Capital Visions

The PHANTOM of the MARKETS

"No more talk of darkness . . . forget those wide-eyed fears . . . I'm here.
Nothing can harm you, my words will warm and calm you.
Let me be your freedom . . . let daylight dry your tears . . . I'm here.
With you, beside you, to guard you and to guide you . . ."

These are the opening words from our favorite love ballad in the musical show "The Phantom of the Opera." With music by Andrew Lloyd Webber and lyrics by Charles Hart, this show captures the imagination of all who see it. Set in a Paris Opera House in 1861, it's a story about "good" versus "evil" and "honor" versus "lust." No, we're not referring to the current international conflict, though the story does possess some similarities. It's about an opera "ghost" (he signs his letters "OG") who is really just a clever man in hiding due to a disfigured face that he covers with a white mask. To feel alive and part of the world again, OG (played to critical acclaim by Michael Crawford and others) writes his own opera and chooses his secret protégé, singer Christine Daaé, to play the lead. He insists that his work be performed according to his instructions and that if it isn't "a disaster beyond imagination will occur!"

All the while, OG continues to tutor the naive, yet talented Christine (originally played on Broadway by Andrew Lloyd Webber's then wife, Sarah Brightman) in order to develop her voice perfectly for the part to come. But Miss Daaé is torn between her clandestine tutor (OG comes to her secretly, appearing only as a faint shadow in her mirror that she refers to as her "Angel of Music") and duty to the other cast members as well as her long-lost and now-found beau, Raoul, the Vicomte de Chagny. So the ballad continues as Christine sings to Raoul:

"Say you love me every waking moment . . .
Turn my head with talk of summertime.
Say you need me with you now and always . . .
Promise me that all you say is True. That's all I ask of you."

What Christine is really saying is "Raoul, please resolve the dilemma of my many masters." What is apparent throughout the show are the many allegiances that Miss Daaé has. Indeed, her many masters pull at her in different directions. Of course she feels gratitude to the Phantom for his expert tutelage. But OG is jealous of Christine's love of the real life suitor, Raoul, and wants him to keep away from her.

"*Ignorant fool this brave young suitor [trying to] share in my triumph!*"

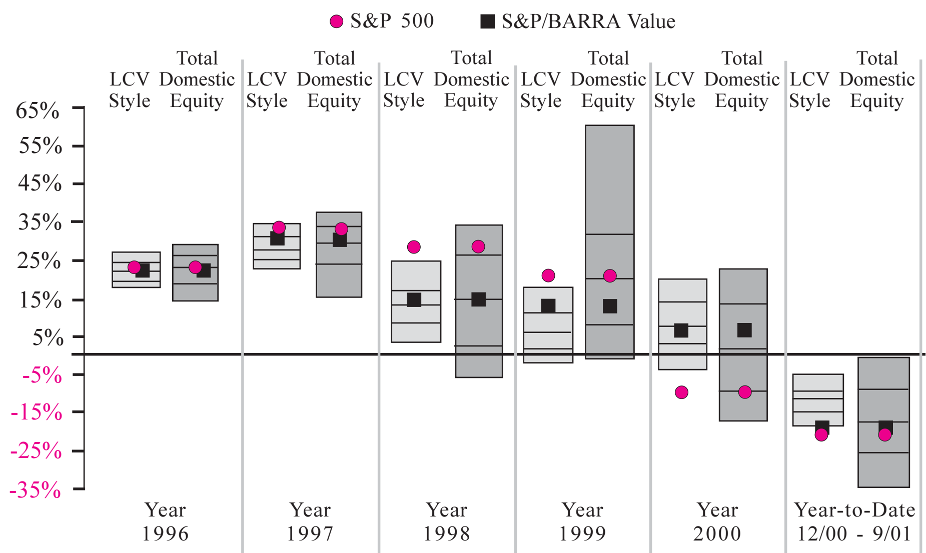
And the conflict doesn't end with those two. Christine also has the "masters" of her audience who have come to revel in her exquisite tones. And she has other masters, such as fellow cast members and the Diva Carlotta Giudicelli whom the Phantom wants her to replace. Finally there are the owners of the Opera House and, of course, herself to take care of as well. How can she please everyone all at once? Or should she even try?

"The Phantom of the Opera" is a wonderful show that has pleased many. But what can it teach us about investing?

Our Many Masters

Just as Christine Daaé has many masters to please, some with conflicting agendas, so do money management firms. It is not always possible (or even wise) to meet everyone's expectations at all times. We at MetWest Capital employ a conservative style of managing Intrinsic Value Equity, Balanced and International

Intrinsic Value Equity vs. CAI Universe (Yearly 1996 - 2001 9 months)



Source: Callan Associates Inc.

portfolios for the benefit of our clients. While all of our clients desire "good" results, there are often disagreements about what "good" really means. The chart on the first page depicts some of **our** many masters.

The graphs present investment management returns for the calendar years 1996 - 2000 and the first nine months of 2001 (final 2001 data were not yet available at the time of this publication). We've used data from Callan Associates but must immediately apologize to all the other consultants whose databases are surely equally impressive. The chart shows two "universes" of managers and two passive benchmark indices. For each period, the left bar (light shading) represents the range of returns for 47 managers that employ a Large-Capitalization Value (LCV) style. The right (darker shading) bar is the range of returns for 786 domestic equity managers of all styles (growth, value, small-, mid-, large-cap, etc.) The red bullet is positioned on the return of the S&P 500 Stock Index and the blue square is the S&P/BARRA Value Index. The top and bottom lines of each graph represent the 10th and 90th percentile ranks of manager returns.

For example, the S&P 500 gained 21% in 1999, making it around average for all managers but "off the chart" in the top decile of value managers. Conversely, in 2001 the S&P 500 is near average again relative to all managers, but lagging more than 90% of value managers. Note also that in 1997, almost all managers of all styles performed admirably with median returns in excess of 25%. But those who were median in 2001 (9 mos.) were all down more than double digits.

So who are the "masters" of MetWest Capital? We think there are many. We must outperform on an absolute basis, relative to our value peers, relative to all equity peers and relative to multiple benchmarks. Like Christine Daaé, MetWest Capital has multiple constituencies. Let's explore these in turn.

1. Absolute returns: This master includes those individual clients on a fixed retirement budget living off the returns (both dividends and capital appreciation) of their portfolios. If the value of the portfolio is $3 million and their before-tax needs are $150,000 annually, then a 5% return will preserve the principal of the portfolio (for their estate perhaps) while providing for their ongoing living expenses.

The absolute master may also include charitable foundations that, like the individuals above, need funds for operating expenses. Some foundations are required by their charters to spend only what the endowment earns and so they are most interested in positive absolute returns (yes, as high as possible is nice, but positive is a must).

Contra: But is it really in the best interest of clients for money managers to seek absolute returns from stock investments? There could be significant lost opportunity "cost" if a manager seeks only to achieve a desired level. Most would argue that the stellar returns of the mid-1990's were an aberration from the norm. Thus while absolute returns of 10% may sound good today, those managers realizing only this level were not participating in the excess returns of the time and thereby lost a unique opportunity for growth.

2. Style-relative returns: This master wants the manager to perform better than those of its peers that employ similar investment styles. This master may include large retirement plans that use a multi-style approach. They (typically with assistance from consultants) allocate their assets amongst several different managers with the aim of choosing the best within particular styles. So, for example, General Motors' retirement plans may hire Janus to manage aggressive growth portfolios and MetWest Capital to manage a value-oriented portfolio. Even if one's style is out of favor, these clients say they will be satisfied if the manager does better than the average of its peers on a consistent basis.

Contra: Are relative returns, then, truly the best master? What if a particular style stays out of favor long enough for pension plans and consultants to begin to predict a long-term trend and allocate assets away from that style? This is what happened to growth in the early 1990's and value later on. So it seems best that managers at least perform near the median of all managers even when their style is out of favor. Beware, however, that this may mean less-than-stellar results when any particular style dramatically outperforms all others. This phenomenon, however, has historically lasted for only short periods (at most for several years) and so a long-term investor should still be satisfied.

3. Benchmark-relative returns: Similar to the style-relative master, the benchmark-relative master is looking for its manager to outperform what it considers to be appropriate benchmarks. Often, MetWest Capital's investment returns are compared with large-capitalization value-oriented benchmarks (such as the S&P/BARRA Value Index or the Russell 1000 Value Index) or large-cap broad-based indices such as the S&P 500. This master is more akin to an "inanimate" object because the benchmarks are not actively managed. Instead, stocks are selected to be included in the indices due to reported data such as book value, size and industry representation. The thought here is that an appropriately selected benchmark reflects available choices of stocks in which to invest.

Contra: Benchmarks are not really "unmanaged." The McGraw-Hill Company, owner of Standard & Poor's, has a team that does nothing but manage their indices and make changes as to which companies are included and which are not. Often the decisions are based on cursory looks at easily attainable public information. Active managers are hired to do precisely the opposite: Make decisions based upon extensive research into hidden, sometimes non-public information. So, ultimately, how a particular index performs may not be relevant to an investor's ultimate goals and objectives.

Finally, there's one more master that exists in more places than one is ready to admit.

4. Cocktail party returns: Unfortunately, these are the most difficult

for a conservative manager to generate. The purpose of results here is to provide fodder for conversations with one's peers at social events so as to cause envy and admiration. We strongly believe that motivations such as these have no place in investing and discourage all managers from attempting to achieve them.

Christine Daaé continues her plea to Raoul:

"*All I want is freedom . . . A world with no more night.*
. . . and you always beside me . . . to hold me and to hide me."

Yes, that would be nice. One "master." One person to love and one person to forever look after you. In life and love this is a desired possibility. But in the world of investments we must learn to live with and please multiple masters. The goal of MetWest Capital is to exceed **all** of our masters' objectives over a long-term investment cycle. This we have done. But we realize and caution our readers (as we have done before) that this means we could fall somewhat short of some goals in the short run so as to achieve each client's objectives over the long term.

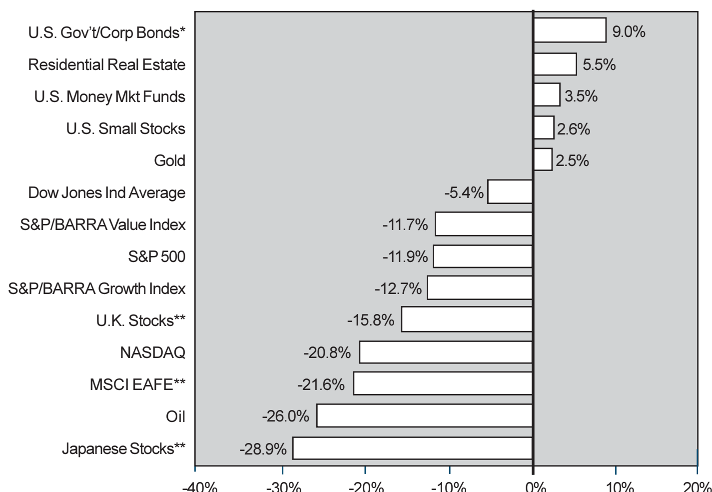
Now let's look at 2001's performance by asset class and comment on our results.

[PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.]

[NOTE: Due to space limitations we cannot provide our past investment returns in this newsletter. The description of the precise methods we use to calculate returns, the nature of our outside independent auditors, clients' fee schedules and the like would surely turn one's eyes bleary.]

VALUE EQUITIES STRATEGY

2001 Asset Performance



** Intermediate term (total return)* ***In U.S. dollars*
Source: Various

As the data show, it was a difficult year for stocks. It was the second down year (as measured by the S&P 500 Index including income) since 1990 and only the second back-to-back down years since pre-WWII (the other pair being 1973 and '74). The last time the market was down three years in a row was 1939, '40 and '41. Statistically speaking then, we are likely to have an up market in 2002. Fixed income again was the best performing asset class. Bonds benefitted from a flight to quality due to both the weak global economy and tragic events of September 11. But historic precedent did not hold as gold gained only 2% (actually, relatively not bad as it had its first up-tick in six years) and Middle East tensions forced oil prices **down** sharply because of reduced demand in a slowing economy. Small stocks did well, but even after two years of out-performance still lag large stocks over the past decade. Seemingly the perennial "phantom," international stocks fared poorly almost uniformly across the board. The Morgan Stanley Capital International Europe, Australasia and Far East Index (MSCI EAFE) declined by 21.6% as measured in U.S. dollars, with nearly a third of that loss due to the strength of the U.S. dollar relative to most foreign currencies. We'll discuss this further in the International section that follows.

Within the U.S. market, value and growth performed in line with each other after value dramatically out performed in the first quarter and growth did better for the remainder of the year. Some of the best performing industries for 2001 were what some refer to as the "old uglies." Thus metals, containers, packaging, auto parts, railroads and furniture companies saw their shares rise 20% or more. At the bottom of the 2001 "heap" was a hodgepodge of industries. These included (i) previous high fliers such as communications equipment and brokerage, (ii) 9/11 "fallouts" like airlines and energy and (iii) surprisingly many non-cyclical industries whose sales and earnings have held up well this year (such as healthcare, telephone companies and food retailers) but whose stocks fared poorly.

Last year at this time we reported that MetWest Capital's *Intrinsic* Value approach exceeded the expectations of all our masters (benchmarks, other managers, other styles, etc.) This year we are pleased to report that our long-term results continue to be superior, but we are disappointed that some of our masters were let down for 2001. While the final Callan Universe results are still being calculated, we believe that our returns were only "middle of the pack" relative to all managers and below the average of other value managers. Relative to benchmarks we were near the S&P 500 and S&P/BARRA Value Indices but below the Russell 1000 Value Index.

Most of our shortfall we believe may be attributed to our moves during the year to take advantage of low-priced, out-of-favor stocks in industries that are taking longer to recover than we originally thought. Thus **NCR Corp.**, while still possessing excellent long-term prospects, saw sales and orders deferred due to economic weakness. **Cytec Industries**' stock was weak because of the company's exposure to aircraft manufacturing and both **Telefónica** and **Alcatel** were caught in the prolonged downtrend of tele-communications. Weakness in these stocks was partially offset by significant strength in other holdings such as **IBM**, **Texaco** (now part of Chevron), **ITT Industries** and recently purchased **Adobe Systems**.

We remain focused on the long term and continue to believe that while some of our masters may not be pleased every quarter or every year, our approach should continue to please them all over longer time periods. To that end, recent additions to our *Intrinsic* Value portfolios include:

Portfolio Activity

- **Clear Channel Communications** is still run by those who founded it nearly thirty years ago. It has grown by acquisition to become the owner of 1,450 radio stations, 770,000 outdoor advertising (billboards) and a minority stake in Spanish-language radio company Hispanic Broadcasting Corp. The advertising recession of 2001 gave us the opportunity to buy this stock which typically sells at a high multiple of cash flow yet recently has corrected to what we believe is an unsustainably low price.

- **J.C. Penney Company** is an example of our proven practice of "following the leader." CEO Allen Questrom was instrumental in the turnaround of Federated Department Stores, a stock we owned and then sold not long after Mr. Questrom's departure. He is currently using his turnaround skills at J.C. Penney department stores and its subsidiary, Eckerd Drug. While still in the early stages of a resurgence, both companies are showing strength relative to their competition and are expected to enjoy significant margin expansion and earnings growth over the coming years.

- **Apple Computer**, to many, is the inventor of the personal computer. While its market share has slipped over the years, it still has a very strong presence in the education and graphics/publishing markets. Founder Steve Jobs resumed a leadership role at the company in January 2000 and the company's new products have flourished since. With $12 per share in cash and little debt, the stock sells for less than 7x normal earnings and is expected to benefit from a new version of iMAC to be unveiled early in 2002.

INTERNATIONAL STRATEGY

Japan is back in recession for the third time in a decade. The U.S. is in recession and the European continent may now be entering one. The world's three biggest economies are shrinking simultaneously for the first time since 1974. Even emerging markets, which had grown at high rates for most of the past decade, are slowing or, in a few cases (e.g., Argentina), have stopped. What more could a VALUE manager with a contrarian bent ask for? That is, with all this bad news priced into most international stocks, there may be many bargains to be had. But why won't foreign markets continue to decline or, at best, stay flat?

Of course, the "Phantom" of the International Markets may continue to have his way. But we see reason for optimism. First, the engine of much of the world's economies, the U.S., seems poised to recover after eleven Federal Reserve (FED) interest rate cuts. The Bank of England has lowered borrowing costs seven times, while the European Central Bank (ECB) may be behind the curve with only four cuts since the start of 2001. But with European inflation falling, the ECB could get more aggressive with monetary policy and the recovery in Europe may be even more dramatic than that expected in the U.S.

Also, while the Japanese yen could remain weak, the value of the euro may stabilize, thus removing one cause of weakness in European stocks (as measured in dollars). David Malpass, international economist with Bear Stearns, offers several reasons for optimism on the euro; two are as follows:

"*One of the engines behind the 1999-2001 dollar/euro trend line was the extent of the U.S. growth advantage over Europe. While we think average U.S. growth going forward will still be above Europe's, we don't think the differential will be as strong as in [prior periods].*"

"*Also, the advent of the physical euro on January 1, 2002, while expected to be inconvenient for a few days . . . will complete Europe's commitment to the unified currency. It will add to the benefits Europe gets from using the euro [and increase confidence as well].*"

To capitalize on the coming strength we expect, one of the recent additions to our International portfolios includes:

- **Finmeccanica SpA.** We recommend not trying to *pronounce* the name, just focus on understanding its unique value prospects. Headquartered in Rome, Italy, this company is involved in large commercial projects such as power plants, medical and telecommunications equipment, air traffic control systems and components for commercial and military aircraft. Additionally, FNC owns 21% of STMicroelectronics, one of Europe's largest semiconductor manufacturers. Priced in the market as a conglomerate, FNC's stock currently sells at more than a 25% discount to the sum of the parts of its businesses. We believe this discount will narrow, especially now that it is selling 3.4% of its STM holding in what could be the start of a total liquidation.

We have many masters for our International portfolios similar to those described for our domestic *Intrinsic* Value product. We have been able to meet or exceed these masters' requirements consistently over the past one-, two-, three- and five-year periods. Further details are willingly supplied upon request.

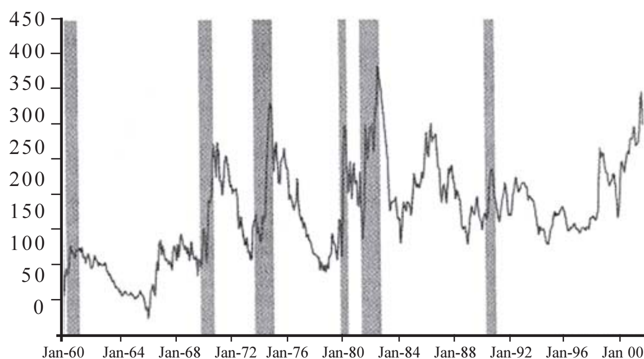
FIXED INCOME STRATEGY

While many people joke about the ineptness of government, we do have to give it credit this past quarter. Not only has the U.S. done an admirable job of dismantling at least one source of global terrorism, but (sometimes embattled) Treasury Secretary Paul O'Neill executed what we believe was a brilliant plan to lower long-term interest rates. Alan Greenspan was doing his job of lowering short-term

rates and adding liquidity to the U.S. financial system. But longer-term rates held stubbornly high. On October 31, the U.S. Treasury announced it would cease selling 30-year bonds. These long-dated securities were considered an important benchmark since their first offering in 1977, with more than $600 billion auctioned since then. With the prospect of future scarcity value, prices of existing bonds skyrocketed, pushing their yields below 5% for only the second time in their history. While yields have since bounced back up, we believe the long-term result may be a more stable yield on long-dated securities throughout economic cycles.

Next, fixed income markets may need some help with corporate securities. Even though most economists expect the U.S. economy to recover in 2002, corporate bond spreads remain extraordinarily high. As evidenced by the following chart, current yield spreads are at levels not seen since 1982. With Baa-rated 10-year corporate bonds yielding around 8.2%, they are 3.1% (310 basis points) higher than similar maturity Treasuries which are at 5.1%. So what's going on?

Corporate Bond Spreads (1960 - 2001)



Shaded area represents U.S. economic recession.
Source: WEFA and Credit Suisse | First Boston

There could be several explanations for current spreads. First, it could just be a matter of supply and demand. While the U.S. Treasury is *curtailing* its issuance of bonds (remember all the talk about our budget surplus?), corporations have been anxious to raise funds via debt because, for the most part, the equity markets have been hostile to new stock issues. Also, the continued strength of the U.S. dollar is inviting additional overseas investments which, thus far, have been concentrated in government debt. Also, while the economy may rebound, international political instability may remain, causing higher levels of uncertainty and, therefore, corporate default risk. Or finally, yield spreads could simply be lagging indicators of the economy and once the U.S. is officially out of recession, spreads could narrow (as has been the case historically).

But the economics team at CSFB (including Paddy Jilek, Dr. Neal Soss and others) has put forth an alternative thesis which we believe is worthy of consideration. They believe:

"*While real GDP is following a path consistent with a shallow recession . . . nominal GDP could remain weak for an extended period, courtesy of low and falling inflation. And it's nominal GDP that matters in judging how effective the corporate sector is likely to be in servicing its debt. So it's not so much the depth and breadth of the business cycle but the longer-term implications of a further erosion of pricing power that's worrying bond investors.*"

They conclude by saying that "*. . . ultimately the [yield] spread is meant to compensate investors for the risk that a company will default on its payment. Very wide spreads suggest very high expected default rates*." As we've seen in Japan this past decade, default rates can remain high when corporations have no pricing power. So as with many things in life, moderation is best. While we would not wish to see a resumption of high inflation rates, some modest increase in corporations' ability to raise prices could be beneficial to our economic system. We shall closely monitor these trends.

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

Christine Daaé, in "The Phantom of the Opera," found it difficult to resolve the dilemma of her many masters. She tried to please them and succumb to all their short-term desires. But the masters were all too impatient and the show ended badly . . . falling chandeliers, abductions to secret underground hideaways, etc. Eventually, many (including the Phantom himself) were never heard from again.

We at MetWest Capital will not attempt to attain short-term objectives. Quite the opposite. We believe that only by looking beyond the short term can our clients truly be pleased. While some investors may *say* they only want one thing (absolute returns without regard for the markets or relative returns without regard for absolutes), we think it is desirable to achieve all the objectives we discussed. But to do so requires a long-term focus. Thus, we seek to invest in companies with excellent long-term prospects and allow superior management teams the time it usually takes to realize VALUE for shareholders. This we have done. This we have proven to be the optimal approach. This we shall continue to do.

We wish you all a healthy, safe, happy and prosperous 2002!

Based on Andrew Lloyd Webber's Really Useful Group

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