financial stocks. The good news is that we expect that just as the consumer starts to pull back, industrial America (including select capital goods, technology and communications industries) could start to rebound. Thus we expect the U.S. (and global) economy to continue to moderate for a little while longer, but then bottom toward the latter part of this year. Consistent with our thesis, two of the new stocks we purchased last quarter are:

Portfolio Activity

- **Wells Fargo** is among the top five banks in the country. The company was formed in late 1998 when Norwest Corp. of Minnesota purchased Wells Fargo and took its name and San Francisco corporate headquarters. After the smooth and successful integration of the two companies, CEO Dick Kovacevich is now back to the strategy that made Norwest one of the most consistently profitable banks in the nation. His goal is to expand earnings by providing better service and more products to his existing customers. Wells is the leader in internet banking and home mortgage finance. It also holds #1 or #2 market share positions in two-thirds of the territories in which it competes. We get all this and only have to pay 14x cash earnings.
- **Raytheon** is the third-largest defense contractor and the largest defense-electronics contractor in the U.S. It also produces small aircraft (Beech, Hawker, Premier and others) and has several large commercial projects such as

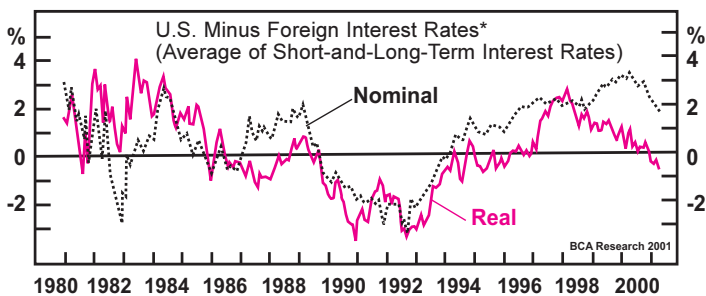
the upgrading of air traffic control systems. It previously divested the Amana appliance as well as Raytheon Engineers & Constructors divisions. We participated in a secondary offering of the company's shares as we believe several near-term investor concerns are not material to the long-term leading positions it has in defense and electronics.

INTERNATIONAL STRATEGY

(This section pertains only to our 100% international portfolios.)

We have been a bit early in predicting a halt to the ascent of the U.S. dollar versus other industrial currencies. Its continued strength has been a factor in the under-performance of foreign shares. We believe, however, that the U.S. dollar is overvalued and likely to decline over the coming quarters. One of the reasons for our view on the U.S. currency is exemplified by the following chart:

U.S. Minus Foreign Interest Rates



Source: *The Bank Credit Analyst and The Federal Reserve Board*
*GDP-Weighted Sum of Germany, France, Italy, U.K., Japan and Canada

This graph shows U.S. interest rates relative to foreign counterparts from January 1980 through May 2001. The dashed blue line is the nominal difference (U.S. rates of 4.6% less foreign rates of 2.8% results in a difference of 1.8% as the last data point) between U.S. and overseas interest rates. The solid red line accounts for inflation differentials. As inflation has been higher in the U.S. than overseas, the chart shows that real interest rate differentials (nominal rates minus inflation) have been lower than nominal differentials for much of the past 15 years. While the extraordinarily low short-term interest rates in Japan (near zero for much of the last several years) impacts the data somewhat, we still believe the graph is a useful tool.

Throughout most of the past 20 years, there has been a strong correlation between interest rate differentials and the trade-weighted value of the U.S. dollar. The correlation has been higher for **real** rates so we pay more attention to that part of the data. In the early 1980's, then Federal Reserve (FED) Chairman Paul Volcker kept U.S. rates consistently much higher than even the high inflation rates of the time. Thus real U.S. rates were above foreign rates and the dollar appreciated until March 1985. From the above chart one can then see that relative real rates fell for most of the next ten years. The U.S. dollar depreciated throughout this period bottoming in the mid-1990's. Since then the dollar has been consistently strong and, on a trade-weighted basis, is now approaching levels not seen since the late 1980's.

There are many explanations as to why the dollar tracks interest rate differentials. In our view, the most important reason is one of simple economics – money flows to where it can earn the highest real return. So if we look back to 1998, investors in U.S. assets could earn risk-free (or as riskless as it gets with U.S. Treasuries) 3 percent more than the rate of inflation. Overseas interest rates were merely in line with inflation rates and thus provided minimal real returns. So the dollar appreciated. Note that in the past year, the real U.S. rate has fallen below the real foreign rate. This is due to falling U.S. nominal interest rates, rising U.S. inflation, flattish overseas rates and modest overseas inflation. It is an anomaly then that the U.S. dollar can continue to move higher.

Part of the reason for the dollar's strength is that **tangible** assets appear more attractive today in the U.S. than overseas. Thus, overseas investors and companies alike are acquiring U.S. companies and real estate at a record pace. While this may continue for a while, we believe that ultimately, the dollar will become realigned with real interest rate differentials and thus could fall modestly over the coming quarters. For this reason (and others) we believe that our international portfolios could provide higher returns in future periods than they have recently.

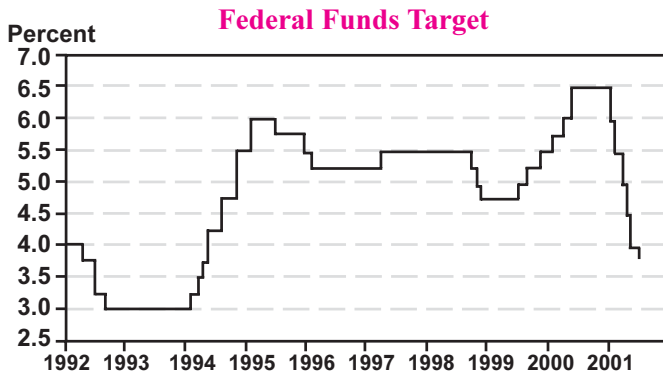
Two of the new stocks that were added to international portfolios last quarter are:

- **BOC Group** and **Linde AG** are two of the world's largest industrial gas companies. BOC, based outside of London, is strong in its home market as well as in the United States, Japan and Far East Asia. Linde is headquartered in Wiesbaden, Germany and is strongest in Continental Europe. Our recent meetings with top management at the companies has led us to believe that the group could regain the premium valuation it once enjoyed. The problems in the industry of late are consistent with the theme of this newsletter. While the industry is highly profitable and generates excess cash, recent investments have been unwise and the returns on capital have been declining. Firms would have been better served investing in zero-coupon bonds. After recent consolidation, we believe that BOC and Linde will both participate in an industry with better, more rational competitors and that profit margins will improve and FREE cash flow will be more wisely invested (or if it can't be invested, returned to shareholders). We believe the better environment to come is not reflected in either stock's valuation of 6x EV/EBITDA.

FIXED INCOME STRATEGY

Unfortunately inconsistent with the theme of our report this quarter, we actually hold few zero-coupon bonds in the fixed income portion of MetWest Capital's balanced portfolios. There are two explanations for this. First, many of our balanced portfolios have periodic distribution requirements. Interest on the fixed income may be accumulated to meet the redemptions. Second (and more importantly), relatively few such instruments are issued, making their liquidity less than adequate for institutional investors.

In response to the weakening U.S. economy, the FED continued to lower short-term interest rates this past quarter with the Fed Funds target rate now 3.75%, fully 275 basis points (2¾%) lower than its year-end 2000 peak. The following chart shows that we are rapidly approaching the lowest level for short-term interest rates that we've seen in this country in almost **four** decades. Prior to 1992, the last time the Fed Funds rate was 3% was in 1963.



Source: Merrill Lynch and the Federal Reserve Bank of New York

There are some who think the FED is acting too quickly. Should the economy snap back later this year, then inflation could become an issue that could stall an otherwise normal recovery. There are two sides to the question as to whether inflation should be a worry with five equally compelling arguments for each. They may be summarized as follows:

Arguments for secular disinflation

1. U.S. monetary policy has been and will continue to be implemented masterfully.
2. Productivity will continue to be driven by the implementation of new technologies and an educated and motivated workforce.
3. As an add-on to #2, technology itself can be implemented in new ways to cut costs and prices.
4. Economic globalization.
5. Demographic trends including an aging society.

Arguments for re-inflation

1. The imminent departure of Alan Greenspan from the FED.
2. Energy prices could be on a secular uptrend.
3. Recent under-investment in basic and capital goods facilities could lead to shortages and price spikes.
4. Less U.S. fiscal discipline.
5. Growth in immigration could mitigate other demographic trends.

We are not convinced that *any* of the above theses are wholly correct. But we do think it more likely that (after a cyclical up tick) consumer inflation will be contained to less than 3% in the coming years. While some economic sectors will experience greater pricing flexibility than others, demographic and productivity forces may overwhelm the pro-inflation trends to keep prices in check. This is good for holders of long-duration assets (such as stocks and bonds) whose prices may rise if inflation (and interest rates) fall. Investors in cash-equivalents (including most money market funds, Treasury bills and short-term CD's) could find it more difficult to maintain their income streams and must understand the trade-off between short-term certainty and longer-term investment results. We have therefore maintained our relatively conservative posture by holding fixed income securities with an average maturity of three to five years. But when we believe the cyclical inflation forces are set to abate, we are prepared to lengthen the duration of our portfolios to "lock in" higher long-term interest rates. We will have more to say on this in future reports.

Not all securities mentioned herein are necessarily owned in all MetWest Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decision to buy and/or sell certain securities at specific times. A list of all recommendations made by MetWest Capital within the prior one-year period is available upon request.

CONCLUSION

As an investment, zero-coupon bonds are not appropriate for all portfolios. But where fixed income is appropriate and current income is not needed, they can offer an optimal vehicle for steady and stable returns. We introduced the concept this quarter to illustrate a point about investing in companies. A company may be thought of as a standard, coupon-paying bond. If it generates excess capital, it may pay it out (like interest) to shareholders or reinvest it. We at MetWest Capital invest in seasoned medium- to large-sized companies, many of which generate FREE (excess) cash. This is **not** a requirement of our style and we continue to find many excellent companies that invest all the capital they generate back into their business. But when we do uncover a potential investment with excess capital, we are careful to analyze how that capital is deployed.

Our analyses require that excess cash earn a rate of return **at least** as great as the enterprise currently generates. Good management teams are able to optimally invest their excess cash to generate such profits. If unable to, they will choose to return the capital to investors and run their companies to maximize such payouts. We seek to invest in such companies for the ultimate benefit of our clients.

**You recently received a notification of our move to a larger suite in our building.
Should your summer travels take you to Newport Beach, please feel free to stop by!**

610 Newport Center Drive, Suite 1000
Newport Beach, CA 92660
(949) 718-9701
(949) 718-9122 fax



11440 San Vicente, Third Floor
Los Angeles, CA 90049
(310) 979-6300
(310) 979-6399 fax

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