

Capital Visions

THE KITCHEN REMODEL

The cars were lined up 20 deep waiting to enter the new housing development. Day after day, for months, at a little after six o'clock in the morning, we passed them on our way to work. Patient, these people were. They were not milling around while sipping coffee and munching on doughnuts or bagels. They were still in their vehicles, waiting for the security guard to open the gates. No, these were not prospective buyers waiting to purchase a new home. These were construction workers, waiting for the gate to open so they could start their day's work.

Well, we thought, if so many people were so anxious to do construction work, this must be a good time to do a kitchen remodeling project, something we were contemplating, but had delayed for years! So out we went to peruse designs, select materials, measure for cabinets, etc. We selected a contractor, paid a deposit (with some trepidation) and agreed upon timing for the project.

Kitchen remodels are more disruptive than others because most homes have only one cooking area and it's inconvenient to do without. We considered ourselves well prepared, even for a "worst case" scenario. We set up a microwave in the laundry room, a refrigerator in the garage, some basic utensils in the nearest bathroom and bought lots of paper plates and cups. With an estimated time from start to finish of six weeks, we were mentally prepared for twelve.

It started well with the demolition completed in three days. But the delays then began. At first it seemed normal. The city's building permit came a few days late, some materials were incorrectly ordered and the contractor was delayed on his previous job and thus had to postpone ours. This used up a week, but "no biggie." But with the cabinets only half in, no plumbing (i.e., running water), no appliances and the nearby rooms of the house now covered in dust (apparently **not** impervious to plastic sheathing), work stopped.

A week went by and no resumption of activity. Ten days, eleven . . . what's wrong? Apparently, the cabinet manufacturer omitted one piece and made another too big. But there was plenty of other work to be done. Why grind to a halt for two (out of twenty) bad pieces? The answer we received was "scheduling." There was so

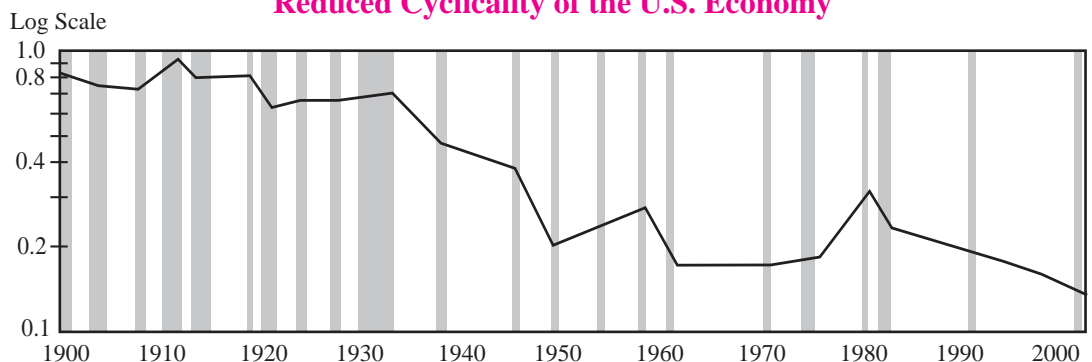
much contracting work (both in new and remodeled homes) that the crews were told to work on **only** those jobs that had everything perfectly in place. The crew represented by the line of cars we still saw every morning was working on an entire development and with an exclusive contract. A single home has no such leverage.

As investors, we try to learn from everyday experiences. So what is the significance of our kitchen remodel delays? Partly, it's the obvious. Housing-related sectors have been extremely strong the past few years. This strength is attributable, to a large extent, to the decline in interest rates and heavy refinancing activity. It was made possible, however, by an overall U.S. economy whose cycles have become much less pronounced and more muted. The reason lies in the ever-increasing adaptability of global economies.

Adaptability

The following chart depicts the relative cyclicity of the U.S. economy since the start of the prior century. On a logarithmic scale, the line represents the ratio of "bad" times to "good." More precisely, it's the number of months of a contracting economy compared to the number of months of expansion, as defined by the National Bureau of Economic Research (NBER).

Reduced Cyclicity of the U.S. Economy



Sources: Lehman Brothers and NBER

Note: The U.S. economic cycles are 3-month moving averages of duration of contractions relative to expansions from 1900 to 2001.

The shaded areas in the above chart represent periods of recession. Note that during the earlier parts of the century, recessions were frequent and, in many instances, fairly long. The values approaching 1.0 on the graph indicate that the economy contracted just about as often as it expanded. In more recent times, the unshaded areas of expansion were far longer than the recessions. The most recent contraction, officially declared at March 2001 through November 2001, lasted only eight months. It followed more than eight years of expansion, resulting in a ratio of close to 0.1, its lowest in recorded history.

Federal Reserve (FED) Chairman Alan Greenspan has taken notice of this trend. He attributes the less volatile economy to greater flexibility and adaptability. For example, when defense spending contracted in the early 1990s, many laid off engineers became “forced” entrepreneurs. While disruptive for a while, these were some of the people involved in the creation and popularization of many new technologies, including wireless phones, high-definition television and broadband computing. In the recent downturn, those involved in the failed internet startups or telecommunications companies, while also having to endure a transition, may wind up powering our next expansion.

Other factors have also served to dampen economic cycles. These include:

- **Less pronounced inventory swings.** Inventory build-ups followed by corrections used to be a major cause of economic cycles. As “just-in-time” techniques have taken hold, these imbalances occur far less frequently.
- **Efficient financial instruments.** One reason for the current housing-related strength is the ease with which homeowners can refinance their mortgages. It used to be an arduous and expensive process requiring a savings of at least 2% off the mortgage rate to make it worthwhile. Today, savings of less than even 1% can be advantageous. Thus, *increased* volatility in the financial economy (including interest rate cycles) may be causing *reduced* volatility in the real economy.
- **Maturation.** As the U.S. economy has matured, it shifted, first from an agrarian economy to an industrial one, and now to a knowledge-based, services-dominated market. If the weather causes a crop to fail, one cannot simply move the farm to another state, so in an agrarian economy, a recession surely takes hold. When manufacturing dominates, if labor issues make it advantageous to relocate a factory, although costly, it is possible (and ultimately profitable) to do so. This transition may cause a recession, but possibly a shallower one than before. Today, knowledge and service may be the easiest assets to transport, thus adding great flexibility and adaptability to society by further reducing the peaks and valleys of economic activity.

From our kitchen remodeling project, we reluctantly learned of the continued strength of that part of our economy. This provided insight into the greater picture, focusing on the reduced cyclicity of our economy as a whole. Reasons cited for muted cycles give us cause for optimism that longer periods of prosperity may persist. Finally, greater stability leads to increased predictability of returns that over the long-term can lead to higher valuation levels and increasing equity prices.

So how predictable were the financial markets last quarter?

VALUE EQUITIES STRATEGY

We must remember that reduced cyclicity works both ways. As the 2001 recession was much shallower than may have been expected, so too is its recovery. This is normal, should be expected and is quite similar to the last recovery in 1991. Considering the strong

winds of adversity facing global economies over the past few years, the short and shallow recession followed by the current resumption of growth is actually quite encouraging and a sign of underlying fundamental strength. Corporate malfeasance, natural disasters, man-made calamities and a tech-media-telecom speculative bubble and bust resulted in great market imbalances, first one way during the late 1990s and then a reversal in recent periods.

We now believe that many of the past few years’ imbalances have been corrected. This past quarter’s +2.6% rise in the S&P 500 Index (including income) brings the market’s gain to +14.7% for the year-to-date. Many of the most undervalued stocks (including some of MetWest Capital’s holdings) fared best and closed the gap between those that had held up better in the last two years.

As for the economy, reports of continuing weakness, we believe, may be somewhat due to OLD economic statistics. Many of today’s measurement techniques were developed when manufacturing was the main driver of U.S. economic activity. While manufacturing remains the main *variable* in the economy (haircuts and healthcare typically fluctuate far less than auto and furniture purchases), it is far less significant than twenty or thirty years ago when many of today’s measures were developed.

The Bank Credit Analyst points out that “*The service sector is a bigger user of capital equipment than manufacturing, and it is continuing to expand. [But] most high-frequency data still relate to manufacturing and that contributes to an excessively gloomy perception of overall economic health.*” Job creation still lags that of previous cycles. But employment too will catch up with an improving economy, should the upward trajectory be maintained.

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

Portfolio Activity

- **Vodafone** is the world’s largest provider of wireless telecommunications services. One in four wireless calls placed globally today goes through a VOD company (in the U.S. it owns 44% of Verizon Wireless). Think of the following “complaint” as reported in a recent article in *The Wall Street Journal*: “Philip Buchan is a lobbyist in Washington, D.C. He says he gets poor wireless reception on Capitol Hill. Sometimes he has to leave his office and sit in his car to make cell phone calls.” Poor Phil, but think of it: Mr. Buchan (and millions like him) is so enamored with wireless that he would rather leave his office to sit in a garage and use the service. It is clear that wireline to wireless substitution will continue to expand the use of Vodafone’s services, thereby increasing its already substantial cash generation abilities. Selling at less than 14 times next year’s cash earnings, the stock does not nearly reflect the growing *intrinsic* value of its enterprise.
- **Archer Daniels Midland** is an example of a beneficiary of the shift from an agrarian to a “modern” economy in the U.S. As one of the world’s largest processors, transporters and merchandisers of agricultural commodities, ADM’s products wind up in all our daily diets. From soybean oil

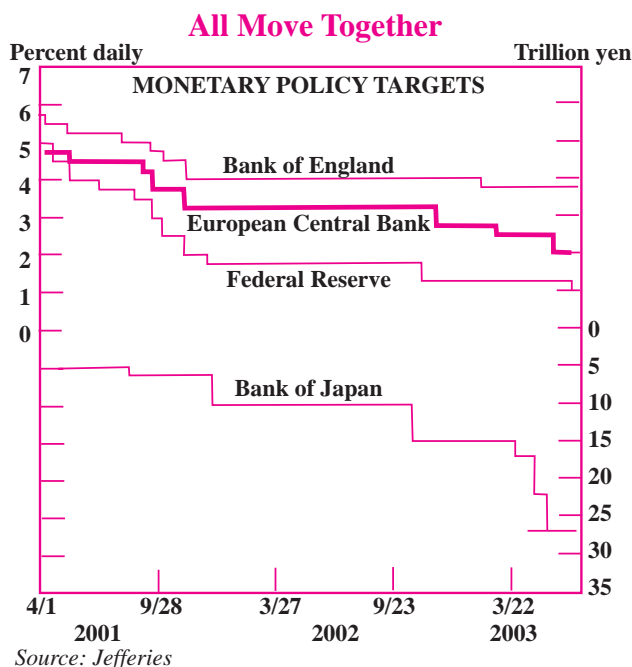
to xanthan gum, food companies worldwide need ADM to provide raw ingredients for both human food and animal feed. Consolidation over the past century has resulted in a near oligopoly in this business. This should allow more stable pricing for both farmers and food companies with improving profitability for ADM.

INTERNATIONAL STRATEGY

Most international stock markets performed better than U.S. markets last quarter. Foreign developed markets, as measured by the Europe Australasian Far East (EAFE) Index, jumped +8.2% including income and have now gained +18.8% year-to-date. Even including a late-quarter hiccup, Japan continued to lead, with the Topix Index gaining more than +13% in local currency. German stocks rose +1%, while the U.K., one of the weakest markets in 2003 thus far, added +2%.

In Japan, Prime Minister Junichiro Koizumi was reelected as leader of the ruling Liberal Democratic Party. His 61% decisive victory likely assures him at least another three years in office leading the country out of its decade-long malaise. His policies (somewhat questionable at first, but now showing signs of success) include reduced government spending, the closure and/or privatization of government enterprises and the cleaning up of bad loans hampering the banking system. His basic tenet has been to get the government out of the way of private enterprise. Japan's economy grew at a 3.9% annual rate in this year's second quarter, its fastest in almost five years.

One of the reasons for Koizumi's aggressive policies is the pressure he is receiving from the rest of the world. Once an engine of global growth, Japan had turned into a significant threat to a global economic recovery. But while in prior periods countries were left to "go it alone," today there is much greater economic cooperation. Indeed, global policies are converging so much that interest rates often move in tandem. The following chart illustrates this point.



Global coordination is yet another reason for the shortened economic contractions we described earlier. By going down such a path, the world is increasingly becoming one global market. This is different from a collection of disparate economies in earlier years and warrants altered investment methodologies. MetWest Capital understands this new reality and is largely focused on the research of individual companies, relegating country decisions to a lesser, diversification-related role.

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

- **Terumo** develops and markets medical-related supplies and equipment. Based in Tokyo, its prefilled syringes, catheters, transfusion bags and medical instruments are sold around the world. An in-development implantable heart-pumping device, known as *Duraheart*, holds great long-term promise and is one of many new products to be introduced in coming years. Increasing sales and margins make the current stock price quite compelling at only 8 times EV/EBITDA, a significant discount to its global peers.
- **Standard Chartered plc** is a London-based bank focused on the emerging markets of Asia, the Middle East and Africa. Its consumer-oriented activities should benefit from increasing income levels throughout the developing world. Aiming to improve its returns on equity to an industry-leading 20%, Standard's management team is working to better integrate its operations that span more than 50 countries. Currently, its largest bank is in Hong Kong, a market that has been depressed since its integration with neighboring China, but one that continues to act as a gateway to its parent's vast long-term potential.

FIXED INCOME STRATEGY

Last quarter, bond prices declined (interest rates rose) modestly for all maturities. But as the moves were largely just the unwinding of the Iraq war-induced rate declines of the first half of the year, yields are nearly unchanged thus far in 2003. The FED (rightly so) is still on a deflation watch. Thus, with the value of the U.S. dollar as a wild card, the FED may not begin to raise short-term interest rates for the foreseeable future -- at least through most of 2004. This, however, may cause longer-term rates to rise as the threat/fear of future inflation increases. We may therefore expect the yield curve to remain very positively sloped.

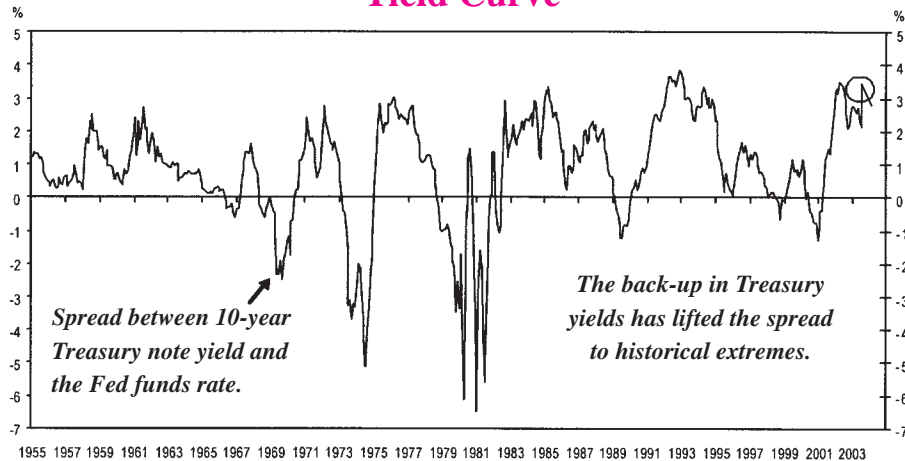
The chart on the following page shows the spread, in percent, between long-term (10-year U.S. Treasury notes) and short-term (Fed funds) rates since 1955. At September 30th, the Fed funds target rate was 1.00% and 10-year notes yielded 3.93%, for a spread of 2.93%. This is near an all-time high spread. There are many positive aspects to a steep yield curve and historically, it is a positive leading indicator of both the economy and stock market. Low short-term rates allow companies and individuals to borrow cheaply. Higher long rates attract investors to the bond market, allowing the government to fund its budget deficit. Also, a steep yield curve is typically favorable for banking profits (banks tend to borrow short and lend long), allowing for a healthy financial system.

We believe that the FED is likely to learn from the poor Japanese experience and begin to raise rates only after a sustained economic resurgence (combined with corporate pricing power) takes hold. Ed McKelvey, Senior U.S. Economist with Goldman Sachs, pointed out that after past recessions, the FED began to raise rates "as soon as the unemployment rate began to fall – even though inflation was still declining." This time around, they are unlikely to do so (as long as the expected accompanying dollar weakness is contained).

quality municipal bonds. As always, we will carefully monitor economic and market trends, taking actions we deem appropriate.

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. Inclusion does not imply that investments in these securities have been profitable. A list of all recommendations made in the prior one-year period is available upon request.

Yield Curve



Source: Bear Stearns & Co.

Note: Federal funds rate is the Fed funds effective rate from 1955 to 1983 and the Fed funds target rate from 1984 to date.

Furthering our case, *The Bank Credit Analyst* states that "The FED went to great lengths to try and manipulate bond yields lower by repeatedly emphasizing that short rates will remain low for a long time, even as the economy accelerates. However, instead of being comforted by such pronouncements, bond investors are becoming unnerved by the thought that FED policy will lead to higher inflation down the road. Bond investors are absolutely correct in thinking this because the FED will only be reassured that deflationary risks have been squashed when actual inflation moves higher." It is possible that, at that future time, the market could interpret the FED as being behind the curve and too late in controlling an increase in inflation. While this indeed may happen, we think it could be several years in coming.

We are thus staying the course outlined last quarter. The fixed income portion of MetWest Capital's balanced accounts is invested with a "mini-barbell" approach. About 80% of the portfolio is invested in 5-year notes with the remaining 20% in short-term cash equivalents. 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-

CONCLUSION

Now more than four months since the demolition of our old kitchen, running water has been restored, appliances reinstalled and most of the structural work is complete. Finishing touches remain to be done and our updated estimated total job time is now 21 weeks. We'll be lucky to be able to have Thanksgiving dinner at home!

But as with all annoyances (and we consider this to be a small one in the grand scheme of life), there are lessons to be learned and future opportunities to be recognized. This quarter, we thought it important to recount a personal tale in order to illustrate the development of one of those lessons. The recent strength in

the housing market is one element leading to a less cyclical U.S. economy. The combination of a multitude of global tragedies and poor corporate governance resulted in only a mild recession.

Note that we say a *less* cyclical and not a *non*-cyclical economy because we do believe that downturns will still occur. But slowdowns may be less frequent than in prior periods and our investment techniques must recognize and take advantage of this. Further, international trends are following those of the U.S., diminishing the longevity of cycles even more.

As we believe interest rates are near bottom, the housing market may cool from its heady pace. Construction may indeed shift from residential to office buildings and eventually to industrial/manufacturing space. With an increasingly adaptive economy, if managed properly (and if the government largely stays out of the way), resources can be quickly shifted from one sector to another with the result being a continued healthy overall environment. We believe that current equity prices may not fully value this relative stability and, as always, are seeking opportunities for our clients to benefit from the trends we foresee.

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