

Capital Visions

IN TIMES OF ADVERSITY

A parable was once told to us about a farmer and his old mule. We wrote it down and kept the tale to recall at a time like today. It seems as though a stately, but slow-moving mule somehow wandered off his path and unwittingly fell into his farmer's well. The farmer heard the mule braying – or whatever mules do when they fall into wells. After assessing the situation, the farmer sympathized with the mule, but decided that neither the mule nor the well was worth the trouble of saving. Instead, he called his neighbors together and told them what had happened. They all agreed to shovel dirt into the well to bury the old mule and sympathetically put him out of his misery.

Initially the old mule was hysterical! “*Woe is me, woe is me!*” he said; then he did some more braying. But as the farmer and his neighbors continued shoveling and the dirt hit his back, the mule had a thought. It suddenly dawned on him that every time a shovel load of dirt landed on his back . . . HE SHOULD SHAKE IT OFF AND STEP UP! This he did, shovel after shovel.

“*Shake it off and step up, shake it off and step up, shake it off and step up!*” the mule repeated to give himself encouragement. No matter how painful the piles of dirt were as they fell on his bruised body and no matter how distressing the situation seemed, the old mule fought off the urge to panic and just kept right on SHAKING IT OFF AND STEPPING UP.

It wasn't long before the old mule, battered and exhausted, stepped triumphantly over the wall of that dirty well. What at first seemed like it would bury him actually saved him. This was due to the manner in which he handled his adversity.

THAT'S LIFE! If we face our problems and respond to them positively, and refuse to give in to panic, bitterness, hatred or self-pity, the adversities that come along to “bury” us always have within them the power to benefit.

That's the way it will be in the aftermath of the terrorist attack on America. It was terrible; of course we wish it never happened. But we're in that well and the dirt is coming down. What do we do now? We see the possibilities as a multi-step process that may apply to our personal lives, government actions, the economy and financial markets:

First: A normal spontaneous reaction to terror of fear and inaction – like the bray of a mule.

Second: Thoughtful reflection of one's own fate.

Third: The notion of what one cannot do: sit idly by.

Fourth: Then the epiphany hits, as it did for the mule, of what to do. This is the key step that turns adversity into triumph.

Final Result: While seemingly farfetched right now, we as a society, economy and market may become better off than before the disaster hit.

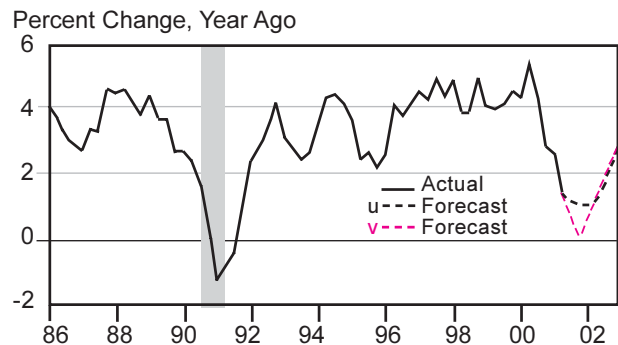
We will now lay out our view of how the U.S. economic environment may unfold in coming quarters. Then in the Strategy section, we will go through some examples of the companies in which we invest and how they have dealt and will deal with adversity. Next we will give a few thoughts on International investments and the Fixed Income markets. Finally, we will conclude with our expectation of a bright long-term future.

Economic Aftermath

Prior to September 11, we mostly agreed with the economics team at the *International Bank Credit Analyst* who said: “*Equity prices remain trapped between the two opposing forces of positive liquidity conditions and negative earnings announcements. Although the stock market has been weak, a drop in the dollar exchange rate should reinforce the FED's efforts to reflate the economy. Add in the stimulative effect of a tax cut, and the economy should soon be on its way out of the woods.*”

Then came the unsuccessful attempt to topple global freedom. The biggest unknown in assessing the likely impact from the September 11 attack is the resultant change in business and consumer confidence. We **had** believed that business confidence would improve later this year and that capital spending would begin to increase and offset a coming slowdown in consumer spending. Thus, as the following chart depicts, we **had** thought a “U”-shaped economic recovery was most likely. We now believe a moderate “U” could turn into a somewhat deeper “V.”

Real GDP Growth



Shaded area represents U.S. economic recession.

Source: Merrill Lynch and the Bureau of Economic Analysis

As the chart shows, the last U.S. recession (defined as two back-to-back quarters of negative GDP growth) occurred in late 1990 - early 1991. Since then, growth has been robust, averaging nearly 4% . . . until 2001. Even before the recent tragic events, U.S. GDP was slowing markedly. All areas of the economy were tepid (some more so than others), with the exception of government spending. Thus one can see that we were already in a slowdown. But the Federal Reserve (FED) has been aggressively lowering interest rates since early this year, businesses have rapidly depleted inventory levels and there were a few signs emerging that the economy may have found its bottom. Thus, we were expecting the "U"-shaped recovery as shown by the dashed blue line in the above chart.

But the events of September 11 stopped the U.S. economy in its tracks – temporarily, we believe. Uncertainties, some of which will persist, have both consumers and businesses putting off decisions. So we now expect GDP growth to slow further, and possibly contract for a brief period. The "V"-shape is shown in red in the above chart. But the extra slowdown could be overcome in early- to mid-2002 with a sharper recovery than we were previously forecasting. This snap-back would be due to pent-up demand, an eventual "rally around the flag" leading to higher confidence levels, lower interest rates (reserve banks around the world are easing even more aggressively) and more fiscal stimulus. The important thing to note is that the expected "end point" (the growth rate in 2002 and 2003) is right back to the 3% level we were forecasting before the change caused by recent events. Thus, while a lot looks different for the next few quarters, little may have changed in our two- to four-year investment time horizon. Given these expectations, what is our investment strategy?

VALUE EQUITIES STRATEGY

A year ago we urged investors to contain their enthusiasm as the "bubble economy" was unsustainable. We now must urge investors to moderate their despair. While we lament the events that precipitated the fall and the resultant temporary dip in the value of our clients' equity portfolios, we are pleased to report that MetWest Capital's conservative and well-diversified portfolios held up better than many – actually, much better than most.

So we now turn our attention to the dual task of continuing to protect principal should the markets fall further, while simultaneously positioning portfolios to benefit from an eventual rebound. As corporate earnings typically track closely with GDP, and stock prices usually lead earnings by six to twelve months, we may expect the economy's "V"-shaped decline and recovery to be closely correlated to similar moves in the equity markets. Of utmost importance, we detect no major structural (long-lasting) imbalances in our economy or impediments to an eventual resumption of healthy overall growth. Therefore, over time stocks should go back up.

Our strategy is a simple one. We will absolutely maintain our long-term *Intrinsic Value* focus. During the immediate aftermath of September 11, we allowed the market to "find its course" and "seek its level," not wishing to be whipsawed by the heightened

volatility. Going forward, however, should other investors stray from long-term thinking and cause anomalies in individual stock prices, we are prepared to take advantage of such price movements. We will favor and look to build further positions in companies that (like the farmer's mule) have proven adept in times of adversity. Let's cite a few examples:

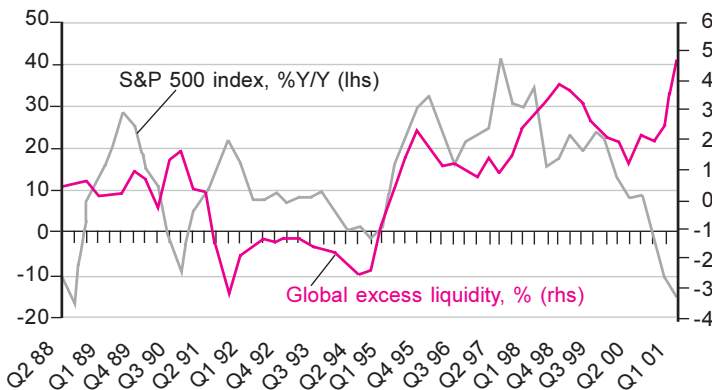
- **Johnson & Johnson:** This is not a stock we currently own for valuation reasons. But J&J, like few others, exemplifies the type of character we seek in corporate management. In 1982, an unknown individual tainted some jars of Tylenol causing several deaths. As a result, the company couldn't guarantee the safety of its product. So it spent \$100 million to voluntarily recall every jar of Tylenol in existence (both in stores and in people's homes), reimbursing consumers and risking the reputation of one of America's most trusted brands. By doing this recall, and later inventing caplets and blister packs as well as other safety measures, J&J secured its reputation in corporate history, endeared itself with the public and the brand eventually came back stronger than ever. Today, Tylenol is still the most-prescribed pain reliever in U.S. hospitals and the largest-selling major analgesic brand.
 - **IBM:** We have owned this stock for our clients since 1993. Here was a company whose time had passed. It invented the mainframe computer, which was being supplanted by personal computers. While it also invented the PC, its market share was eroded by lower-cost and nimbler competitors. "*Woe is me, woe is me!*" said newly appointed CEO Louis Gerstner. But then, just like the mule STEPPED UP and shook off the dirt, IBM changed its strategy and began to benefit from changing technology. "*Look,*" said Mr. Gerstner, "*if technology can change so rapidly that even we are caught by surprise, what about our corporate customers?*" So Mr. Gerstner **embraced** change and got into the computer service business to help his customers do the same. Today, services account for more than 40% of IBM's \$90 billion in annual revenues.
 - **AstraZeneca:** This is a U.K.-based pharmaceutical company whose stock we recently purchased for our clients. Its adversity is due to a patent expiration. While all companies in this industry constantly face this challenge, AZN's challenge is particularly acute. Its largest-selling drug, Prilosec, accounts for 39% of its healthcare sales and will go off-patent in 2002 (at the latest). While there are healthcare stocks we could buy that aren't facing such difficulties, they are richly valued, as are most stocks without any apparent challenges. We have done much better by finding companies that may face near-term adversity (and are therefore selling at bargain prices), yet have proven strategies for dealing with the trouble. AZN has developed several new pharmaceutical products that if marketed properly, will more than offset the decline in Prilosec. Nexium is a "next generation" version of Prilosec that has shown greater efficacy and is priced lower than Prilosec. Thus, by the
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time doctors are able to prescribe generic Prilosec, patients may already be doing better by taking Nexium and unwilling to switch. AZN also has developed the most powerful cholesterol-lowering medication available today. Crestor should be approved by the FDA next year, just in time to take up the slack from the declining Prilosec.

Other attractive investments we own include **ITT Industries**, whose growing defense businesses should more than offset some of its more cyclical ventures like telecommunications connectors and industrial components. **Cytec Industries** has seen its stock under pressure of late due to its commercial aerospace business (it sells composite chemical materials to Boeing and Airbus). But CYT is a leader and it continued to grow sales during the last commercial aerospace cycle, benefitting from adversity much more so than its peers. **Motorola's** sales of wireless communications devices (handsets) and infrastructure may actually benefit from the September 11 attack due to their now obvious safety and security advantages. These are exciting, well-run companies whose stock prices will eventually reflect their managements' abilities to manage through adversity.

But why do we think the markets could rebound anytime soon? The following chart is one reason:

Plenty of Excess Liquidity



Source: UBSW/Datastream. Global excess liquidity is the difference between GDP-weighted M3 growth and nominal GDP growth in the G7.

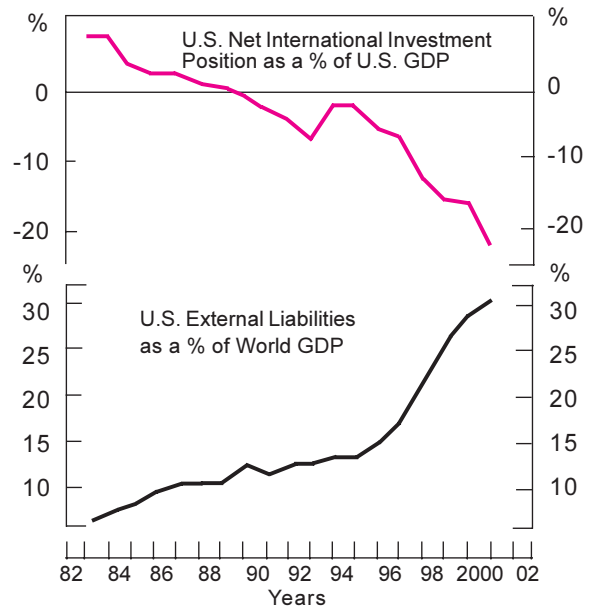
This graph compares the year-on-year change in the S&P 500 Stock Index (light blue line, scale on left) with the percent change in Global excess liquidity (solid red line, scale on right). Global excess liquidity is calculated as global broad money supply growth less global GDP (weighted by each of the G7 countries). Note that since 1988, the correlation has been high. When liquidity is high, stocks do well. Basically, this is saying that when global monetary authorities such as the U.S. FED or the European Central Bank (ECB) lower interest rates and force money into the system, this "excess" money often finds its way into financial assets. Note that most recently, excess liquidity has been very high yet stocks have sold off. We believe this is not sustainable and has been due to a temporary "flight to quality" into short-term Treasury instruments. When the global fear subsides, money, as it always does, will seek higher returns, partly via the stock market.

We must caution that the markets are moving very rapidly – even as *Capital Visions* is being penned. Therefore, stocks mentioned herein may reach selling points or other securities may be found that we deem as superior.

INTERNATIONAL STRATEGY

The world outside the United States may be acting as much with business sense as it is with compassion and altruism. As the following chart shows, foreigners have been large purchasers of American assets over the past two decades.

U.S. External Debt



Source: Bank Credit Analyst

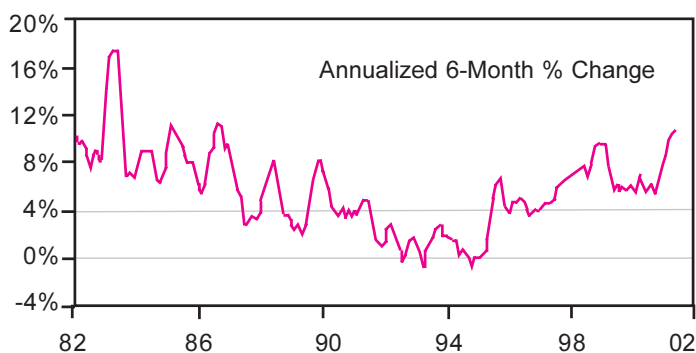
This chart shows that far more U.S. assets are owned by foreigners than are foreign assets owned by Americans. While a large part of the assets are in the form of fixed income securities (remember that until just a few years ago, the U.S. government funded its budget deficit by selling Treasury bonds), it also consists of real estate, oil field equipment, equities and entire companies. Some of the recent high profile acquisitions of corporate America by foreigners include the U.K.-based Vodafone purchase of Airtouch to become one of this country's largest wireless phone service providers; British Petroleum's acquisition of **both** Amoco and Arco after a decade earlier having purchased Standard Oil of Ohio to become the largest landowner in oil-rich Alaska; French-based Alcatel's slew of acquisitions (the largest being DSC Communications of Texas) to become one of the largest providers of telecommunications equipment in North America; and in one of the highest profile deals, Daimler's (manufacturer of Mercedes Benz) purchase of Chrysler, America's third-largest auto manufacturer. While U.S. companies still make large investments abroad, the relative attractiveness of this country to foreigners has served to further intertwine the world's economies. It is no wonder then that foreign governments are most willing to stand by our

side at this time of crisis. In addition to being the right thing to do, it makes good business sense.

FIXED INCOME STRATEGY

Federal Reserve Banks around the world are aggressively providing liquidity to the financial system. This past quarter, even the conservative ECB lowered interest rates by 50 basis points. During the same period, the Alan Greenspan-led U.S. FED lowered short-term rates twice more for a total of eight times this year (thus far) for a more than 50% decline in the Federal Funds target rate from 6½% on January 1st to 3% today. This lowering of rates has been coincident with a near “flooding” of money into the financial system.

Growth In Money (M2)



Source: Federal Reserve data

The above chart shows that the U.S. money supply (as measured by M2) is now growing in excess of double digits, its highest growth rate since the inflationary periods of the early 1980's. While this is necessary as part of the process to reinvigorate global economies, it may not bode well for the future of fixed income investments.

The fixed income portion of MetWest Capital's balanced portfolios has acted very well to buffer the downdraft of equities. Our portfolios have been positioned particularly well as our emphasis on intermediate-term (three- to five-year) high-quality notes (with an emphasis on Treasuries and U.S. government agencies) is just

where the recent “flight to quality” has been. Looking forward, however, we do not believe that short- to intermediate-term yields will decline much more from the current 2%-4% levels. We are thus becoming more conservative in our interest rate expectations and will seek higher yields, where appropriate, in non-Treasury securities. We will stick to investment grade bonds, thereby favoring government agencies (such as Fannie Mae or GNMA) and “quasi” corporates such as Tennessee Valley Authority electric power bonds. As always, we consider the fixed income portion of balanced portfolios to be an “anchor” of stability, while the equity portion is chosen to provide higher long-term returns.

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

We cannot yet say whether good will come out of the horrific events of September 11, 2001, and if so, what forms it will take. But we have strong conviction that the faith and perseverance of Americans and the world at large will find positives and emphasize them over the evil we have witnessed. Uncertainty persists as our nation braces for what may be a long struggle. But the braying will end, we will SHAKE OFF the adversity and STEP UP to all future challenges. Maybe the good will be the uniting of many countries and faiths to face down a common enemy. If we can, as a global society, solve one problem, we can then turn our attention to solving others.

Global economies may decline further than we earlier thought. But the “V”-shaped rebound could be a powerful one and stocks will rise to reflect future prosperous times. We at MetWest Capital have protected our clients' portfolios as best as practical within the confines of the equity market. We now turn our attention to all the great companies that can shine in times of adversity. While continuing to be prudent and conservative, we believe that we are extremely well positioned to outperform in the coming good times and remain steadfast in our diversified *Intrinsic Value* approach. We wish everyone . . . **life, liberty and the pursuit of happiness.**

While always available to you, we would especially like to emphasize at this time that we are ready and **anxious** to discuss the above or any other investment topics with our clients, consultants and interested readers in whatever form of communication you are most comfortable. Please feel free to call, write or email us at any time.



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