Capital Visions

The Singer

"There are worse things in life than making your acting debut on the much ballyhooed *Ally McBeal*, though 21-year-old baritone Josh Groban doesn't seem destined to encounter them anytime soon." During an episode of the television show, a high school senior, played by Josh, sued his prom date for backing out on him and wound up going to the prom with Ally. If you are not familiar with the program, Ally is a smallish, young-looking high-energy partner in a law firm filled with quirky characters. Ms. McBeal agreed to the date only if the student would sing a song to his class in an effort to get him to overcome his awkwardness. As the episode finale, "Groban performed his debut album's 'You're Still You' as a heart-tugging literal showstopper." For Groban, the show vaulted him to notoriety. The quotes above were taken from a review of his one and only album (to date) entitled with his name.

At first it was thought that Josh Groban was a new actor whose voice was dubbed for the song. When it was learned that Josh was in fact the singer, the song and his album started climbing the charts. He began getting interview requests and appeared on many talk shows including *Good Morning America, The Tonight Show with Jay Leno* and *The Rosie O'Donnell Show*. He sang "The Prayer" as a duet with Charlotte Church at the 2002 Olympics closing ceremonies and was profiled on *20/20*. The Singer had long been told he had a good voice, and so he studied music throughout his school days. When he was 17, his music teacher sent a tape to producer David Foster (who has won fourteen Grammy Awards with various artists). While Foster admitted that rarely is talent found this way, for Josh it was different. In 1999, Mr. Foster was at a rehearsal with singer Celine Dion when her duet partner, famed Italian tenor Andrea Bocelli, said he would be late. Josh Groban was called to stand in for Mr. Bocelli. If one closed their eyes at the rehearsal, it would have been hard to tell if Josh were singing or if the seasoned Bocelli had finally arrived.

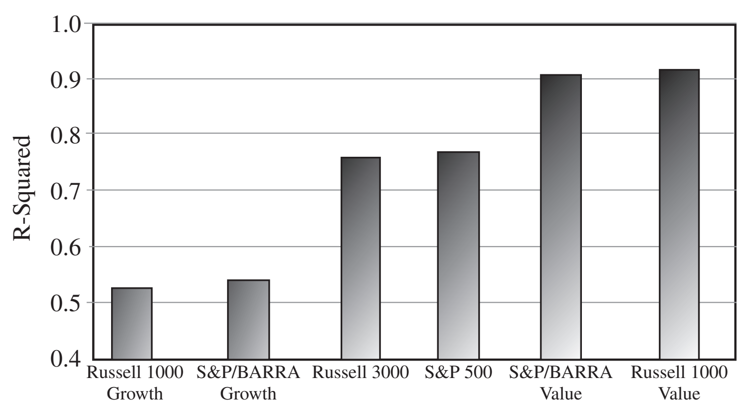
What is so unique about The Singer is his appeal across a wide spectrum of musical tastes. The selections for his album exemplify this distinction. The opening numbers are the Italian ballads "Alla Luce del Sole" and "Gira Con Me." But Josh also sings Richard Marx's "To Where You Are" as well as a very clean adaptation of Don McLean's "Vincent (Starry Starry Night)." The addition of the Irish pop group The Corrs to his rendition of "Canto Alla Vita" surely brings in a younger element, as does what one reviewer described as a "neo prog-rock-opera take on Bach's 'Jesu, Joy of Man's Desiring.'" So versatile is the collection that record stores cannot agree on the section in which to stock the CD. Nor can radio stations decide, as he can be heard on hard rock, classical, crossover and pop stations. In an industry that insists on dividing artists into categories, Josh Groban best fits into the classical genre. But don't tell that to his many fans who consider him unique and say they "just like the way he sings."

What can this introduction to The Singer teach us about investing? Each quarter in *Capital Visions* we hope to impart insight into our methodology, forecasts and results so our clients may gain a further understanding of our investment style and develop realistic expectations for the future. When we learned of Josh Groban, we recognized a similarity with MetWest. While most would classify The Singer as classical, his unique style transcends that narrow category, giving his music a broad appeal. Similarly, MetWest's style is closest to Large Capitalization Value. But we have shown that our investment results can be good in many market environments and thus we are confident of our broad appeal when Value is both "in" **and** "out" of favor.

MetWest Correlations

The Singer excels in a style most similar to classical. But not every song he sings was written by Puccini. Similarly, MetWest's style is closest to Large Capitalization Value, though not every stock meets others' classic definition of Value. The following chart proves this point.

MetWest Capital Intrinsic Value Equity Correlations



Source: Mercer Performance Analytics

The above graph shows the results of a statistical analysis using five years of quarterly data (ending March 31, 2002) . The analysis was performed by an independent consulting firm. The chart shows the R-Squared (R^2) measurement of MetWest Capital's *Intrinsic* Value Equity returns versus six market indices. We definitely want to avoid a statistics tutorial here, so we will simply define R^2 as a measure of the tightness of the fit in a correlation between variables. At one extreme, an R^2 of zero means there is no correlation, while on the other hand, a value of one implies a perfect fit. In the chart above, note that the R^2 between MetWest's *Intrinsic* Value Equity and the S&P 500 Index is 0.77. This is considered a "moderate" fit, meaning that 77% of MetWest's return is "explained" by movements in the S&P 500. Note the very low R^2 between MetWest and the two Growth indices compared to the greater than 0.90 R^2 between MetWest and the two Value indices. So these analyses show that we are most highly correlated with Large Cap. Value.

One final comment on statistics: The above analysis does not mean that whatever Value does, MetWest will do 90% of it. This has not been the case. It does mean that in the quarterly movement of stock prices, historically MetWest's returns have been highly correlated with Value indices and not well-correlated with Growth. Other important statistical measures, such as alpha and beta, show that MetWest's five-year investment returns have added value relative to the degree of risk taken.

So, just what is MetWest Capital's *Intrinsic* Value approach? *Intrinsic* Value is our measurement of the *"true"* worth of a company. It may be calculated in a variety of ways for different industries or stocks. As one example, let's use "CFROIC"-- cash flow return on invested capital. If a prudent investor could purchase the entire outstanding equity and debt of a business and manage that company to generate cash profits, what would be the cash-on-cash return of that investment? We use at least a three-year time frame for our calculations (to eliminate cyclical factors) and do not rely on growth in our analysis. We then compare this cash flow return on invested capital to alternative investment vehicles, adjust for risk and uncertainty and calculate the intrinsic value of the enterprise. If the resultant value is higher than the current stock price and we have conviction that *catalysts* exist to close this valuation gap, we consider the company for investment.

This methodology results in a diversified portfolio of about 35 stocks that we typically hold for greater than three years. It also results in investment returns that most closely correlate with Large Capitalization Value. We emphasize this point because, in today's market, the terms "Growth" and "Value" have blurred. Former telecom growth stocks now sell at less than book value while some railroad and capital goods stocks trade at more than 20 times earnings. This is why *Intrinsic* Value is critical for today's investors. For just as "Starry Starry Night" fits perfectly as a selection in The Singer's album, so too do **Alcon, Dow Chemical** and **Cincinnati Financial** fit as part of an "album" of stocks that may do well if either Value investing remains in favor or Growth shines once again.

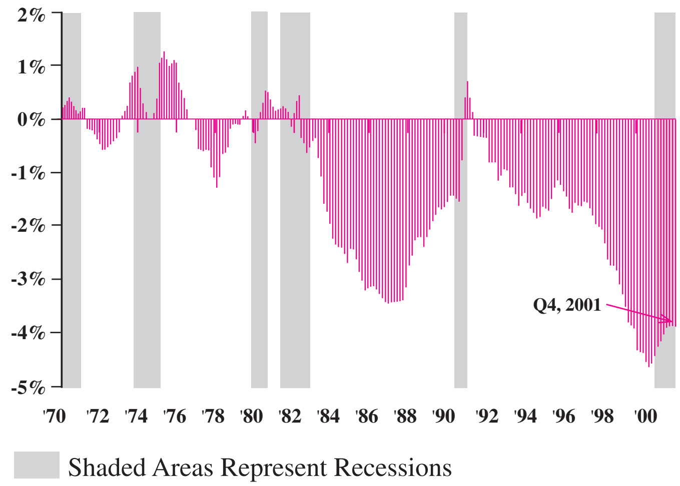
So how did the financial markets sing last quarter?

VALUE EQUITIES STRATEGY

Unfortunately, the U.S. equity markets have not been very melodic thus far in 2002. Stocks were very volatile last quarter, with the S&P 500 Index declining by -13.40% (including income); the index lost ground in each of the three months of the quarter. Value indices dropped in April and June but rose modestly in May as, for the quarter, the S&P/BARRA Value Index lost -10.64% while the Russell 1000 Value Index declined -8.52%. MetWest Capital's equity portfolios declined for the quarter, but less so than most Growth and Value indices and our large capitalization equity peers.

While we continue to believe that the U.S. equity markets will resume their long-term upward trend in the not-too-distant future, we think that gains will be muted relative to the recent past. One of the reasons for our caution is the very large Current Account deficit built up by this country over the past decade.

Current Account Balance as % of GDP (Quarterly Annualized)



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

The Current Account Balance measures the cross-border flow of:

Goods (including cars, oil, chemicals, food, etc.), which makes up by far the largest portion of our deficit balance;
Services (such as financial transactions, travel/tourism, etc.), which is now the only area in which the U.S. runs a current surplus;
Income (like interest payments on debt held by foreigners as well as repatriated corporate profits), which went negative for the first time ever in 1998;
and **Unilateral Transfers** (including U.S. military grants), which have consistently risen just about every year since the end of World War II.

Note from the chart above that during all past recessions, the Current Account Balance returned to a surplus position. This is because in past downturns, U.S. exports rose while imports fell, allowing foreign trading partners to cushion our economic fall. This past (short-lived and now complete) recession was different as global economies shrank in unison, causing both U.S. imports and exports to decline and the trade deficit to remain high. We are concerned by the side-effects that might result from a continued degradation of the Current Account.

One of the reasons to be mindful of a widening Current Account Deficit is the potential for dollar weakness. Recently, the Federal Reserve (FED) did a study which concluded that when the current account deficit of an industrial country exceeds 5% of GDP, a subsequent currency decline may follow. The chart above shows we are nearing the 5% level. While a weaker dollar would be welcomed by U.S. export industries (such as agriculture and aircraft manufacturing) and those industries subject to intense foreign competition (such as steel and autos), it could also bring unwanted side-effects. Interest rates could rise as foreigners cut back on their purchases of dollar-denominated debt, and consumer spending could be restrained due to price increases. While both of these events would be perceived as negative by investors, they could be offset by a stronger U.S. manufacturing sector.

We do not wish to imply that we are negative on the outlook for U.S. stock prices. A slightly weaker dollar could be very good overall and could certainly help the global economy move forward. We merely want to temper our enthusiasm by expecting moderate, mid- to high-single-digit annual returns for the overall market. For MetWest and our clients, this is good news. Our *Intrinsic* Value stock-picking style typically performs best in a moderate growth environment. So just as The Singer's individual song selection has worked to endear him to his audience, so too can individual stock-picking differentiate MetWest from its peers.

To that end, two recent additions to our *Intrinsic* Value portfolios include:

Portfolio Activity

- **Valero Energy** is one of the largest oil refiners in the U.S. with 12 refineries, an interstate gas pipeline and 4,600 gas stations under several brands including Valero, Ultramar and Total. After nearly two decades of excess capacity, we believe that demand for gasoline in this country has caught up with supply. With little prospect for new refineries due to environmental and permitting difficulties, if Americans keep driving their cars (and "gas-guzzling" SUVs) and delivering goods by truck, capacity could tighten further and allow refining companies to increase their profitability. While the industry will still endure cycles, Valero is uniquely positioned to benefit from the favorable long-term trends.

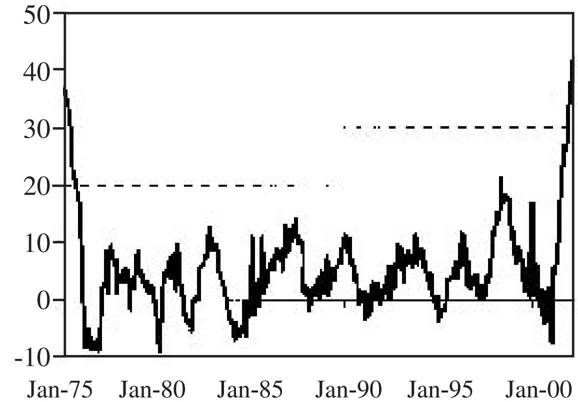
- **Boeing** is the world's largest manufacturer of large commercial aircraft and one of this country's biggest defense contractors. While the events of September 11 exacerbated a down cycle in aircraft, the company has planned well and remains far more profitable in this cycle than in previous ones. FREE cash flow generation is 8% of total market capitalization, and the defense business is clearly benefitting from some of the same trends that are hurting the commercial business. With the stock selling at only 10 times our estimate of *normalized* earnings for 2002, we see it as a compelling long-term investment.

INTERNATIONAL STRATEGY

Foreign equity markets declined along with the U.S. for the quarter, but the strong rally in foreign currencies has resulted in more modest declines for those markets year-to-date as measured in U.S. dollars. Japan is one of the few industrialized stock markets worldwide to be showing gains thus far this year. We believe this marks just the beginning of what could be a sustained upward move in Japan's stock market.

All during the 1990s, while the rest of the world pointed out Japan's ills, little was done to combat the issues of deflation, excess regulation and a weak financial system. It wasn't until the latter part of the decade that the "average" person on Japan's streets even acknowledged there was a problem worth addressing. But now that has changed. The slow but persistent rise in the unemployment rate in Japan has lead to a widespread "call for action." The following chart shows that the Bank of Japan is heeding the call.

Excess Liquidity in Japan (percentage points)



Source: Lehman Brothers

This chart depicts the *excess liquidity* in Japan's financial system. This is the difference between the year-on-year rate of growth in the money supply and industrial production. Note that it hasn't been since the late 1970s that money supply growth has so exceeded economic growth. As there is a strong correlation between liquidity growth and consumer spending, we expect that, while it hasn't happened yet, Japanese consumers could, over time, begin to spend more of their built-up savings. This will lead to overall economic growth, an improvement in sentiment and, most importantly, a healthier and more robust banking and financial system.

In addition to the rebound we expect in Japan, European stocks (as measured in U.S. dollars) could rise. This is partly explained by our expectation for a strengthening euro. Tracy Herrick, Chief Economist at Jefferies and Company, believes that *". . . it now appears that the recent slide of the [U.S.] dollar is probably the beginning of a longer-term decline. The reasons for a dollar retreat are (1) an overvalued position on the basis of purchasing power parity, (2) a rising current account deficit [discussed above], and (3) long-term money supply growth in excess of an expansion of output."*

To capitalize on the economic strength we expect, two of the recent additions to our International portfolios include:

- **KLM Royal Dutch Airlines'** stock has declined by 40% since we sold it from our international portfolios early last year. It is now back to a valuation level that we believe fully reflects all the bad news about the slowdown in global air travel. Yet the stock may not reflect many potential future positives. These include: (1) European air traffic has held up better than that in the U.S. and has rebounded since late last year; (2) Buzz and Basiq, KLM's "low-cost" carriers, are rapidly adding capacity and are now the third largest in Europe; and (3) the company has clearly stated that industry consolidation is necessary and would welcome a combination with another carrier. KLM's attempt to combine with British Airways two years ago would have resulted in a much higher valuation than is recognized by today's stock price. We thus consider KLM's stock to be significantly undervalued and likely to appreciate as air traffic conditions improve (and maybe even if they don't).

- **Suez SA**, since its merger creation in 1997, has refocused from a Belgo-French conglomerate to become a global utility leader in electric energy, water services and waste management. It has the unique ability to manage large utility assets for both public (municipalities) and private (corporations) entities. Its businesses earn operating profit margins in excess of 12%, and we expect Suez can generate 12 billion euros in FREE cash flow over the next five years. Thus, more than 40% of its current market capitalization will be available for dividends, share repurchases, acquisitions and other shareholder-enhancing initiatives within our investment time horizon.

FIXED INCOME STRATEGY

Fixed income markets have been on "hold" for much of this year as investors await the FED's next move. Interest rates across the yield curve spectrum moved higher during this year's first quarter, but retraced that move almost precisely during the second quarter. So, at quarter-end, 30-year Treasury bond yields were 5.50%, only four basis points (0.04%) higher than last December. Similarly, 3-month T-bills yielded 1.68% on June 30, four basis points lower for the year. Most expect the next move by the FED to be an increase in short-term interest rates, but the timing of that move remains uncertain. While the short-term Federal Funds rate, at 1.75%, is low relative to core consumer inflation of 2.50%, FED Chairman Alan Greenspan has said he wants to see the U.S. economic recovery sustained before raising rates back to a more normal level.

Early last quarter, for those clients with available cash, we fully invested balanced portfolios by purchasing additional bonds and notes with a maturity date near 2008. Thus, the fixed income portion of MetWest Capital's balanced portfolios is now positioned with securities in the 5- to 10-year maturity range. We believe this will be the most stable portion of the yield curve. When the FED does raise rates, short-term securities (maturing in less than 5 years) will be affected most. Intermediate and long-dated bond yields may rise only modestly, as inflation is expected to remain contained. Where appropriate, fixed income portfolios are well diversified in U.S. Treasuries, government agencies, corporate and mortgage-backed bonds. We are somewhat overweight in agencies as these government-backed securities currently provide yields about 50 basis points (0.50%) greater than Treasuries without the default risk of higher yielding corporate bonds. As always, we shall closely monitor fixed income trends and make adjustments as necessary.

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 introduced you to Josh Groban. We pointed out that while The Singer best fits into the "classical" music category, his appeal transcends that narrow niche. Categorizing him in only *one* way could result in his talent being missed by those who think classical is not for them. It's the individual songs that The Singer chooses, combined with the execution of those songs, that has resulted in so much acclaim. Similarly, in the investment world, money managers are classified into "Growth," "Value" and other categories. MetWest Capital's equity style is most similar to Value and this is borne out by the correlation of investment returns.

MetWest has been able to exceed the long-term expectations of our clients by focusing on individual stock selection, rather than broad market predictions, using our *Intrinsic* Value approach. Given our expectation of modest (yet still positive) returns for U.S. stocks, we are currently invested in a group of companies that are not wholly reliant on robust markets or economic activity, but are largely in control of their own destinies. We believe these companies have the ability to do well in many market environments. We highlighted four this quarter and are constantly seeking out new opportunities. Our firm remains steadfast in its focus on a conservative long-term approach to investing in well-run companies whose proven business models should add shareholder value over time. We wish you a safe and happy Summer!

Please join us in welcoming Eric T. Smith, CFA,
the newest member of the MetWest Capital portfolio management team.

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