

Capital Visions

THE TROUBLE TREE

The following story was told to us by a fellow investor. It got us thinking about the many “troubles” facing financial markets in recent quarters and, in particular, about one big trouble currently confronting policy makers the world over. The story he told goes something like this:

The carpenter I hired to help me restore an old cottage had just finished a rough first day on the job. A flat tire made him lose an hour of work, a hard-to-find belt snapped on his electric saw and now his twenty-year-old pickup truck refused to start.

While I drove him home, he sat in stony silence. On arriving, he invited me in to meet his family. As we proceeded up the walkway toward the house, he paused briefly at a small tree, touching the tips of the branches with both hands. His movements were routine, but ceremonial. When he opened the front door, he underwent an extraordinary transformation; his tanned face was wreathed in smiles as he hugged his two small children while giving his wife a tender kiss.

After brief introductions, I begged out so as not to delay their dinner. As the carpenter walked me to my car, we passed the tree again and curiosity got the better of me. “*What did you do earlier with that tree?*” I asked.

“*Oh, that’s my trouble tree,*” he replied. “*I know I can’t help having troubles on the job. But one thing is for certain, troubles don’t belong in the house with my family. So I just hang them up on the tree every night when I come home. Then in the morning, I pick them up again. Funny thing is,*” he smiled, “*when I come out in the morning to pick them up, there aren’t nearly as many as I remember hanging up the night before!*”

Ah, if it were only as simple as leaving your troubles outside! But it’s not always that easy. Typically we select our topics for *Capital Visions* so as not to replicate what is over-discussed elsewhere. This often leads us away from lengthy economics and strategy discussions as endless drivel can be found in so many places. For this edition, however, we wish to highlight a “trouble” that many are trying to hang outside because there does not seem to be an easy solution – DEFLATION.

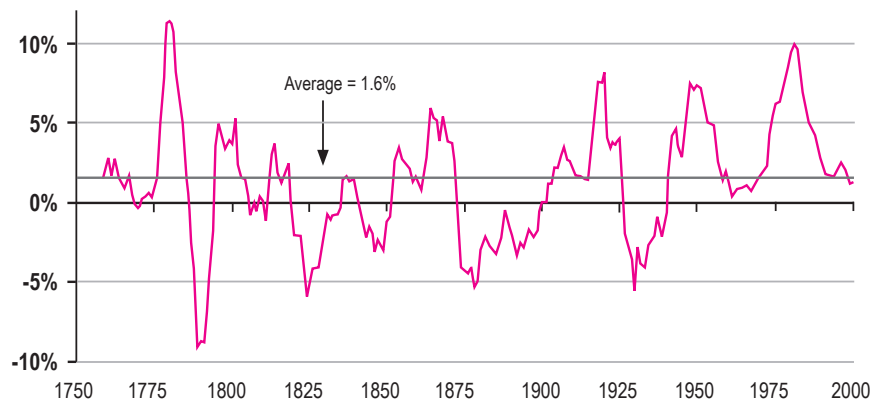
We believe we are witnessing a monumental sea-change in global policy from fighting inflation (rapidly rising prices) to preventing persistently broad-based falling prices. Both monetary and fiscal policies are at work while only corporate policy now needs changing. The understanding of this important issue and its successful resolution is critical to our long-term positive view for stocks. Let’s discuss this a bit further.

(In / Disin / Z- / De / or Re)flation

To begin, is there a problem? The following chart shows wholesale price changes in the United States dating back to the 1700s. Note that for much of the past seventy years (since the end of the 1930s depression), on a rolling ten-year basis, prices have been rising in this country. For the past twenty years, they have been rising at a decelerating rate (this is **disinflation**). Currently, price changes are headed toward zero. Keep in mind that consumer prices are still rising as services inflation (from health care to housing to haircuts) runs above wholesale (also referred to as “producer”) inflation. Ultimately though, the two will trend together.

Ed Kerschner, the renowned strategist for UBS Warburg, believes that **Z**-flation (near-zero inflation) will persist. But the chart below is not on Mr. Kerschner’s side. Only once in the past three hundred years did disinflation fail to turn into deflation; that was in the 1960s. Today’s policy makers have no experience in dealing with deflation, so they are now trying to change the problem into one with which they have proven success – inflation. If they do not succeed, then falling prices may lead to sustained corporate difficulties, lower job growth and flat stock prices (at best). So will deflation be avoided?

Wholesale Prices in the U.S.
Rolling 10-year CAGR, annually



Source: UBS Warburg and the Historical Statistics of the United States

Even perennial “bear” economist Stephen Roach of Morgan Stanley thinks the policy makers have a good chance of success. In a recent commentary entitled “The Reflation Trade,” Mr. Roach commented “... *I’ve been bearish for so long, they’ve removed the ‘plus key’ from my laptop. But [led by the U.S. Federal Reserve,] policy makers around the world have jumped on the anti-deflation bandwagon as never before. The FED threw down the gauntlet with its larger than expected 50 basis point monetary easing on November 6. This was soon followed by the European Central*

Bank's cut on December 5 while the Japanese have witnessed deflation for eight years but only recently concluded it was 'trouble.' So there you have it – a full-scale frontal assault on the perils of deflation by the world's major . . . authorities. This is precisely the type of ammunition that has spurred major recoveries in the global economy in the past.”

We too believe that as the trouble is taken off the tree and fought head on, there is a good chance of achieving reflation (**re**-inflation). Along with monetary and fiscal authorities on board, we still need an additional player to take on the trouble – corporations. Companies' relentless focus on cost-cutting and lowering prices is exacerbating the deflation dilemma. Yes, efficiencies are good. Yes, society benefits when competition forces out the highest cost producers. Yes, the quality of all lives improve via automation and proper use of the Internet. But this should not be the sole corporate focus.

We believe that **innovation** must regain priority status on corporate agendas. Innovation allows for new value-added products and services for which consumers may be willing to pay **more**. This is what we mean by saying that we at MetWest Capital focus on quality companies in good businesses. **Gillette** charges more for its new Mach3 Turbo than it did for predecessor razors. Consumers will pay more because it is truly a unique and better product. The same goes for **Apple Computer**, whose 28% gross margins far exceed those of Dell, whose commodity products are made efficiently but with unexciting designs. Another example is **Matsushita**, whose Panasonic brand recordable DVD players retail for *three times* the price of play-only models.

Selling a product or service similar to that of one's peers may win business for a while. But eventually competitors will learn the cost-cutting tricks and take back share. The only way to keep customers satisfied and loyal is to provide innovative solutions to **their** troubles, while charging a price commensurate with the value added. Companies that do this will succeed in any type of pricing environment and so these are the ones we seek.

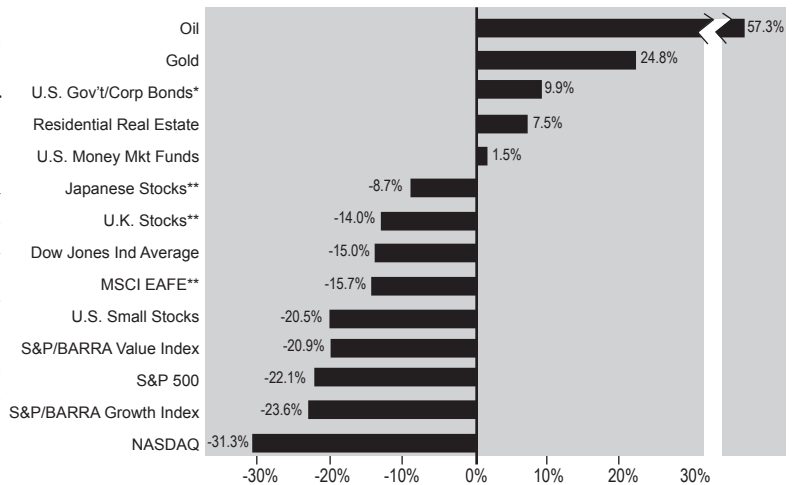
So, what “troubles” did the financial markets overcome last quarter?

VALUE EQUITIES STRATEGY

Stocks did well in the fourth quarter of 2002, but for the year, the S&P 500 dropped (-22.1%) including dividends, the first consecutive three-year decline since the end of the last deflationary period, 1939-1941. The stock market hates uncertainty and it had plenty to loathe last year. As the following table shows, oil prices shot up more than +50% as a combination of threatened military action in the Middle East and a worker strike in Venezuela foretold a potential shortage. But as a group, oil company stocks **fell** more than -10% due to the potential for an oil glut should both of these issues be resolved.

Bond prices rose due to a “flight to quality.” Within the fixed income sector, Treasuries performed better than corporate bonds as large bankruptcies continued to make headlines. The NASDAQ continued to unravel the late 1990s dot-com bubble and Value stocks outperformed Growth stocks for the third year running. Foreign stocks in local currencies mostly underperformed U.S. stocks, but the dollar weakened materially (-9.8% versus the yen and -15.3% versus the euro), causing the Europe, Australasia, Far East (EAFE) Index to decline by “only” -15.7%. Finally, residential real estate

2002 Asset Performance



* Intermediate term (total return)

**In U.S. dollars

Source: Various

prices rose +7.5% on average throughout the country, with some large markets (such as California) advancing even more rapidly. What do we believe is in store for the new year?

Of course, all our expectations are subject to acceptable outcomes for geopolitical events. That said, for 2003 we expect sustained low short-term interest rates (the FED's deflation “trouble” will keep rates low longer than in prior cycles) together with modestly rising long rates (if inflation picks up a little as we hope). This could be very good for stock prices. The U.S. economy, we believe, may continue its uneven yet definitive recovery from the 2001 recession. There is some concern that auto and housing spending could collapse given their strong recent trends. While we think it most likely that auto and housing spending will moderate, we are not of the belief that such expenditures will deteriorate dramatically. The simple reason is that we see little evidence of the “bubble” that troubles some.

The American consumer rarely stops spending unless forced to do so. As credit remains plentiful, wage growth is (modestly) positive and demographic trends are favorable, we expect consumer spending on durable goods to moderate from recent trends, but not so as to tip the economy back into a recession.

As for MetWest Capital's results and recent actions: Investment performance for all of 2002 was about average relative to our large capitalization value peers and better than average relative to a broad universe of all U.S. domestic equity managers. We again emphasize the consistency of our results. While short-term periods are subject to distortions, our *Intrinsic* Value style has resulted in returns typically between growth and value managers for periods of less than a full cycle (like a year or two) and greater than both growth and value managers over full market cycles. Further, our conservative style has resulted in returns that are more closely correlated with other large cap value managers than any other investment style.

We remain steadfast in our approach. We continually monitor our existing holdings while seeking out new opportunities to invest in high-quality companies, in good businesses, with unique products, experienced management teams and a focus on building long-term value for shareholders. To that end, recent additions to our *Intrinsic* Value portfolios include:

Portfolio Activity

- **Kimberly-Clark** is one of the world's largest consumer companies, focused on tissue and paper-based products including Huggies diapers, Kleenex tissues, Kotex feminine products and Depend undergarments. It also has a rapidly growing disposable health care products division. We believe that KMB is in good, stable businesses that benefit from increasing standards of living around the world. It is also a natural deflation fighter, as proven by its unique recent success at battling cheaper private label competition with innovative new products such as Pull-Ups Training Pants.
- **STMicroelectronics** has grown organically to become the third largest semiconductor company in the world. Longtime CEO Pasquale Pistorio has taken this onetime French/Italian partially state-owned small player to leapfrog everyone in its industry save Intel and Toshiba. By largely avoiding the rapidly commoditizing computer segment of semiconductors and instead focusing on consumer and telecommunications products, STM has developed strategic relationships with firms from Nokia to Philips to Sony. While we long admired the fundamental prospects of this company, only recently has the stock price allowed us the opportunity to purchase this world-class company at a significant discount to our estimate of its intrinsic value.

INTERNATIONAL STRATEGY

Stock markets declined around the world in 2002 with, in local currencies, Germany amongst the worst markets (-43.9%), Mexico one of the best (-3.3%), Japan a bit better than average (-17.5%) and the U.K. right in the middle (-22.0%). Geopolitical events continue to concern all investors and have caused asset shifts out of stocks and into bonds and money market funds. One of the reasons we expect a favorable resolution to the terrorism and "rogue nation" troubles is the increasing interdependence of the world's economies. The following map depicts why.

This capital flow graph shows estimated fund flows out of (represented by the outgoing arrows) and into (represented by the incoming arrows) the United States for the year 2001. (2002 numbers are not yet finalized but show a similar pattern.) For example, American citizens and corporations invested \$107 billion in Europe while Europeans bought \$392 billion worth of U.S. stocks and bonds. Some of this is due to large corporate mergers, such as the expansion of Bank of the West by France's BNP Paribas and the acquisition of Ralston Purina by Nestlé of Switzerland. But much of the \$24 billion invested by the Japanese went to buy U.S. Treasury securities and some of the \$50 billion flowing to Japan represents Americans buying Japanese stocks.

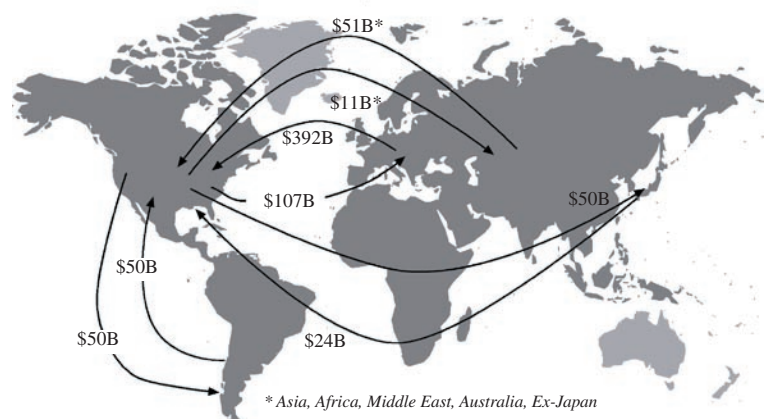
Capital flows such as these have been increasing for decades, which is why more than \$1 trillion of U.S. Treasury securities are now owned by foreigners. With similar amounts of foreign securities held by U.S. entities, it is in everyone's best interest to resolve the global troubles so as to protect all investments. We note that while investments in and by Asia (including China and the Middle East) are still relatively small, they have been growing rapidly and could soon surpass those of Japan. We shall continue to monitor international events with the utmost diligence and make investment

decisions accordingly.

To capitalize on recent opportunities, additions to our International portfolios include:

- **Diageo** was purchased for our International portfolios the day after it completed its divestiture of Burger King. This followed its sale last year of Pillsbury to General Mills and refocuses the company almost exclusively on the high margin global spirits business. Well-known brands include Johnnie Walker, José Cuervo, Smirnoff, Baileys, Guinness, Captain Morgan, and Seagram's 7 Crown and VO. Long-term volume growth of its brands is likely, operating margins are in excess of 20%, the balance sheet is solid and FREE cash flow will be used for stock repurchases. With a P/E ratio of 13x and a 4.0% dividend yield, we believe the stock price does not reflect the positive fundamentals we envision.
- **Marui** operates 31 mid-sized department stores in Japan (half in Tokyo and half in neighboring prefectures) specializing in clothing and accessories. While retail sales in Japan remain anemic, Marui has remained consistently profitable, gaining market share due to superior merchandising. Its focus on the younger shopper makes it unique, and the company is one of the few in its industry to still be expanding via the opening of new stores.

U.S. Capital Flows - 2001



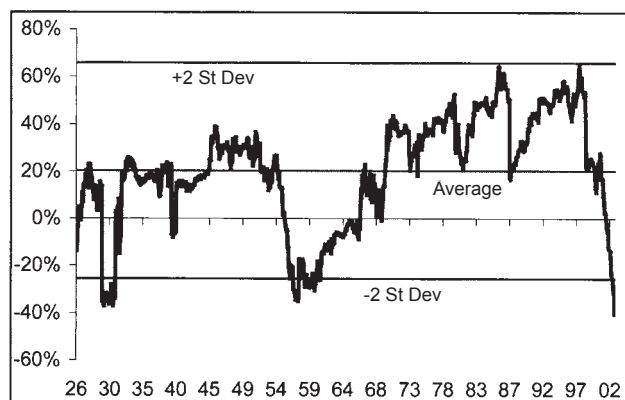
Source: Merrill Lynch and the Bureau of Economic Analysis

FIXED INCOME STRATEGY

Interest rates again declined in 2002 with most maturities hitting four-decade lows. This was not surprising given the many "troubles" worrying investors and the historical safe haven status of U.S. Treasuries. But the extent of fixed income gains was unusual in the context of very weak equity prices. The past four years have witnessed an historic decoupling of stock and bond trends.

The following chart shows correlations between equity and fixed income returns dating back to 1926. Note that during periods of above-trend inflation (such as most of the 1970s, '80s and '90s), stocks and bonds showed high positive correlation. That is, when bonds did well (lower yields and rising prices), stocks did well too. This is because the trouble of focus was rising price levels. Lower interest rates were a sign that inflation was not getting out of hand and thus stocks took their cue from bonds and advanced.

Stock-Bond Correlation



Source: Ibbotson, Morgan Stanley Research

Today, we have the opposite situation as bonds seem to be taking their cue from stocks.

Note the extreme *negative* -40% correlation most recently recorded between stocks and bonds. Literally day by day, when stocks advance, bond prices fall – and vice versa. This is telling us that fixed income investors see declining stock prices as adding to the potential deflation trouble. In a way, deflation is “good” for holders of fixed payment instruments as their coupons are worth more in a declining price environment. If reflation takes hold, we may expect stock prices to advance while fixed income prices fall. This is why during the third quarter of last year, we moved 20% of the fixed income portion of MetWest Capital’s balanced portfolios to cash-equivalent U.S. Treasury Bills. As stock prices recover over the coming quarters, we expect to reinvest the proceeds of those sales in bonds with more attractive (i.e., higher) yields.

Corporate bonds are currently the most fundamentally attractive fixed income sector because yields haven’t fallen nearly as precipitously as Treasuries. This is due to continuing default risks caused by falling prices in the corporate sector. We have only modestly increased our exposure here as profit growth does not yet appear sufficient to warrant improving credit quality trends. As fixed income is, for us, managed as an “anchor” for portfolios,

we will continue to err on the side of caution until value – and *catalysts* to realize that value – appears more clearly.

We are becoming somewhat cautious about the outlook for municipal bonds. For the first time in recent memory, state and local spending may be constrained. Tax receipts declined by -2½% this past year while spending continued to rise. The state of California is predicting a \$35 billion budget deficit. As most state constitutions prohibit deficit spending, outlays may have to be cut. In the meantime, state balance sheets are at risk and credit ratings may decline. (California’s was recently dropped one notch to single A, among the lowest in the nation.) We are therefore cautious about municipal debt, even while understanding the attractive yields available to our taxable clients.

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

“Everything in moderation.” This is true for many things in life, but not necessarily for all things. Deflation is very difficult to control once it takes hold so avoidance is the only real choice.

This quarter we introduced “The Trouble Tree.” The carpenter in our story hung his troubles on a tree overnight to be picked up for work the next day. Global policy makers may not have that same luxury. We are heartened by the actions recently taken to combat the potential for global deflation. We believe the combination of low interest rates, growing money supply and proactive fiscal policies can effectively head off deflation before it takes hold. We may then have to fight **in**flation again, but proven effective tools exist for that trouble. Corporations must be coaxed to join the reflation charge by refocusing their efforts on innovation and sustained productivity, not simple cost-cutting designed to lower selling prices. We are optimistic that this can be accomplished and we are focusing our investment efforts on those firms with proven records of growing profits and rewarding shareholders via acumen and innovation.

We wish you a prosperous and trouble-free 2003!

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