# Capital Visions

## WHAT'S IMPORTANT

The following story was recounted on KNX 1070, a local news radio station. It was told as a "human interest" piece that we found thought provoking enough to recount it here this quarter . . .

A middle manager in a local downtown-based firm was leaving his office building on his way home as usual. He was particularly pleased this day because he just had a meeting with his boss who commended him on the performance of his recent assignment and gave him a nice bonus check. About a block from his office, while waiting for a traffic light, the man was approached by a woman carrying a baby wrapped in a brown blanket. The woman and blanket were clean yet both looked worn from the weather.

*"Sir,"* she asked, *"could you possibly spare a few dollars to help me? My baby is ill and I need to buy her some formula and medicine that the doctor said she must have. I don't have insurance and the pills are expensive. If I can't buy them for her today that would be the second day without medication and I don't know what will happen."*

The man was in a good mood, so he reached into his pocket for a few bills. Fumbling around he pulled out his bonus check by mistake. As he began to put the check back into another pocket, his eyes were drawn to the brown blanket and he could just barely see the baby's eyes and nose as she slept peacefully. He stood silently for a moment, then looked at the check and back at the baby. He pulled a pen from his breast pocket, took his bonus check and endorsed it over to the woman.

*"Please,"* he said, *"use this money to do whatever you can to help your child."* With that, he walked away and went home.

He was greeted at home by his wife and two teenage sons. Over dinner, he described his day including the visit with his boss, the bonus and finally the encounter with the troubled woman. His eldest son was outraged. *"How could you do that, Dad? You don't know who she was or what she really intended to do with* ***our*** *money!"* The second boy was obviously equally upset but realized there was nothing he could do now, so he sat silently, leaving the rest of his dinner uneaten. The wife, on the other hand, congratulated her husband on his job performance and hoped the money would be well spent on the baby.

A week later, upon arriving home from the office, the man was abruptly greeted by his two sons waving the front page of the local section of a daily newspaper. *"Dad, DAD!"* exclaimed one son, *"there's an article in here about a woman working the streets downtown near your office scamming passers by with a phony sick baby story. It sounds exactly as you described last week. There's a picture of her on the front page. Here, look! Is this her?"*

The man took the paper, carefully examined the picture and gave it back to his son with a big smile. *"Is it her?"* the son asked. *"Yes, that's the same woman to whom I gave my bonus check." "Then why are you smiling?"* gruffly asked the son. *"You don't seem to understand, that woman conned you and took* ***our*** *money!"*

*"No, I comprehend very well,"* replied the father. *"Some day you will understand too. You see, if that woman tricked me, it means that her baby is not sick after all. Isn't that knowledge worth at least the amount of the bonus?"*

We retell this story here to illustrate the importance of focusing on what's important. Sure, the man valued his money and all else being equal may have preferred to have never met that woman. But what was really important to him was the health and safety of the child. The other matter, while of concern, took a back seat.

We at MetWest Capital understand the plight of the man and see what made him so happy. In our search for value-oriented investments, we too must focus on what's important and what is not. With so much recent business news focused on a few companies and intricate accounting conventions, we thought it time to step back and reiterate what truly adds long-term value for our clients.

### What Adds Value?

Of course we must ensure that we are not "duped" by others in our profession. So, while always wary, our analysis of investment opportunities takes us through corporate annual reports, conversations with top management, industry conferences, competitive analyses, lots of numbers and spreadsheets and just walking around the local shopping centers to see who is buying what. With so much to evaluate, we have developed, as a competitive advantage of our own, the ability to ferret out the "gold dust from the dirt." That is, we believe any good money manager must sift through literally mountains of facts and data to identify those few issues that are likely to determine the future stock prices of individual companies. Then, by properly understanding and forecasting the **important** issues, we can make informed decisions and build an optimal investment portfolio. Sometimes, paying less heed to daily minutia (such as quarterly earnings reports) allows us the time to focus on and analyze the "big picture."

The table on the next page compares some of the main issues we focus on to other items that may get more day-to-day press coverage but that we feel are of limited long-term investment value. Let's delve into a couple of them. The first is the namesake of our domestic equity product: *INTRINSIC* VALUE. We have long said that *intrinsic* value may be calculated in almost as many ways as there are companies. Reported "book" value is one way, but hardly the only way, and often not the best way, to calculate what a company is truly worth. Take the example of **Gillette**, one of the companies whose stock we own. Its reported book value is only $2.20 per share. That's $2.2 billion for the entire company. This for a company that earns more than $1 billion in net after-tax profits annually. So how could it be worth only $2.2 billion? Simple; it isn't. We believe that its valuable brands, insurmountable market shares, healthy operating margins and worldwide manufacturing facilities are worth in excess of $40 per share and thus we hold the stock.

Most of our estimates of *intrinsic* values are based upon a form of cash flow returns on invested capital (CFROIC). That is, if we could purchase an entire company (including all its stock and debt outstanding) and run

## Table of Importance

| More Important | Less Important |
|---|---|
| *Intrinsic* value | Book value |
| Long-term secular trends | Quarterly earnings |
| Positive economic value-added | “Beating the street” |
| Return on Invested Capital | Earnings growth |
| Significant achievements | Media reports |
| Able to perform “in times of adversity” | Playing the cycle |
| Innovation & Adaptability | One bad product, division or concept |
| A proven management team | A “High Profile” management team |
| Strong and/or increasing market share | “Buying” temporary market share |
| Cash accounting | GAAP |
| Customer focus | Sole focus on stock price |
| Good, profitable, sustainable business model | In a flashy business |
| Pricing power | Following the leader |

the company to maximize cash generation, what would be the long-term return earned on our invested capital? Future growth is not considered in this exercise unless it is a result of the reinvestment of current cash flows. In the case of **Gillette**, this analysis yields a CFROIC of 15%. This return is far in excess of alternative investments with comparable risk profiles and thus we deem Gillette’s stock to be undervalued. In this example, book value is far less important than *intrinsic* value.

A little further down our Table of Importance is SIGNIFICANT ACHIEVEMENTS, which is not always properly captured by the popular press. Here we’ll use the example of **Apple Computer**, another company whose stock our clients own. In this case, the media did get it right by highlighting the uniqueness of the new all-in-one flat panel iMac when it was introduced in January 2002. But many reports missed the most important elements of the announcement. If the new iMac had simply been a replacement for the old iMac, then the company did not really add lasting value. For after the remaining Apple “diehard” fans are through upgrading, the company’s sales will falter. The true significance was the new software that allows interoperability with Windows-based products as well as “lifestyle” additions such as iPhoto and the new iPod. Yes, the new iMac’s unique design made the front pages of many magazines, but the prospect of a sustained increase in market share – and hence profitability – was what influenced us to buy the stock. Of course $12.50 per share of cash on the balance sheet doesn’t hurt either.

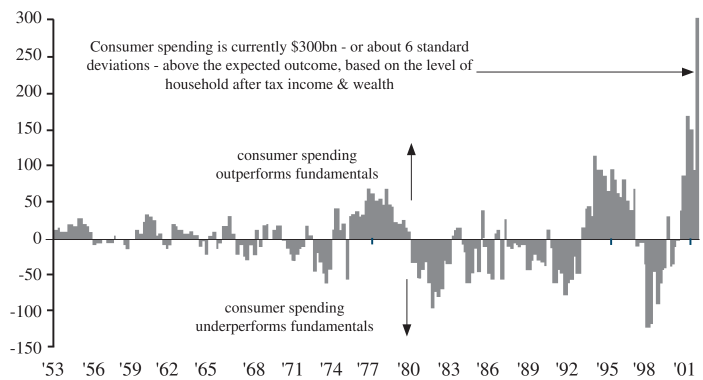
These are but two examples of what’s important to investing. We simply don’t have the space here to detail each item in the table. But please review them carefully and when you next hear or read a story about a company, ask yourself (as we do daily), “What’s really pertinent to the long-term success and profitability of the enterprise?” We may discuss other examples from the Table of Importance in future client communications.

So what was important to the financial markets last quarter?

## VALUE EQUITIES STRATEGY

We may have just concluded one of the shortest and shallowest economic recessions ever experienced in the U.S. While the industrial economy has contracted meaningfully due to a rapid drawdown of inventories, consumer spending has held up surprisingly well. Dr. Neal Soss and the economics team at Credit Suisse | First Boston have a long-term model that shows that *“over 95% of the time, household sector income and net worth can explain the level of consumer spending . . .”* But the current cycle is very different. The following chart shows the difference in spending between that predicted by the CSFB model and actual consumer expenditures in the U.S. since 1953. Note that current spending is $300 billion greater than what should be expected given current levels of income and “wealth” (mostly stocks, bonds and real estate). While past divergences have occurred, the current difference is unprecedented. What is the cause?

### $300 Billion Spending Residual




*Source: Credit Suisse | First Boston and the Bureau of Economic Analysis*

Many believe that the basis for the anomaly lies in the housing market. As housing prices have remained firm and interest rates plummeted, mortgage refinance activity has exploded. Further, it seems as though more than half of the current refinancing boom is resulting in higher mortgage balances. Thus, households have been taking some of the built-up equity out of their homes . . . and spending it. It works something like this: Take a $250,000 home with a $150,000 mortgage at an 8% rate. Current principal plus interest payments are $1,100 per month. Refinance into a $175,000 mortgage at a 6½% rate. New payments of the identical $1,100 per month. Now, can you guess what the average American consumer with $25,000 of “free” money is going to do? Probably spend it all. So sales of new refrigerators, dishwashers and even cars and boats (and other “big ticket” durable goods) have actually **increased** during the past six months. This is unprecedented for a recessionary environment.

This has resulted in what Dr. Soss refers to as an “upside down” business cycle. He says that *“housing and consumer spending played a counter cyclical rather than a traditional pro cyclical role last year. There are good reasons to expect that to continue this year.”* It’s this last point that concerns us. If consumers are just coming off of a spending spree $300 billion greater than that supported by income, then even if the overall economy improves in 2002, consumers may take a breather. Unless the 6½% mortgage can be refinanced into a 5% loan, housing equity may not be the source of funds in 2002 as it was in 2001. Thus, we may expect that just as businesses begin to reinvest and build back inventory levels, this could be partially offset by a slowdown in final sales resulting in a tepid rebound to the overall economy. These are some of the **important** events that we will carefully monitor as they unfold.

So we are looking for investments that will either benefit from the rebound in the industrial economy or not be hurt by a slowdown by the consumer. To that end, recent additions to our Intrinsic Value portfolios include:

## Portfolio Activity

- **Alcon** is the largest eye care company in the world. It develops, manufactures and markets pharmaceuticals, surgical equipment and devices, and contact lens care and other products that treat conditions of the eye. If you know an elderly person who has had cataract surgery, chances are they were implanted with an Alcon intraocular lens. Based in Fort Worth, Texas, Alcon has been owned by Nestlé (the world's largest food company) since 1977. With strong and growing profits and the industry's best pipeline of new products, we believe that Alcon is poised to add considerable value for its shareholders over the coming years.

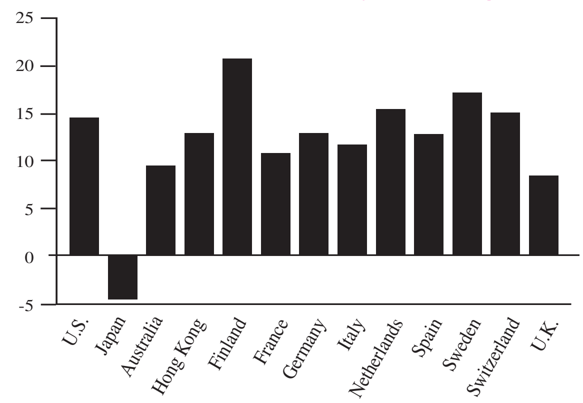
- **PG&E Corp.** owns the largest electric utility in the state of California. The company is close to resolving the issues brought on by the state's energy crisis of late 2000/early 2001. Its subsidiary, Pacific Gas & Electric, while considered financially sound today, voluntarily entered Chapter 11 bankruptcy last year as its best option to resolving the mismatch between what it had to pay for electricity and what state regulators allowed it to charge its customers. The earnings "power" of PG&E is in excess of $3.00 per share and should be realized in 2003. With the stock trading at less than 8x its earnings, we find it a unique investment, one that should appreciate sharply when the regulated utility regains its creditworthy status late this year or early next.

## INTERNATIONAL STRATEGY

Most foreign stocks modestly outperformed most U.S. stocks during the first quarter of 2002 with (believe it or not!) Japan as the best-performing major market. The Europe Australasia Far East Index (EAFE) gained +1.0% for the quarter compared to the S&P 500 which gained +0.3% (both including income). As the following chart shows, over the past eleven years many foreign markets outperformed the U.S. Yet EAFE gained only 5.5% annually, as the weak Japanese market badly lagged the rest. What is in store for the next eleven years?

### Market Performance (1991 - 2001)

**Annualized Return in Local Currency (including dividends)**




*Source: Bloomberg Financial Markets*

We believe that international markets could outperform the U.S. over the coming years. We offer three possible reasons:

**1. Reversion to the mean.** Because the U.S. <u>has</u> outperformed the rest of the world as a group in recent years, it could be time for international markets to play "catch up." Money flows are fluid and thus funds can easily move cross-border to where the highest expected returns exist. While in recent years the highest returns were expected in the U.S., any change to this thinking and funds will move rapidly offshore. As international economies become more open and interconnected it becomes harder to sustain a competitive advantage in all lines of business in one country. As an example, witness the relative fall of the U.S. from the 1960's to the 1970's and then of Japan from the 1980's to the 1990's. The conventional wisdom of those times surely did not call for those changes in fortune.

**2. Restructuring.** U.S. industry went through massive restructuring in the 1990's, which led to large gains in productivity, innovation and profitability. These, in turn, led to outsized stock price gains. The rest of the world has learned from this and is now beginning a restructuring of its own. Consider **Matsushita Electric Industrial** of Japan. Heretofore the company was comprised of six separate businesses, each with its own manufacturing, R&D, sales, overhead and even stock market listing. **MEI** has just announced that it will dissolve that inefficient structure and combine all entities into one focused enterprise. We believe this will unlock substantial value and offer investors an unprecedented opportunity for profits.

**3. Currencies.** The U.S. dollar has had a definitive advantage over most European currencies due, in some part, to the relative size and liquidity of dollar markets. But with the euro-conversion now complete, European companies may begin to reap the rewards of a common currency and the world could view the euro as a viable alternative to the dollar. At worst, we see very little reason to believe the euro will continue to depreciate at the same rate it has since its introduction.

These are three of the **important** trends we will monitor carefully over future quarters and years. To capitalize on the coming strength we expect, two of the recent additions to our International portfolios include:

- **Magna International,** based in Ontario, Canada, is one of the world's largest auto parts suppliers. It was one of the few auto-related companies to grow earnings last year in the face of reduced global auto shipments. Its broad parts and assembly capabilities enabled it to grow content per vehicle at more than twice the industry average. So, what's **important** for Magna is that it is gaining share of the auto parts industry which itself is gaining share from global auto manufacturers. Combine Magna's favorable fundamental prospects with a very conservative balance sheet and a stock priced at only 11x earnings and you have a very compelling investment.

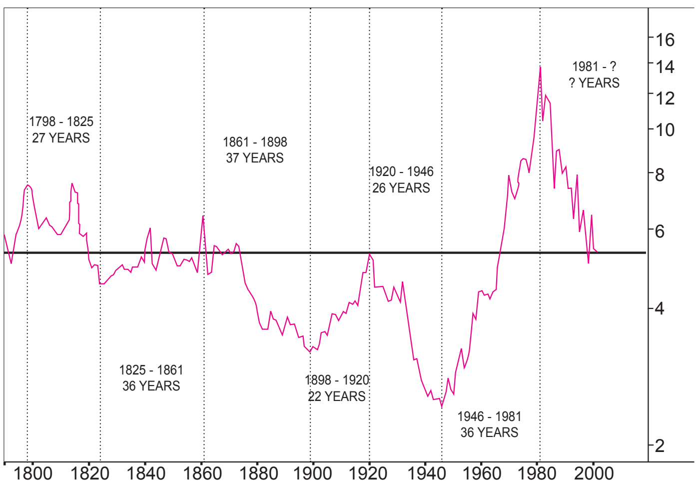
- **BAE Systems** is Europe's equivalent of Boeing. It owns 20% of the consortium that builds Airbus planes. It has a large pan-European defense business (including 35% ownership of Saab – the aircraft manufacturer, not the car company). It also has a strong U.S. presence through BAE-North America, which provides 20% of BAE's total revenues. The company should generate sustainable cash flow in excess of £800 million per year — close to 10% of its market capitalization. These factors lead us to the conclusion that the stock, at current prices, is 25% undervalued.

## FIXED INCOME STRATEGY

Sometimes it is better to do nothing than something. Since late last year, some of our clients with balanced portfolios (containing both stocks and bonds) have been positioned with what appears to be excess cash in their portfolios. We believe that a cyclical low in interest rates occurred last year with short-term rates below 2% and most intermediate and long rates at or below 5%. Therefore, we chose to protect our clients' fixed income principal by temporarily holding cash/equivalents. While the returns on money market funds have been below 2% thus far this year, that's better than the -0.2% **loss** on fixed income securities as measured by the Lehman Brothers Government/Credit Intermediate Index.

Some have asked why the Federal Reserve (FED) is expected to raise short-term interest rates if inflation is still at such low levels. The FED believes that with rates where they are now (1¾% FED Funds target), they are in an "aggressive easing" mode. Thus, by raising short rates closer to 3% over the coming quarters, monetary policy will revert to a "neutral" mode. But as the following chart shows, we don't necessarily believe we are yet entering a **secular** period of rising rates, only a **cyclical** upturn.

**200 Years of U.S. Interest Rates**




Data Used in Chart:
Foreign loan made to U.S. government: 1790, 1792, 1794.
Average foreign loans made to U.S. government: 1791.
Federal government bonds: 1798-1820, 1860-1.
Federal government average new issue: 1841.
Federal government average market yield: 1842-8.
New England municipals: 1821-5, 1827, 1829-30, 1832-40, 1849-59, 1865-1884.
Highest grade corporates (RR): 1862-4, 1885-98.
30-year prime corporates: 1899-1976.
30-year treasury bond yield: 1977-present.
Interpolated: 1793, 1795-7, 1822, 1828, 1831.

Note: 1821 - U.S. debt insignificant. 1833 - No federal debt at all.

*Source: Salomon Smith Barney Technical Research*

As the very long-term chart shows, the U.S. entered its current phase of declining rates in 1981 when the 30-year long bond yield peaked at 15¼%. While we don't anticipate that long-term rates will drop to the lows of the 1940's and 50's, we could see them declining toward the 4% range as continued global productivity and competitive trends keep a lid on price increases. The **important** decision we must now make is how best to position the fixed income portion of balanced portfolios to benefit from lower long-term rates in combination with higher short rates. We are beginning this transition process and will have more to report to you in future quarters.

*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

This quarter we highlighted what's **important** to successful investing and a little bit of what's not. Our example of the con artist with her baby was not meant to dismiss her ill deeds nor condone unethical behavior. Rather, it was meant to illustrate what was really important to the man, even though his charitable decision was not popular at home. Had he the choice between a sick baby and being duped out of a bonus check, he would have made his selection very clear. With investments, we too have choices. We must at all times carefully analyze what's truly **important** to our long-term investment selections versus the sometimes short-term thinking of others.

Recently, we read with great interest the final report to shareholders by IBM's retiring Chairman and CEO, Lou Gerstner. Mr. Gerstner is a great example of a corporate manager wholly focused on the important long-term future of his company. He has come to stand for technology not just for its own sake, but for the benefit of customers. Early in his leadership of IBM he made strategic decisions that only in the past couple of years have been proven correct. Keeping the company together as one, continuing to come out with new mainframe computers and growing a powerhouse services business were all controversial acts at the time. We believe that many great ideas are controversial; if they were so obvious beforehand, they would have been implemented elsewhere.

We first invested in IBM's stock back in 1993 and will surely miss the insights of Lou Gerstner. For now, we have confidence in his successor, Sam Palmisano. We have identified this management transition as one of the very **important** factors to monitor in our continuing quest to add value for our clients.

***Please join us in welcoming Sandra L. Incontro, CFA, the newest member of the MetWest Capital portfolio management team.***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