

Capital Visions

CHECKS & BALANCES

Four years ago, in the *Capital Visions* issue entitled “The Class of 1999,” we described high school graduation ceremonies and the questions being asked of and by the seniors. We paralleled the fundamental question of “What is life?” with “What are stocks?” and went on to answer the latter question. We think it appropriate today, after attending some more commencements (this year at the college level), to again think on a higher plane and ponder some of the issues raised by today’s graduates.

At the University of Pennsylvania’s 247th commencement, the school’s founder, Benjamin Franklin, was much discussed. We will have a lot to say about Dr. Franklin in future quarters, as his numerous contributions to American society are perhaps unequalled in history. This quarter, we focus on his role in the formation of the United States government. While many had an important hand in its crafting, Dr. Franklin was a proponent of one of its most important founding principles – the notion of “checks and balances.”

While not specifically expressed in the U.S. Constitution, the concept of “checks and balances” is referenced throughout our founding principles. Many of the speeches we heard at this year’s ceremonies credited that notion (more than any other) with contributing to the greatness of our country. In “Defence of the Constitutions,” John Adams stated that “. . . representations of the people shall be accomplished through a total separation of the executive from the legislative power, and of the judicial from both.” In this way, he argued, each can act as a check on the other two, while the tyranny of absolute power may be avoided. Thereby, the executive may suggest but not create laws. The legislature (Congress) may create laws so long as the judiciary deems them consistent with the Constitution. The Constitution may be amended, but only with great process and, thereby, overwhelming consensus. Throughout, the aim is to minimize corruption and keep it in check through its earliest possible discovery.

The framers of our Constitution went on to say that “*in a republic it is of great importance not only to guard the society against the oppression of its rulers, but to guard one part of the society against the injustice of the other.*” This, Dr. Franklin thought, was the founders’ finest hour. Thus our society has grown to withstand many an injustice and to eventually rectify most all of them. So much has been said in recent years about the “injustice” of corporate executives and their abuse of power. It has not been widely broadcast, however, that the vast majority of these excesses was allowed to continue for but a very short period of time. The

villains were found out and put out. This is a great strength of our nation and one that should be emphasized.

There is, however, one source of imbalance that we believe still requires minimizing. That is the media. Where are the checks and balances here? Where within the newspaper, television, cable, radio, movie, satellite and internet industries do we find one body looking to keep the others honest? Our Constitution rightly guarantees **freedom** of the press, but does it ensure **accuracy** as well?

The Media

The freedom to uncover and expose information truly does add value to society. Remember that the media exposed Watergate, aided in the capture of the recent accused sniper attackers and brought global attention to the SARS virus. But this last point is somewhat controversial. Dr. David Baltimore, president of the California Institute of Technology and a 1975 Nobel laureate in medicine, wrote an interesting editorial in *The Wall Street Journal* last quarter entitled “SAMS – Severe Acute Media Syndrome?” Dr. Baltimore asserts that the hyperbolic media coverage of SARS did more harm in economic destruction than good for the protection from one of hundreds of new viruses that “*suddenly infect the human population . . . but [soon] burn themselves out.*” He complained that “. . . the public deals with danger not as a matter of statistical probability but as a function of media exposure.” We in no way wish to diminish the seriousness of SARS and salute all those working to contain its spread and comfort those affected by it. But we wonder why the media highlights this particular epidemic while giving little coverage to many others.

The business and financial world is also not immune to such selective coverage. Seemingly every day we read reports of massive layoffs at large companies. But where do the articles point out that Fortune 500 companies have layoffs in both good times and bad in their efforts to cull underperforming workers? Or where when they say “15,000 to lose jobs” do they explain that in larger firms, job losses are often accomplished simply by not filling vacant positions (most of which become vacant due to retirement or voluntary resignations)? Yes, the overall unemployment rate *has* increased of late, but more due to the expansion of the workforce than the outright firing of capable workers.

While the vast majority of media firms and reporters are honest and well intentioned, complete and accurate reporting unfortunately

does not always make for good headlines. We have found that some media portrayals of business and financial events are biased and/or exaggerated. The events are often reported in such a way as to create headlines (which increases viewership and sells advertising) more than to fairly communicate all relevant information. Astute long-term investors understand this and may use it to their advantage.

Some investors believe they can profit from short-term trading strategies involving the reaction to news reports. We at MetWest Capital disagree. In contrast to popular thinking, we may analyze misleading media reports and act in a contrary fashion if other investors cause a temporary distortion in stock valuations. There are many examples of our success in this regard. For instance, while the media portrayed **IBM** as simply a “computer” company subject to severe competition, we saw the growing domination of its services businesses that today comprise more than half the company’s sales. Another example is our investment in **Washington Mutual** (far earlier than was fashionable) when we believed press reports of the demise of savings and loans were too simplistic. More recently, we increased our holdings of **Tyco** when the media could not distinguish between former management and the great value of the company’s businesses as going concerns.

The next time you watch CNBC, ponder some of the following questions: What is the **motivation** of the commentators? What **experience** do they have? What has been their long-term **track record**? What is the **time frame** referenced in their comments or future views? Are they concerned with both **risks** and **rewards** or just emphasizing one over the other? The reporters and commentators are not held to these standards, so be wary of press reports and do not take them as gospel. We certainly do not when evaluating news and data on our investments. We strive to employ good judgment and the checks and balances of our long-term investment methodology.

So how did the financial markets balance out last quarter?

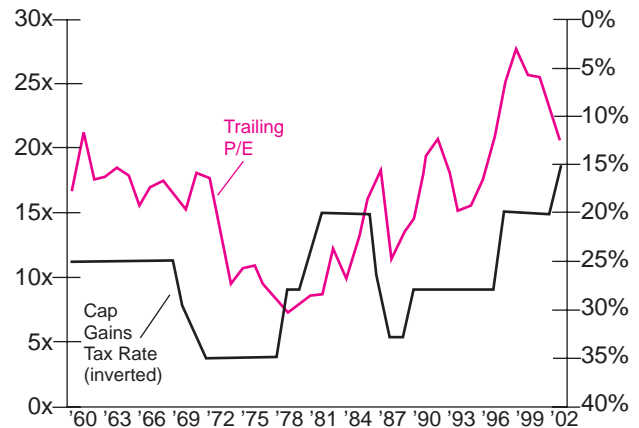
VALUE EQUITIES STRATEGY

After some disappointments in recent periods, it is heartening to report about a quarter in which just about everything went right. The war in Iraq ended; global economies, while not bouncing to new heights, did not sink either; and stock and bond markets around the world sustained significant rallies. The U.S. equity market, as measured by the S&P 500 Index including income, jumped +15.4% in one of the sharpest short-term rallies since the market bottom of 1982. MetWest Capital’s equity portfolios fully participated in the rally, outperforming most major market indices, both growth and value oriented.

We believe that, with the certainty of corrections along the way, this could be the start of a multi-year trend of higher equity prices. We spoke in our last quarterly report of the aggressive attempt at reflation taking place in the U.S. on both the monetary and fiscal fronts. More of this came to pass recently. On June 25, the Federal Reserve Board (FED) lowered interest rates for the (lucky?) thirteenth time in the past three years. The Federal Funds

Target Rate now stands at 1.00%. Also this past quarter, Congress passed tax cuts which resulted in, amongst other changes, the lowest capital gains tax rate in more than four decades. The following chart depicts our enthusiasm for this move.

P/E Varies With Tax Policy



Source: ACCF, S&P and Credit Suisse / First Boston

This chart shows the positive correlation between **higher** stock price-to-earnings (P/E) ratios and **lower** capital gains tax rates. This says that investors place a higher value on equities if they are able to keep more of the gains generated. We thus may expect that the recently enacted 15% rate may result in stocks consistently selling for 20+ times earnings, significantly higher than the valuation of today.

With a continuing long-term focus, recent additions to our *Intrinsic Value* portfolios include:

Portfolio Activity

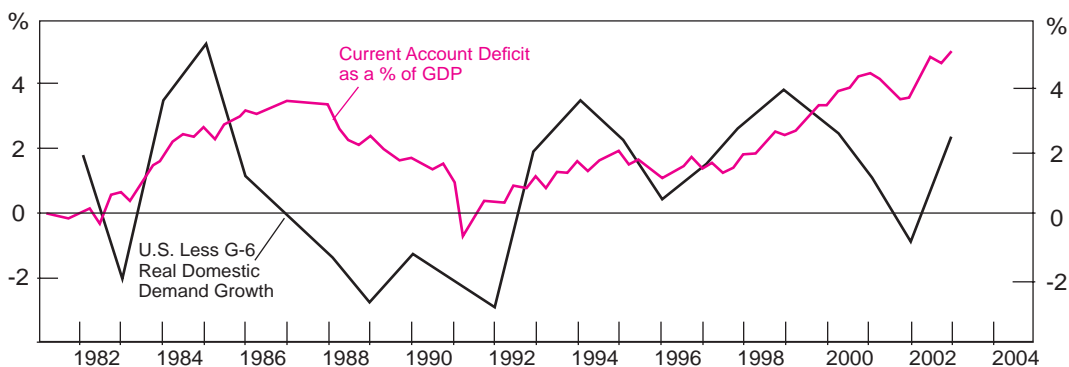
- **Duke Energy** was repurchased for our clients after being sold (at much higher prices) two years ago. Duke is in two classes of businesses. The first class consists of two excellent, stable, regulated electric and natural gas utilities. These companies provide significant cash flow and earnings to support the stock’s 6% dividend yield. The second business, Duke Energy of North America (DNA), has built one of the U.S.’s largest merchant power generating fleets. DNA sells more than 15,000 megawatt hours of power, on both a contracted and spot basis, to utilities around the country. Today, excess supply of power is keeping prices low and Duke’s earnings below their potential. In three years, we expect power demand to be in balance with supply and Duke’s earnings to exceed \$2.50 per share (up from \$1.50 expected for 2003). Our patient, long-term investment discipline finds this a compelling opportunity while the 6% yield “pays” us to wait comfortably.
- **Lucent Technologies** remains one of the world’s largest providers of telecommunications equipment. Spun off from AT&T in 1996, the company’s equipment touches just about every voice and data, wireline and wireless

phone call and internet connection in the world. This is an out-of-favor company in an out-of-favor industry, but one that holds great long-term promise. All recent operational issues have been resolved, the company is well funded and sales to China and India are taking up the slack awaiting the increase of sales to U.S. and European carriers. Lucent's Bell Laboratories research facilities continue to attract some of the best scientists in the world who are today inventing the communications systems of tomorrow.

INTERNATIONAL STRATEGY

Most international stock markets performed as well as the U.S. market did last quarter. Add to this the strength of foreign currencies (predominantly the euro) and foreign developed markets, as measured by the Europe Australasian Far East (EAFE) index, which jumped +19.5% including income. Many economists are troubled by the large and growing current account deficit of the United States. As the U.S. has been the engine of world growth in recent years, the fear is that a growing current account deficit will lead to unsustainable net external debt. This could crimp the U.S.'s ability to continue to grow and all nations may suffer. The following chart illustrates this point.

Economic Drivers of the Current Account Deficit



Source: OECD and The Bank Credit Analyst

The solid red line represents the U.S. current account deficit as a percent of GDP. In 2002, the U.S. imported \$400 billion worth of goods and services *more* than it exported. Add to this roughly \$60 billion of unilateral transfers (gifts, aid, military grants, etc.) and a slight deficit on our income account (U.S. assets owned by foreigners generated more income than foreign assets held by U.S. entities for the first time since WWII), and nearly 5% of our \$9.6 trillion GDP has been transferred abroad. Since funds flows must be a zero-sum game, foreigners have financed our appetite for their products by investing in U.S. assets (stocks, bonds, real estate, etc.) A continued increase of this magnitude would be unprecedented and, in all probability, unsustainable.

The blue line in the chart above is what we believe the future portends. This line represents the difference between U.S. and foreign growth. Note that since 1982, each time the U.S. current account rose substantially, foreign growth in the ensuing several years began to outpace that of the U.S. This is shown by the blue

line trending below zero. Should foreign growth pick up faster than domestic, U.S. exporters could benefit, the trade gap may stop expanding, the current account deficit could shrink and foreigners may begin to repatriate some of their U.S. assets. The best scenario would be for the U.S. to grow while non-U.S. economies grow somewhat faster. This is what we believe is most likely and we are positioning international portfolios accordingly.

To that end, last quarter's new investments include:

- **Repsol-YPF S.A.** was formed through the 2000 merger of Spain's and Argentina's largest energy companies. Upstream operations (exploration and production mostly in Latin America and the Caribbean) comprise 67% of revenues while downstream (refining and marketing largely in Europe) make up the rest. Since the merger, the company has reduced its indebtedness by 9 billion euros to a now comfortable 30% level. The Argentinian economy is on the mend and REP's return on capital should reach that of its peers within three years. With the company's very high-quality assets, increasing production profile, experienced management team and very cheap stock price, we find REP to be a compelling long-term investment.

- **Business Objects** is a Franco-American company focused on providing Business Intelligence (BI) software to its global clients. BI is a niche product that allows users to extract transactional data from a corporate database and provide useful analysis to management. It offers a relatively inexpensive solution to "How can I provide the optimal products for my customers

where they want to purchase them and at prices they can afford?" BOBJ is a leader in its field, generates strong cash flow (resulting in \$3.70 of net cash per share on its balance sheet), is undergoing a strong new product cycle and has successfully grown its market share in recent years. Selling for less than 20x earnings (ex cash) with operating margin potential of near 20%, we find the stock undervalued.

FIXED INCOME STRATEGY

Somewhat surprising to us, fixed income yields continued their descent last quarter with interest rates falling to levels not seen in nearly half a century. Short-term circumstances notwithstanding, we believe that the longer-term "steady state" inflation rate in this country is 2% - 2½%. Given that, we see short-term interest rates rising (not this year, but possibly beginning next) to about 3½% and long-term yields increasing to about 5½%. We expect that these steady state rates could be overshoot should the economy rebound strongly and the FED be successful in eradicating a deflationary possibility. Furthering our own work, the *International Bank Credit*

Analyst asserted:

“The fundamentals for U.S. bonds are bearish:

- 1. Economic growth is likely to accelerate . . .*
- 2. The weak dollar [and strong gold] means that inflation has probably bottomed and*
- 3. The widening fiscal deficit means that Treasury supply will grow rapidly . . . ”*

Our checks and balances approach to fixed income investing results in a multiple scenario analysis whereby we look at the expected total return of fixed income investments across a broad range of future assumptions, including, but not limited to, those discussed above. Recently, the result of this exercise was that under a majority of reasonable scenarios, U.S. Treasury total returns are expected to be **negative** over the coming two years. We therefore made some changes to our investment strategy for the fixed income portion of MetWest Capital balanced portfolios.

Strategy	LBGC/I Index*	MetWest Capital Target Prior	Current
Duration (years)	3.8	4.5	3.4
Avg. Maturity (years)	4.5	5.6	4.0
Avg. Quality	A+	AA	AA

*Lehman Brothers U.S. Gov't/Credit Intermediate Bond Index

We have implemented this strategy change with a “mini-barbell” approach, investing about 20% of fixed income portfolios in cash-equivalent securities and 80% in 5-year bonds. We favor corporate and mortgage-backed bonds for the 5-year portion but still employ some Treasuries for safety and liquidity. Taxable portfolios may utilize high-quality municipal bonds. The average maturity is declining by 1.6 years, more than that typically associated with a duration drop of 1.1 years. This is because we favor high coupon bonds – those that offer a higher-than-current yield. Using Treasuries as an example, a “current-coupon” 5-year offers a coupon of 2½% and therefore trades near par (\$1,000 for each

bond). We purchased a 5½% coupon Treasury which, because of its above-market rate currently, trades at \$1,140. While the yield-to-maturity of each of these is similar, our preferred high-coupon bond will outperform the other should the general level of interest rates rise before maturity. (Please contact us should you want further clarification on this or any other investment-related topic.)

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

In the Federalist Paper No. 51, written by Alexander Hamilton or James Madison in 1788, the author writes: *“If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. [But] in framing a government which is to be administered by men over men, . . . , you must first enable the government to control the governed; and in the next place oblige it to control itself.”* This, too, could be said of business and investments.

We introduced checks and balances this quarter so that we could emphasize its importance not only in government, but in investing as well. We pointed out that our society is not entirely protected and that some imbalances still exist. In business, the imbalances are exemplified by the spate of recent corporate scandals. Most of these have been uncovered quickly, evidence that our system works well in the long run. But the media exemplifies that a lack of checks and balances can lead to inaccurate or exaggerated news reports. We at MetWest Capital understand the biases that may exist in media reports and have used such inaccuracies, where they may occur, to identify mispriced securities.

We shall remain diligent in our efforts to uncover hidden values and take advantage of temporary distortions as they occur. We are optimistic that economic activity will strengthen, both in the U.S. and abroad, in the coming years and believe that equities should outperform bonds in such an environment.

We wish you a most pleasant summer!

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