

# Capital Visions

## WAITER, WAITER!



“**W**aiter, waiter, there’s a fly in my soup.”

“Oh, that’s O.K.,” the waiter replied, “it won’t drink much.”

“But waiter, there’s a **FLY** in my soup!”

“No, that isn’t a fly,” he retorted, “it’s a piece of dirt.”

“That’s disgusting. What are you going to do about it?”

“Give the soup to the next table.” And the waiter did. Then, at the next table . . .

“Waiter, waiter, this soup tastes funny.”

“So why aren’t you laughing?” the waiter retorted and walked away. Stopping him midway across the room, another patron exclaimed . . .

“Waiter, waiter, there’s a dead beetle in my soup.”

“Yes sir,” he replied, “they’re not very good swimmers.”

In disgust, the patron yelled “Waiter, you’re not fit to serve a pig!”

“I’m serving you, aren’t I?” he said and stormed out of the restaurant.

We could go on for pages with “waiter, waiter” jokes. While funny to some, they actually have their origin in real life situations from times when *good service* was an oxymoron. Today, some restaurants purposefully employ such waiters as a tourist attraction with bad service as a form of entertainment. The establishments we know of like this are located on the East coast, so we sought out the next best thing we could find in L.A. This took us to Rodeo Drive in Beverly Hills.

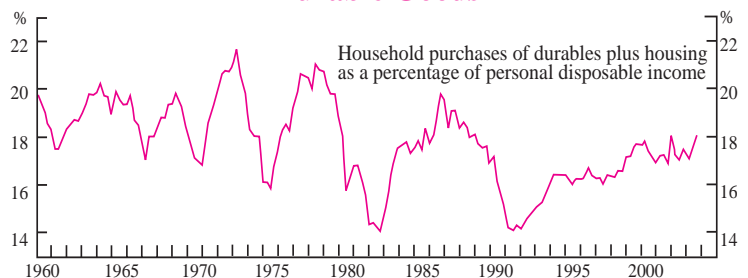
Known for its clothing boutiques serving wealthy movie stars, we used to get a kick out of how “ordinary” people like ourselves were treated at some stores. Usually, we were just ignored. But sometimes we were treated with such disdain (“How could they think they would be welcome to shop here?”) that first cowering and then exiting seemed appropriate. This year, however, we were absolutely shocked at our treatment. No, we were not banished from these stores, but were warmly welcomed. How could this be? We even wore our unfashionable straight-legged blue jeans to garner extra wrath! This is a story of changing consumer spending habits and our interpretation of what it may mean for the U.S. economy.

## Consumer Spending

What we learned on Rodeo Drive confirmed the trends seen elsewhere in the malls and on the “Main Streets” of America. That is, over the last few years, consumer spending has been concentrated in durable goods (homes, cars, appliances, etc.), leaving fewer sales available for nondurable purchases (food, clothing, cosmetics, etc.) When business is slow, *any* sale is a good one, even for the haughty salespersons of Beverly Hills.

Americans typically don’t stop spending unless “a gun is held to their head” – even this doesn’t always discourage buying as evidenced by the 17 million vehicles purchased, on average, in the months following September 11, 2001. Recent times have been no exception. But the composition of that spending has changed. In *Capital Visions* last quarter entitled “The Kitchen Remodel,” we described the strength of housing-related sales. This has come somewhat at the expense of other consumer expenditures. The following chart illustrates our point.

## Durable Goods



Source: *The Bank Credit Analyst*

This graph, going back to 1960, depicts durable goods spending as a percentage of disposable income (that remaining after taxes and other fixed deductions). Note the steady rise over the past ten years. Data since 1929 show that the current 18% spent on household durable items is about the average for the past 40 years. Typically, recessionary periods cause a temporary dip, as happened in the early 1980s and early 1990s. This time, no such drop occurred during the 2001-2002 recession. But while durable spending held up well, nondurable spending has been stagnant.

There is a common perception that after the strong consumer spending of the past several years, the rate of growth will slow. This may well be, but we foresee more of a *shift* in consumer spending,

rather than a dramatic reduction. Absent a “pointed gun,” there are several trends in place that will, in our opinion, keep consumers spending. These include: higher disposable personal income; lower mortgage/rent payments; lower tax rates; higher employment rates, hours worked and real wage growth; continued low savings rate; high net worth-to-income ratio (due to both a legacy of the 1990s stock market rally and the current housing strength); continued low product inflation (consumers perceive themselves to be getting good “deals”) and above all, the uninterrupted availability of credit.

The shift we see may be from durable to nondurable items. (If this comes to pass, we may then want to again avoid Rodeo Drive.) But seriously, tax refunds and mortgage refinancing have resulted in large one-time increases in consumer income. This, we believe, was spent on “big ticket” purchases of cars, homes, appliances, etc. While such spending could remain at healthy levels, it is unlikely to grow dramatically. But while one-time tax refunds and “cash out” mortgage refinancing will not repeat, the ongoing benefits of lowered tax rates and monthly mortgage payments could result in greater disposable income. Remember that we believe consumers will spend until they can spend no more. So while they may not have the one-time boost to buy a new house, they will have the few extra dollars to go to the movies, eat out or buy some (back in fashion) corduroys.

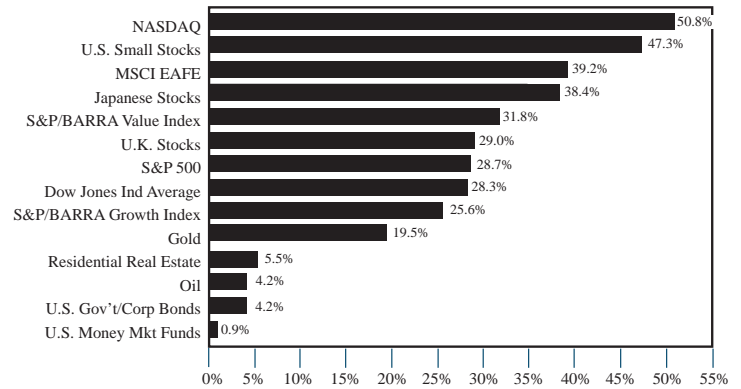
The shifts we foresee may result in a few less houses sold and a few less cars driven away, offset by increases in clothing, cosmetics, jewelry and a wide range of consumer services from hospitality (travel) to foot massages. This shift may occur gradually and we are currently researching investments to take advantage of the trends we foresee.

## VALUE EQUITIES STRATEGY

Our strategies to benefit from the trends we predict may not revolve around exclusively investing in those companies that benefit directly from increased nondurable spending (such as clothing retailers). Rather, due to the excessive competition in the retail sector, we look to invest further up the “value chain.” So companies such as **Kellogg** (food and cereal), **Matsushita** (Panasonic and JVC branded consumer electronics) and **Apple** (computers and iPods) may benefit. Even technology and capital goods companies stand to prosper, since their equipment is purchased to help support the production or sale of consumer goods. Thus **NCR** may sell more point-of-sale terminals to retailers and ATM’s to banks while **Honeywell** will be aided by a resumption of air travel. All MetWest investments are “bottom up” driven, meaning that we focus on individual companies. At times, however, broad economic or industry themes, such as the one discussed herein, may serve to augment our individual stock selection process.

As for the overall markets, 2003 was strong across the board. It has been a long time since we have seen a yearly Asset Performance chart like the one following. Note that every single asset class generated positive returns last year. This is highly unusual in that several are inversely correlated. Stocks and bonds often move in opposite directions. Bonds and commodities (oil and gold) mostly move apart. Growth and Value equities (many times) are at odds with each other. Finally, typically at least one major foreign market declines, while last year there were none (not counting some smaller

## 2003 Asset Performance\*



\*All figures represent total returns as measured in U.S. dollars.  
Source: Various

markets such as Cyprus and Lebanon).

We really are in a “Goldilocks” environment where global growth is accelerating yet under-utilized capacity keeps inflation in check. So interest rates have remained low while stock markets have rallied. Even a weaker U.S. dollar and higher commodity prices have not caused economic imbalances.

We are pleased to report that MetWest Capital’s client portfolios have benefitted handsomely from this environment. With results still going through a final tally, portfolios outperformed all their major benchmarks and peers for both the fourth quarter and full year 2003. Our diversified approach and individual stock selection methodology, coupled with a long-term focus, resulted in gains greater than we have reported in nearly six years. While we think it unlikely that future returns will be as robust, we do think our *Intrinsic* Value investment style will continue to reward our long-term oriented clients.

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

## Portfolio Activity

- **Autodesk** is a software company focused on architectural design, manufacturing, infrastructure and digital content. Its AutoCAD program is ubiquitous in the mechanical design field, while its low \$5,000 per seat price is taking share from higher-end, more costly products. The company’s stock price had fallen because, in the past two years, as sales fell due to the poor economy, ADSK chose to maintain its high level of R&D expenditures, causing earnings to decline. But the company increased its market dominance and now has new products which should further solidify its lead as IT spending returns to its historic patterns. With greater than \$2 per share in cash and no debt, the company is financially secure and poised to prosper.
- **C.R. Bard** is a hospital supply company whose products we hope our readers never need. Fortunately for the company, however, demographics are well on its side. Bard specializes in products used during surgery, such as catheters, stents, hernia repair kits and laparoscopic products. Previously content at merely participating in a growing market, Bard has recently undertaken a program

to dramatically increase its R&D efforts in order to find and develop new value-added products for which a premium price may be charged. This strategy is already showing signs of success, while the current stock price of less than 17x earnings does not account for the future value of the company.

## INTERNATIONAL STRATEGY

Propelled by significant strength in the value of the pound, euro and yen, most international stock markets performed even better than the U.S. did last quarter and for all of 2003. Foreign developed markets, as measured by the MSCI Europe Australasian Far East (EAFE) Index, gained +17.1% for the quarter and +39.2% for the year. Even including a late-year correction, Japan kept pace, with the Topix Index rising more than +38%. German stocks, one of the weaker markets in prior years, jumped ~67%, while the U.K. was a laggard at “only” +29.0%. (All results measured in U.S. dollars.)

While there are many questions regarding international investing, two are paramount today: Will foreign currencies continue to strengthen and will Japan continue its recovery? In short, we believe the answer is **yes** to both questions and we therefore remain optimistic for the prospect of international investments. Let’s briefly explain our optimism, focusing first on the currencies.

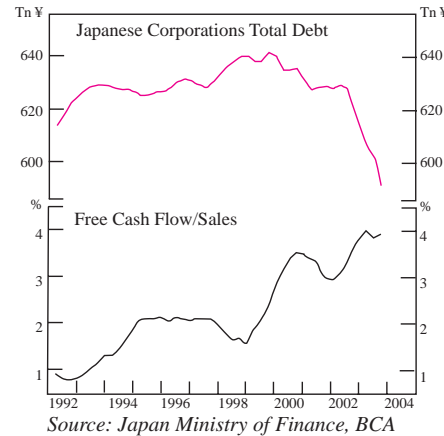
We find that it’s not so much pound, euro and yen **strength** we have, but dollar **weakness**. Regardless of the rhetoric we hear from politicians, we think this has been orchestrated and is a desired outcome of both monetary and fiscal policies. Following are a few reasons:

- As discussed in previous issues of *Capital Visions*, the Federal Reserve (FED) wants to ensure an end to the deflationary threat. One tool the FED has is to attempt to devalue the dollar. Doing so makes foreign goods more expensive and, since the U.S. runs a large trade deficit, allows prices to rise.
- Politically, a weak dollar could provide a “quick fix” for the manufacturing sector. The U.S. suffers from a lack of labor competitiveness (exacerbated by legacy retirement benefits that developing nations don’t offer) as well as high energy (natural gas) prices. Lowering the value of the currency raises the dollar prices of foreign goods and gives U.S. manufacturers another weapon to use in today’s very competitive global economy.
- Lastly, a weak dollar encourages capital to flow out of the U.S. and into developing countries. Long term it may be that the best way to combat terrorism, drug trafficking and illegal immigration is to build up the economies of those countries facing the greatest social unrest. Thus, fostering investments in Mexico, China and even Iraq, “exports” some strength from the U.S. and delivers it where it may be needed most.

One may see why the above arguments would be difficult to make in public but may influence policies that could result in continued dollar weakness.

Now let’s turn to the second paramount issue – Japan. We believe a big impediment to that country’s success has been the high level of corporate debt. The following chart shows the meaningful

## Improving Corporate Finances in Japan



progress made in combating this issue over the past two years.

Note that Japan’s corporate debt peaked at more than ¥640 trillion (\$6 trillion) in 1999. This is 133% of Japan’s GDP. As a comparison, U.S. corporate debt is currently about \$7 trillion, or 70% of GDP. Since 1999, partly due to bank write-offs, but

mostly due to better corporate management, the debt has declined more than 10% and is approaching ¥500 trillion. As the bottom portion of the above graph shows, Japanese companies are managing themselves to generate FREE cash flow (that available after capital expenditures) and have had great success in recent years. Our conversations with Japan’s managers lead us to conclude that this trend will continue and Japan’s economy may finally help propel the rest of the world upward as well. Japan’s recovery, however, is not yet assured to be sustainable, so we will carefully monitor its progress.

Last quarter, new international investments included:

- **Honda Motors** is an example of Japanese efficiency. While Ford and GM struggle to generate 3% net margins in their *best* years, Honda regularly earns more than 5%. It is the second-largest auto maker in Japan but generates half of its sales in the U.S. and Canada, (producing most of its vehicles in the country of sale). Autos (including SUV’s) comprise 80% of sales, while motorcycles and power products (ATV’s, lawn mowers, etc.) make up the balance. Its “slow but steady” approach has won it accolades for more than a decade. Rarely first to market with a new product, once Honda does come out with something, it is often amongst the best. Its quality reputation, coupled with manufacturing plants that are always just a bit behind end-demand, has resulted in Honda’s ability to charge premium prices and thus earn higher returns. With the stock selling at only 8x ’04 earnings estimates and the company having no net debt, we find this a compelling long-term investment.

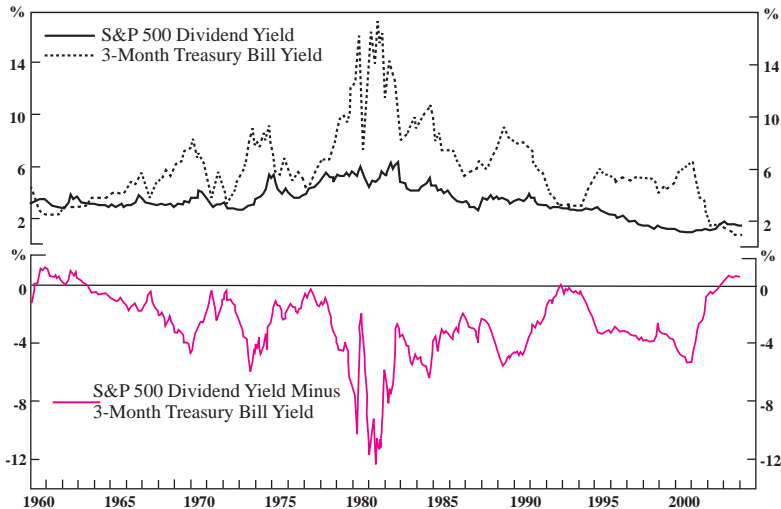
## FIXED INCOME STRATEGY

With some interim volatility, fixed income yields changed very little last quarter and for 2003 as a whole. The 30-year U.S. Treasury yielded 4.78% at the beginning of the year and 5.07% at year’s end. Short rates declined by 25 basis points (0.25%) as the FED lowered its targeted FED FUNDS rate to 1.00% on June 25. Including interest earned, the Lehman Brothers Government/Credit Intermediate Bond Index gained 4.24% for the year.

The following chart shows that for the first time in 40 years, the dividend yield of the S&P 500 (1.8%) is greater than the yield of

3-month Treasury bills. David Rosenberg, Chief North American Economist at Merrill Lynch, points out that “. . . we now have this unusual situation where almost half of the S&P 500 commands a yield premium to the 2-year Treasury note and almost one-third is above the 5-year note!”

### U.S. Dividend Yield Exceeds Short Rates



Source: Merrill Lynch

Should very low inflation persist, interest rates will likely remain low. But then corporate America would likely prosper and have the wherewithal to further raise dividends. Should the economy continue to gain momentum, then at some point inflation could take hold, forcing interest rates higher (bond prices lower). The only scenario under which we could predict a decline in interest rates from current levels would be **deflation**.

The current debate over whether deflation has been avoided is a healthy one. We are of the opinion that global monetary authorities are, and must continue, fighting to combat the threat of falling prices and thus, so resigned, shall prevail. We point out, however, that this is a critical element of our positive market stance and so we shall monitor the pricing environment with deserved diligence. *The Bank Credit Analyst* points out that . . .

*“The FED is comfortable taking some risks on inflation to be sure that deflation is avoided. The risks are asymmetric in that the FED knows how to deal with inflation . . . while it is not entirely sure that it would be able to [effectively] deal with deflation. Thus, it is important to make very sure that deflation does not occur. If that means inflation picks up, then so be it.”*

It may be that the only way for the FED and its overseas peers to know their mission is accomplished is for some inflation to take hold. As monetary policies work with a time lag of up to two years,

it is possible that the targeted inflation rate (about 2½ % for core CPI) will be overshoot. We will not, however, act on this premise until we see more evidence of its inevitability.

Given the above, for most of the past year we have maintained a “barbell” strategy for the fixed income portion of MetWest Capital’s balanced portfolios. That is, about 20% of portfolios are invested in very short-term cash-equivalents that will hold their value in the face of an eventual rise in interest rates. The balance of the fixed income is invested in high-quality intermediate-term (5-year average maturity) notes whose yield-to-maturity is 3%-4%. We utilize corporate and mortgage-backed bonds where appropriate for increased yield and municipal bonds for 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. 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.*

### CONCLUSION

Real consumer spending in the U.S. has risen a record 47 consecutive quarters. Even 9-11, a stock market melt “up” then “down,” a recession and two wars couldn’t derail America’s will and ability to buy more “stuff.” It’s just part of our culture and it is unlikely to change unless forced to. Since there’s no advantage gained by such an alteration, we must believe in the continuing growth of consumer spending. The types of goods and services purchased, however, can change. This quarter, we pointed out that recent spending has been concentrated on “durable” goods. This was to the detriment of nondurable spending such as that found on Rodeo Drive. This resulted in heretofore picky salespeople acquiring a willingness to sell to all comers – even Portfolio Managers! Previously unbearable waiters have gone through finishing school and now “waiter, waiter” jokes seem old.

The economy goes through cycles and we could be near the end of extraordinary durable goods outlays. We see a coming shift to smaller ticket nondurable goods such as food, clothing, household items and services. While taking these trends into consideration, our investing shall remain diverse, with a continuing emphasis on individual security selection.

All asset classes gained for the past year and MetWest Capital’s style outperformed most. But the outsized gains of 2003 may be unlikely to repeat, with bonds in particular under some pressure. As always, we will continue to monitor financial markets around the world with an eye toward uncovering hidden values wherever they may be.

***We wish you a healthy, happy and prosperous 2004!***



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