

Capital Visions

WHAT ARE YOUR GOALS?

There was a man who had worked all of his life and had saved all of his money and was a real miser. He loved money more than just about anything, and before he died, he said to his wife:

“Now listen. When I die, I want you to take all my money and put it in the casket with me. I wish to take my money to the afterlife.”

And so he got his wife to promise him with all of her heart that when he passed on, she would put all of the money in the casket with him. Shortly afterwards, he died (of natural causes).

He was stretched out in the casket, his wife was sitting there in black, and her friend was sitting next to her. When they finished the ceremony, just before the undertakers got ready to close the casket, the wife said:

“Wait just a minute!”

She had a box with her; she went over with the box and put it into the casket. Then the undertakers locked the casket and rolled it away for burial. Her friend immediately grabbed her:

“Girl, I know you weren’t foolish enough to put all that money in there with your husband, were you?”

“Listen,” said the wife, *“I am a religious woman and I won’t go back on my word. I promised him that I was going to put that money in the casket with him.”*

The friend shrieked, *“You mean to tell me you put all that money in there to be buried with him!!!?”*

“I sure did,” said the wife, *“I wrote him a check.”*

We have two suggested morals for this story: First, never underestimate the intelligence of a woman! Second, plan carefully, because you just may get what you ask for.

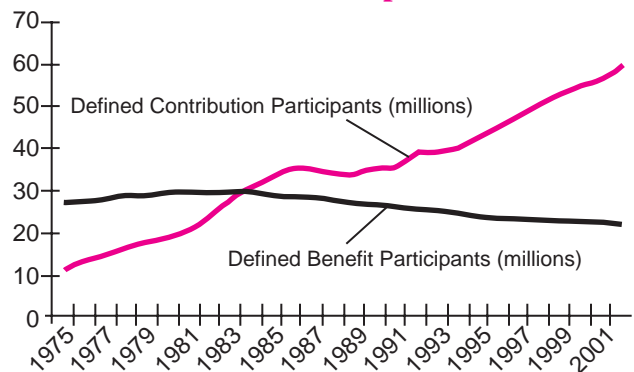
We believe that investors, both individual and institutional, too often have strategies that may be inconsistent with their true long-term goals. What is the purpose of wealth? Why do we save money? How should we invest? What are our goals and how may we best achieve them? Are we just like the man who wanted to make money for its own sake and try to take it with him? These are questions we all must answer individually. We at MetWest Capital would

like to offer a few tidbits of advice. First and foremost is invest for the long term.

The Real Answer

The issue of long-term investing is gaining critical importance because of the growing popularity of defined contribution assets in the U.S. (predominantly in the form of 401(k) plans). This means that individuals now control more of their own investments. The following chart shows the number of people participating in pension plans in the U.S. The blue line represents defined benefit (DB) plan participants. With DB plans, corporations guarantee certain retirement benefits to their workers and then manage the plans themselves to fulfill their obligations. The red line depicts defined contribution (DC) plan participants. Here, individuals and companies contribute a set amount each year for the exclusive

Pension Participants



Source: EBRI, Morgan Stanley Research

benefit of employees, but it often remains up to the individual to determine how those funds are to be invested. With the additional freedom of DC plans comes the greater responsibility to invest wisely, because the only other “backstop” one may have for retirement is Social Security (and who knows where that may be in twenty years’ time).

Note the significant shift over the past three decades from predominantly DB plans to today with 75% of all retirement participants invested in DC plans. So this brings us back to the question of what are your goals?

The real answer is that for most people, investments serve to secure the future. That future may include retirement, estate planning or other long-term objectives. It is also important to point out that the future is typically 10, 20 or even 30+ years away. Therefore, whether we are investing DB, DC, trust, personal, foundation, endowment or other assets, MetWest Capital always takes a long-term view.

Let's look at **Cytec Industries** as an example of a compelling long-term investment. Cytec is a mid-cap specialty chemicals company that we began investing in during 2001. The company participates in several businesses, including water-treatment and mining chemical additives, light stabilizers for paints and composite materials. It is the composites business that is of most interest to investors.

If investors were concerned only with the next 12 months, they might not look so favorably on this business, as nearly 60% of its sales are to commercial and general aviation aircraft customers. Composite materials are used as metal replacements due to their greater strength, lighter weight and lower heat conductivity. These materials are increasingly being used on newer, larger airplanes such as Boeing's 777 and Airbus' A380. As a matter of fact, the A380 is so large (capable of carrying more than 550 passengers on two decks), it might not be able to get off the ground without liberal use of composites. The A380 is still in development and thus generates no earnings for Cytec. But there are 110 planes on current order with the first scheduled for delivery three years from now.

It is estimated that by 2007, the *incremental* profits from providing composite materials to Airbus will be 75¢ per share – more than a 35% increment from today's earnings level. This is not speculation or guessing. This figure is derived from a detailed analysis of composite usage per plane, annual build rates, price per pound and conservative estimates of Cytec's market share of the business. We consider all this information carefully in our calculations of the *intrinsic* worth of Cytec and find that today's stock price does not nearly account for the value inherent in its businesses. Rather, the stock's valuation reflects only near-term cyclical issues, not long-term earnings and cash flow power.

Our equity portfolios consist of approximately 35 companies such as Cytec, each with its own unique story and *intrinsic* value attributes. Portfolios are diversified by company size, market sector, industry, economic cyclicality and interest rate sensitivity. We are careful to design portfolios so as to fulfill the long-term objectives of our clients, with full knowledge that in order to do so, we may have to accept sub-par results in the short term.

We strongly urge investors to take a long-term view. Unless you are like the man in our story, your goal is not to accumulate wealth for its own sake and take it with you. You are certain to have specific needs for your future. Calculate those goals. What is your net worth today and what must it be at various stages in your life to accomplish those goals? Make a plan and stick to it. If you do have sufficient wealth today and desire to maintain it, calculate the deteriorating effects of inflation. If you are a plan sponsor with DC or DB assets, carefully review your actuarial and return assumptions. Then invest with an eye toward accomplishing what you have set out to do.

Whether it's MetWest Capital or other quality managers, ensure that the manager's goals are aligned with your own and continue to ask the tough questions about how your funds are being managed. We will continue to do all we can to minimize the interim "noise" of short-term portfolio returns while concentrating on meeting the long-term objectives of our clients.

So, what goals did the financial markets achieve last quarter?

VALUE EQUITIES STRATEGY

With extreme interim volatility, stocks finished the quarter within about 5% from where they began. As always, there was considerable dispersion between market sectors. Some of the sectors that showed the most strength in recent quarters corrected somewhat. For example, autos and housing-related industries lagged. Basic metals, including gold, rose early in the quarter, but declined sharply toward the end as the military conflict got underway. This is a typical "buy on anticipation" and "sell on the action" short-term trading phenomenon. Growth stocks outperformed value for a change and large companies slightly outperformed smaller ones.

Dominating many of the best-performing industry groups for the quarter was technology. Back in January 2000, we said that ". . . while the explosion of spending on technology . . . equipment has benefitted their *purveyors*, it has only begun to benefit the *users* of such products and society as a whole." We clearly see the capital investment and productivity benefits today. This is evidenced by the short-lived and shallow recession just ended, even in the face of monumental adverse events hitting the U.S. seemingly nonstop for the past two years. Today we believe the opposite about technology. That is, we now expect the purveyors of technology to begin to reap some rewards again – though not of the same magnitude as in the late 1990s. We believe our holdings of **Molex**, **Motorola**, **Xerox**, **STMicroelectronics** and other companies could benefit meaningfully in the quarters and years to come.

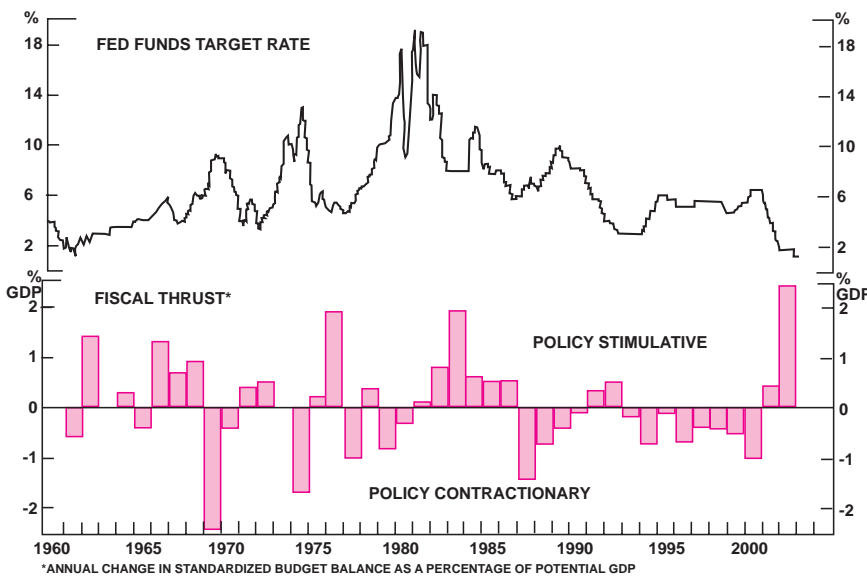
As for the whole of the U.S. stock market, a strong case can be made that predictors of future stock prices are pointing upward.

1. The U.S. money supply, as measured by M2, is growing at more than an 8% annual rate. This is far more than the economy is likely to grow. The excess between money supply and GDP growth often finds its way into financial assets, including stocks.
 2. Interest rates across the yield spectrum are lower than at any time in the past 40 years. In addition, the yield curve is positively sloped with short-term interest rates more than 250 basis points (2.5%) lower than long rates. As most banks borrow short to lend long, this provides a great incentive to allow for relatively easy borrowing conditions.
 3. While some may say that U.S. equity prices are not yet cheap, few now believe they are still expensive. At about 15 times this year's operating earnings, stock prices are
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near their long-term valuation midpoint, given the level of inflation and interest rates.

4. Market sentiment is poor. As a contrary indicator, this could bode well for the future direction of the market. The percentage of investors surveyed as bearish recently increased to 58%, its highest level since 1990. A great many speculative and day-trader type investors have exited the market while long-term pension and 401(k) assets continue to flow in daily. Thus, there may be substantial pent-up demand for stocks.
5. Finally, U.S. fiscal policy has turned expansionary. Dramatic increases in social spending were already planned. Add to this higher defense and homeland security expenditures, coupled with flat-to-down tax collection, and it is clear the government will help stimulate the economy (at least in the short run). The following chart illustrates our points.

Aggressive Reflation in the U.S.



Source: *The Bank Credit Analyst*

The top part of this graph shows the U.S. Federal Funds interest rate target dating back to 1960. Note that with last November's cut to 1¼%, it is now at the lowest level in more than 40 years. So the FED seems intent on doing its job of reflation of the economy. The bottom part of the chart shows the annual change in the U.S. federal budget balance as a percent of GDP. Note that 2002 showed the largest year-to-year fiscal "thrust" since the Korean War and 2003 may show a similar pattern. Part of this stimulation comes from declining tax receipts resulting from lower capital gains tax payments. But as the declining revenue is being met with simultaneous **increasing** expenditures, the government's fiscal stimulus should act to help boost the economy. A stronger economy could positively impact corporate profits and serve as a catalyst to lift stock prices.

This is not to say we believe the stock market may soon be "off to the races" again. If the foreign conflicts are successfully resolved, we may then expect a relief rally in the markets and some pickup in economic activity. But we concur with many who say that current

uncertainties have exacerbated the anemic economic recovery, not caused it. Ed McKelvey, Senior Economist at Goldman Sachs, sums up our thinking by saying, ". . . *it does not follow that . . . uncertainty is the sole, or even the main, factor depressing current economic activity. To us, the most compelling explanation for lassitude in the U.S. private sector is that it is still correcting the huge net saving deficit that emerged during the stock market bubble of the late 1990s.*" Further and succinctly put by *Wall Street Journal* columnist Jesse Eisinger, ". . . *Time, not a smooth war, will heal the excesses of the 1990s . . .*"

We therefore believe that while the overall stock market could resume an upward trend later this year, the greatest value could be added via individual stock selection. So, with a continuing long-term focus, recent additions to our *Intrinsic Value* portfolios include:

Portfolio Activity

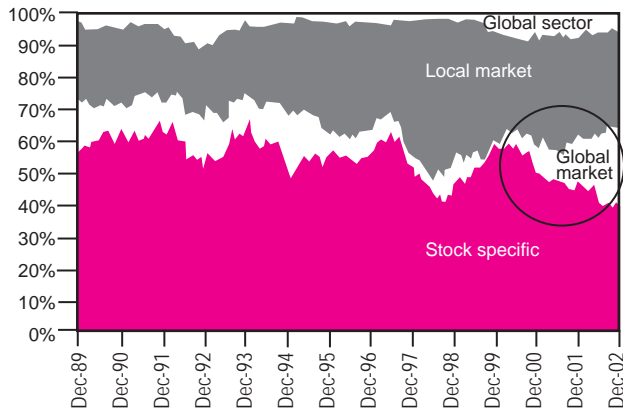
- **(Charles) Schwab** is the world's largest discount retail securities broker. Founded in 1971 by its namesake, it was acquired by Bank of America in 1983, but then spun back out in 1987. It has been publicly traded ever since. Schwab is a great example of a company building long-term value while investors focus only on short-term "DARTS." **Daily Average Revenue Trades** is a measure of how much trading (resulting in brokerage commissions) is handled. It is a cyclical measure of profitability. Of greater importance, in our view, is total client assets held by the company. On this measure (currently \$750 billion), the company continues to gain market share and build its future. Thus, it is this long-term measure that we monitor as the best indicator of Schwab's future strength.

- Our purchase of **L-3 Communications** was not due to the looming conflict in Iraq. Rather, we believe this leading supplier of defense electronics and related products is misunderstood by investors. Since its spinoff from Loral and Lockheed Martin in 1998, L-3 has consistently grown its revenues, operating margins, profits, earnings per share and returns on both capital employed and equity. It does so by inventing new products (such as the black box found in most aircraft) and acquiring technology (such as bomb detection). The company generates FREE cash flow in excess of 8% of its current market capitalization and will benefit from increased defense spending likely to occur well beyond the end of the current conflict.

INTERNATIONAL STRATEGY

Due to significant current global events, most world markets moved in unison last quarter. The fact that **Samsung Electronics** came out with a new low-cost wireless handset for European markets was overshadowed by more important matters. Morgan Stanley and Goldman Sachs estimate that in Asia, for example, global market factors have increased dramatically in recent quarters and now account for 25% of the total return of stocks. The following chart depicts this graphically.

Global Influences on Asian Markets



Source: MSCI and Goldman Sachs

We believe that the decreased relevance of stock-specific factors for Asian equities (and international markets in general) is temporary and could reverse when global hostilities diminish. Longer term, we expect local market influences to lessen, stock specific factors to revert to their normal level of 50% and global sector factors to take over from global markets. For example, in the future, Nokia, Ericsson and Motorola may have greater influence on how Samsung is perceived by investors than do reports of recurring votes at the United Nations.

One example of a unique company that is largely in control of its own destiny is:

- **Serono** is one of the largest pharmaceutical companies in Europe and the third-largest biologics company in the world. Its important products include Gonal-F (for reproductive health), Saizen (a growth hormone), Rebif (multiple sclerosis – MS) and Raptiva (in trial for the treatment of severe psoriasis). The company's value is exemplified by the MS market where not only has it licensed Rebif to Pfizer for additional U.S. sales, but Serono also gets royalties on the world's second-best selling MS compound, Avonex. Formerly attaining a biotech-like valuation, the stock is now priced in line with other major drug companies. With significant patent-protected molecules and unique partnerships for new drug discovery, we feel Serono is a unique investment appropriate for our International portfolios.

FIXED INCOME STRATEGY

After their dramatic drop during the second and third quarters of 2002, interest rates have stabilized recently with rates across the yield curve largely unchanged during the first quarter of 2003. Corporate and municipal bond yields have not declined as much as Treasury yields, due to the perception of heightened default risk.

So if Treasury yields begin to climb, non-Treasury securities may hold up relatively well.

We remain of the view that yields on U.S. Treasury securities are artificially low and could rise meaningfully as the many global uncertainties subside. Given inflation near 2%, short-term rates should be closer to 3% than their current 1¼% and 10-year rates should be closer to 5% than their current 4%. Because we give up so little by waiting on the sidelines, we have maintained about 20% of the fixed income portion of MetWest Capital's balanced portfolios in very short-term cash-equivalent securities like a FNMA discount note due in February 2004. When we believe that the risk due to either rising interest rates or non-Treasury defaults has diminished, we will reinvest the proceeds of cash-equivalents back into longer-dated securities. Meanwhile, to attain somewhat higher yields with minimal absolute risk, we are maintaining our positions in mortgage-backed GNMA securities, believing that refinancing could decline precipitously as 2003 progresses.

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

"When will it end?" "I can't take the torture of this market any longer!" "Just let me join the man in his peaceful casket already!"

The real truth is that the stock market has been in decline (albeit a precipitous one) for only three years, while large cap Value portfolios (such as those managed by MetWest Capital) were at their peaks only two years ago. This should not be considered forever by true long-term investors. For those still accumulating wealth (by adding to existing retirement plans, for instance), a lower market allows for wise purchases at undervalued prices. For those in retirement and drawing down wealth, a temporary market decline should not derail most long-term plans.

This quarter we introduced the miser who believed he could "take it with him." We told the story to highlight the folly of money merely for its own sake. We also pointed out the benefits of long-term planning and investing. We agree that during times of severe turmoil, it is most difficult to focus on the long term. But it is most important, when tempted to look no further than tomorrow, to reexamine one's goals and carefully map out a conservative plan of attaining them.

Be assured that we at MetWest Capital continue to invest for long-term results. Stock by stock and year by year, we hold steadfast to our conservative *Intrinsic Value* style, uncovering unique investment opportunities to attain the long-term goals of all our valued clients.

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