

# Capital Visions

## The Middle Seat

While one shouldn't take U.S. television commercials too seriously, they are often reflective of, or a commentary on, societal trends. Take, for example, the following scene in a recent commercial introducing new products from Apple computer:

The spot opens as 35-year-old, 2-ft. 8-inch tall actor Verne Troyer (best known for his work as Mini-Me in the "Austin Powers" movies) walks into an airplane toward his seat. He moves past 23-year-old, 7-ft. 6-inch basketball player Yao Ming (center for the NBA's Houston Rockets) who then sits in the seat next to Verne. The plane takes off, a chime sounds and Yao reaches for his laptop computer that had been stored in the overhead bin. (He does this while still seated, by the way.) He opens a really nice looking, but quite compact, notebook and turns it on.

Not to be outdone, Verne reaches toward the seat pocket in front of him and retrieves his laptop, a large silver notebook computer almost as big as he is. He opens it and loads a DVD movie.

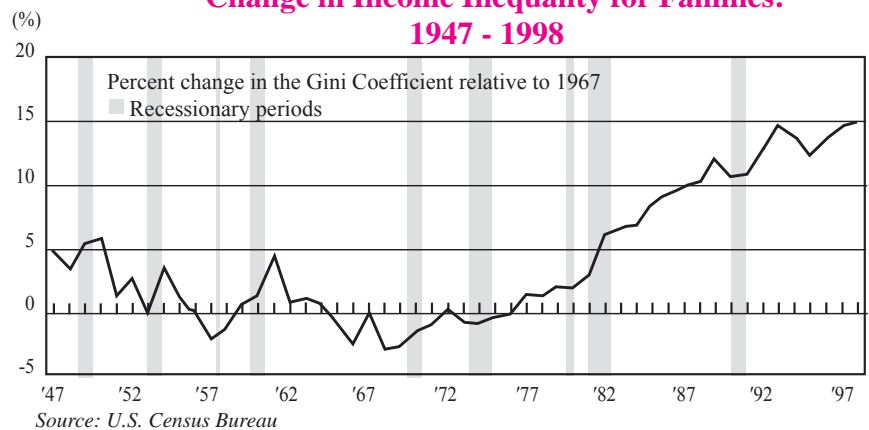
The point of the commercial is to juxtapose large and small by featuring two famous people who are known for their size. The very large Yao likes the "most compact full-featured notebook computer" while the diminutive Verne prefers the "world's first seventeen-inch notebook." All are great and all are unique. The spot ends as Yao briefly looks over at Verne, grins widely and then looks away. We read in a commentary that unknown to anyone, at the time of the shoot, Mr. Troyer (whose feet barely extend past the end of his seat) said to Yao in Chinese, "I love the leg room here in business class!" The commercial announcer is then heard saying the tag line: "The new twelve- and seventeen-inch PowerBooks, the next BIG and SMALL things from Apple." Fade to black . . .

We thought of this commercial recently as an example of the increasingly bifurcated American society. Everything, it seems, is either the "biggest" or "smallest" or "most" or "least" or "grandly precious" or "cheapest of the cheap." The TV commercial exemplifies this by emphasizing "biggest" and "smallest" in both the actors and the products. This, it is thought, appeals to consumers. Being in between is avoided as much as is the middle seat of an airplane. Why is this?

## Bifurcation

Part of the reason for this bifurcation in desires could be the increasing inequality of income levels in the United States. The rich are getting richer; this is well documented. And while the poor are also getting richer, the pace of their climb up the ladder is not as fast as that of upper-income families. Thus, the gap between the highest- and the lowest-income earners is widening.

### Change in Income Inequality for Families: 1947 - 1998



This is a chart of the Gini Coefficient, a measure of income inequality, from 1947 through 1998. (The years since 1998 likely continued these trends, with perhaps a spike through the "bubble" years and a decline back to '98 levels thereafter.) Developed by the Italian statistician Corrado Gini, the Gini Index ranges from 0.0, when all families (households) have precisely equal shares of income, to 1.0, when one household has all the income in the country and all others have none. The Index has ranged from 0.30 to 0.40 since its inception, so we show the yearly percentage differences above to illustrate the bifurcating economy.

For example, in constant dollars (stripping out the effects of inflation), only 10% of U.S. households earned more than \$65,000 in 1967. Today, 30% of households earn at least that much, so the entire society is more prosperous. But in 1967, the top 10% earned 8.9 times more than the bottom 10% (10% earned \$65,000 or more while 10% earned \$7,300 or less). Today, the top 10% earn more than \$100,000 while the bottom 10% earn less than \$9,700. Thus, the ratio of top to bottom has increased to 10.3, a 15% rise in the ratio (similar to the 15% indicated in the chart above). Changes in the ratio of "super wealthy" to "super poor" are even more dramatic.

Why has income inequality increased? According to the U.S. Census Bureau, “. . . researchers have tied the long-run increase . . . to changes in the labor market and household composition.” Thus, more highly skilled, trained and educated workers at the top are gaining disproportionately versus less-skilled laborers at the bottom. Early in the 20th century, a shift from an agrarian to an industrial economy served to **decrease** the inequality, while today’s shift out of a manufacturing-based into a knowledge-based economy is having the opposite effect. Possibly exacerbating the trend is “*intensifying global competition, immigration, the decline of unions . . . and the increasing need for computer skills.*”

Looking at household composition, “. . . changes in living arrangements have occurred that tend to exacerbate differences in household incomes. For example, increases in divorces, increases in one-parent households and increasing age at first marriage may have all led to a shift away from traditionally higher-income married-couple households.” What the future holds for these trends is something the Census Bureau refrains from predicting.

We, too, at MetWest Capital do not attempt to forecast long-term income trends. But most of the causes listed above are likely to persist, so the Gini Coefficient may continue to rise. The patterns of increasing income inequality may affect individual industries and companies in which we invest. Thus, examples of avoiding that “middle seat” include:

- **Autos:** Average incentives are a good measure of a vehicle’s popularity. Higher incentives (e.g., \$4,000 off and 0.0% interest rates) may mean lower-than-planned demand. Today, two of the **lowest** incentive auto brands are Daewoo and Porsche. Daewoo is the Korean automaker with some of the lowest sticker prices in the industry. Porsche is on the opposite end of the spectrum, with many models costing more than \$100,000. Models with the highest incentives are those “middle-of-the-road” brands such as Ford and Chevy.
- **Retail stores:** One would not be surprised to find Porsches parked outside Neiman Marcus (high-end department) stores. But one finds such vehicles also at 99 Cents Only Stores (one of several brands of “dollar” shops promising that all items cost 99¢ or less). So shopping bifurcation patterns cut through income levels. Wealthy, middle class and poor families alike find value at the dollar shops and thus favor them, in addition to an occasional splurge at fancy boutiques, possibly leaving the in-between stores with fewer shoppers.
- **Banks:** We’ve recently seen the announcement of two mega-mergers in the banking industry. Bank of America is merging with FleetBoston, while Bank One and J.P Morgan are getting together. Also in the “mega” camp, **Charles Schwab** just reported that its assets now exceed one **trillion** dollars. These huge financial institutions claim advantages of scale and continue to attract new customers. On the opposite end, small

community banks (including credit unions) can be successful too. They offer personalized service and a familiar face that the behemoths can’t match.

- **Demographics:** The two fastest-growing age groups in the country are the oldest (70 years+) and youngest (<20 years). So just as the middle “seat” is to be avoided, so too is middle “age.” (Ah, if this were only possible!)

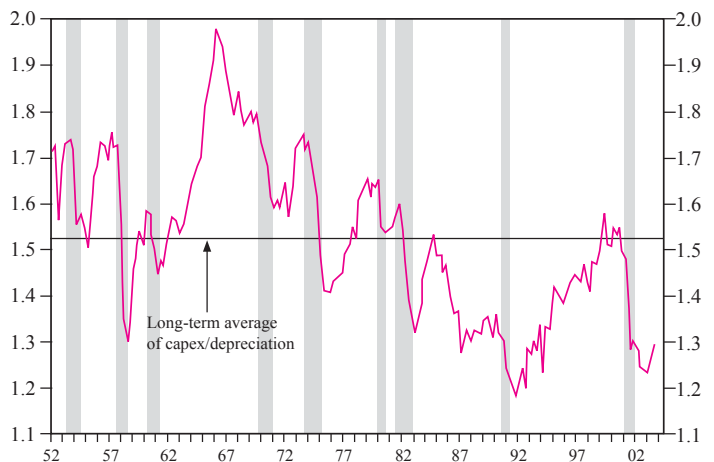
Now we certainly understand the value of mass-market appeal and the allure of “Goldilocks” products (neither too hot nor too cold). We also recognize the vastness of the U.S. economy and the ability of unique companies to cater to individual tastes. So we do not seek to invest exclusively in enterprises catering only to the very rich or poor. But the bifurcation of America is one factor we consider when analyzing investments and a trend that we will continue to monitor.

## VALUE EQUITIES STRATEGY

After a strong start, equity markets sold off slightly late last quarter. For the first three months of 2004, the S&P 500 Index (including income) gained +1.7%. “Value” outperformed “growth,” as the NASDAQ composite declined by -0.4%. What we believe may be just a pause in the market’s upward trend could be expected after last year’s very strong gains. Perhaps adding some volatility is the continued uncertainty of both economic and global/political issues.

With the caveat that external shocks may always foster short-term declines, we find sufficient evidence for expecting the U.S. economy to continue to expand. The strength that had been maintained in the consumer and housing sectors may now spread to the industrial part of the economy. Take, for example, the following chart:

**Pent-Up Demand for Investment**  
(Ratio of Cap/ex-to-Depreciation)



Sources: Morgan Stanley and the Bureau of Economic Analysis

This chart depicts the ratio of capital expenditures (cap/ex) to depreciation from 1952 through 2003. Cap/ex is a business outlay

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for goods and services that are used to produce *other* goods and services, as opposed to for immediate consumption. Thus, a metal stamping machine used in automobile factories would be a capital expenditure. When a finished vehicle is driven off the car lot, the sale of that automobile would be classified as (final) consumption. The stamping machine has a useful life of greater than one year, so companies (for both accounting and tax purposes) may depreciate the asset over time – that is, they charge a portion of the cost of the machine each year until it is completely paid off, instead of expensing it 100% when purchased. Factories that spend more on cap/ex than their depreciation are adding net new capacity, while those that spend less may be shrinking.

The graph on the previous page shows that during recessions (depicted by the shaded vertical bars), companies cut back on capital spending. Note that capital spending typically resumes slowly, with the long-term average 1½ times ratio of cap/ex to depreciation occurring about two years after the end of recessions. As outsourcing and offshore manufacturing continued to make inroads into American manufacturing, the late 1990s saw a much elongated cap/ex cycle. We expect this may also be the case in the current cycle. But even during the 1990s, the trend toward a higher cap/ex-to-depreciation ratio was evident. That same pattern could resume in 2004 and beyond.

We thus expect spending on factories and machines to increase as a share of Gross Domestic Product (GDP), albeit at a moderate pace, for the next several years. As we have described in prior reports, this does not mean we expect consumption to cut off. To the contrary, we expect that the U.S. consumer may continue his and her spending ways **in addition** to a growing industrial sector.

So, if the economy does continue to strengthen, then corporate profits should expand and, over time, stock prices could move higher. We continue to carefully monitor these and other trends while seeking out investments that may benefit from them.

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

## Portfolio Activity

- **Liberty Media** is a diversified media conglomerate controlled by its Chairman, Dr. John C. Malone. For more than three decades, Dr. Malone has successfully invested in value-added properties including cable, programming and cell phone licenses. In recent years, he has swapped most of these assets for operating companies in a tax-efficient and shareholder-friendly manner. Today, Liberty's largest holdings include the QVC shopping network, The Discovery Channel (50% owned), Starz! Encore and UnitedGlobalCom (cable TV in Europe). Combined with large positions in some publicly traded companies such as News Corp. and InterActiveCorp, we calculate Liberty's intrinsic value at \$16 per share. The current stock price

affords us a 40% return potential and we have a high degree of confidence that Dr. Malone and his team could realize that value over time.

- **Performance Food Group** is the third-largest food distributor in the U.S. The company targets casual dining chains such as Outback Steakhouse and Cracker Barrel, as well as regional and independent restaurants. In addition, through its Fresh Express subsidiary, PFGC sells packaged salads and fruits to supermarkets and selected fast-food outlets. Its largest customer in this segment is McDonald's. PFGC's stock price has shown recent volatility due to growing pains. Lettuce consumption is on the rise due to low carb diets and the company has added costs to keep up with demand. Short-term investors caused the stock price to decline, giving us a unique opportunity to invest in this outstanding business at a 35% discount to our estimate of its intrinsic value.

## INTERNATIONAL STRATEGY

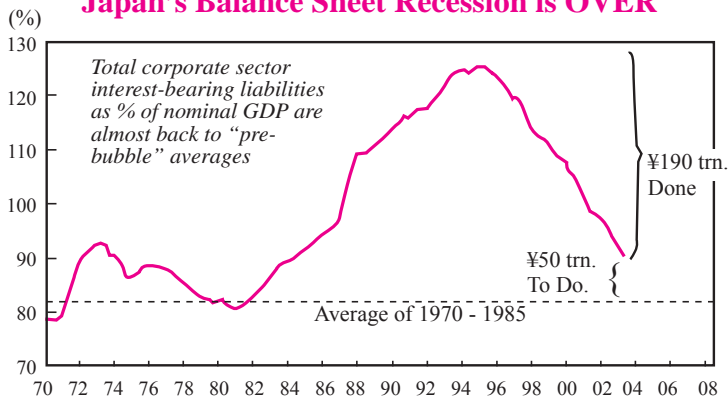
International stock markets were mixed last quarter. Foreign developed markets, as measured by the Europe Australasian Far East (EAFE) Index, gained +4.4% for the quarter. German stocks continued their volatile results and slumped more than -4.0% for the quarter, while the U.K. joined many Central European markets (including Belgium, Norway, Sweden and Denmark) in rising modestly. Most Asian markets climbed with Japan's Topix Index, gaining more than +15.0%. (All results are measured in U.S. dollars.)

Japan remains an important question for international investors. The sustainability of Japan's economic recovery is not yet assured, but more pieces of the puzzle are falling into place. First, the nation successfully dealt with the big banks' weakened balance sheets by reducing equity cross-shareholdings and cleaning up bad debts. Next, the country was able to resume export-led growth through renewed ingenuity resulting in leading-edge products sold around the world, (with an emphasis on consumer products sold to the U.S.) Now we are beginning to see the early signs of a resurgent Japanese consumer. Should this take hold, then even a U.S. import slowdown (which we are **not** expecting, given continued demand for cars, TVs, DVDs, cell phones, etc.) would not derail Japan's expansion. Critically, as all this occurs, Japan must streamline its economy and open up to 21st century distribution techniques. Should this occur, then the wealthy Japanese society may enjoy the benefits of a truly restructured economy and a sustainable recovery. We believe that this is inevitable and have overweighted Japan in our international portfolios.

Part of the reason for our sanguine views is the exceptional progress made by Japanese companies in restructuring their balance sheets and reducing debt. The following chart illustrates this point.

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## Japan's Balance Sheet Recession is OVER



Sources: Merrill Lynch and ESRI of Cabinet Office

This graph shows total corporate debt as a percentage of Japanese GDP. Note the explosion of debt that occurred from the mid-1980s through the 1990s. This was, in part, a leftover effect of Japan's "bubble" economy. At first, Japanese companies believed the "happy days" would last forever and so they built factories and buildings at a rapid rate. Even when the growth slowed, debt piled up as the government encouraged additional borrowing in its attempt to prop up the ailing economy.

But over the past five years, driven more by corporate self-reform than by government policies, the debts have been paid down and companies are once again living within their means and using reasonable growth projections. As the above chart shows, ¥190 trillion has been paid down and total debt is now approaching the pre-bubble average of 82% of GDP.

**Mitsubishi Tokyo Financial**, one of the few big Japanese "city" banks not to require a public injection of funds, recently reported that, for the first time in five years, its net loans have grown. In addition, as MTF has come through the difficult period stronger than its peers, it can lend at higher rates and collect deposits offering lower rates, thereby generating higher loan margins and increasing earnings. We may have been early to identify these trends and believe that progress may continue for the foreseeable future.

But Japan is not the only country where we can identify value. So, to that end, recent new investments include:

- **Bunge** is the foreign equivalent of **Archer Daniels Midland** (described in earlier reports as purchased for our *Intrinsic Value* portfolios). It is truly a global enterprise. Founded nearly 200 years ago in The Netherlands, today it is headquartered in Bermuda, generates a majority of its sales from operations in Brazil and Europe and has customers from France to China. The company is one of the world's largest processors of soybeans that are used for both human food and animal feed. Bunge also has a large fertilizer business in Brazil, enabling that country to become one of the largest agricultural exporters in

the world. Its outstanding management team has more business opportunities to pursue than time or capital. It thus can choose carefully which projects to fund while generating very high returns on its invested capital.

- **Eneris**, headquartered in Santiago, Chile, is one of the largest companies in Latin America. It owns electric utilities operations in its home market as well as in Argentina, Brazil, Colombia and Peru. While Latin America seems never to be out of crisis mode, most of the major countries are now implementing pro-growth policies that may finally put the 1998-2002 disruptions behind. Through its 60%-owned generation company, Endesa-Chile, Eneris is an important partner of most countries' governments, as they need to assure uninterrupted power supplies to help fuel economic growth and prosperity. With its stock selling at less than book value and yielding more than 3%, we find this company a compelling investment opportunity.

## FIXED INCOME STRATEGY

Contrary to most predictions, fixed income yields declined (prices rose) for nearly all maturities during the first quarter of 2004. Cash-equivalents were least changed as the FED held short-term interest rates constant. However, for all maturities of two years and longer, yields declined by 20-40 basis points (0.20%-0.40%). The 10-year U.S. Treasury bond ended the quarter yielding 3.84%, only one-half percent above a multi-decade low.

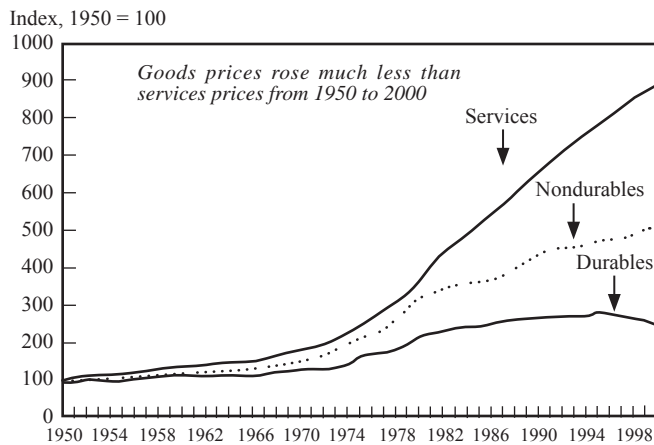
While much of the U.S. economy is strengthening, the labor market is stubbornly weak. This has allowed monetary policy to remain accommodative as the FED is unlikely to raise interest rates in the face of slow job growth, especially during a Presidential election year. Furthermore, inflation has remained very low, even as oil and other commodity prices have risen and the U.S. dollar has weakened. While we remain concerned about the potential for continuing **disinflation** (or even **deflation**) longer term, we believe we may first witness a cyclical rise in price levels over the next couple of years. There are two main reasons for our thinking:

First, while consumer inflation is slow to change course, it must eventually reflect rising costs. Manufacturers and retailers will often absorb initial cost increases before passing them along to their customers. They may limit price increases in an attempt to gain market share. They will try to cut costs elsewhere until forced (via shrinking profits) to raise prices. We may be at the end stages of this phenomenon today. Just about all input costs are on the rise. From commodities to insurance, healthcare and even labor, the cost of doing business is going up. The weak dollar is now giving U.S. manufacturers an "umbrella" under which to raise prices as the costs of many goods denominated in euros and yen are rising more rapidly than those in dollars. As the

economy expands and capacity utilization increases, competitive substitution becomes less of a threat and companies can raise prices without losing business.

Secondly, we question if inflation is being properly measured. The Bureau of Labor Statistics, the government agency that calculates the Consumer Price Index (CPI) amongst other inflation measures, currently weights services at 55% of CPI (including household rent-equivalents). This is consistent with the services weight in overall GDP. But services inflation is inherently more difficult to measure than goods inflation. The following graph shows why we are concerned.

### Price Level



Source: *Economic Report of the President, 2004*

From 1950 through 2000, the prices paid for services increased by almost ninefold. In contrast, prices paid for nondurable goods (food, clothing, household supplies, etc.) rose fivefold, while durable goods' (cars, boats, refrigerators, furniture, etc.) prices rose only 2½ times. Services includes some standard items like rent and college tuition, data for which are easy to collect. But services also includes maintenance and repair, personal services (like haircuts and spa visits) and healthcare. These items are more difficult to compare like-for-like than most goods.

In recent years, as the prices of goods have actually **declined**, services inflation has remained near 3%. But given the increase in prices in the biggest components of services inflation (household rent, healthcare and school tuition), we believe that 3% may be an understatement. Furthermore, many financial services, such as tax preparation, insurance, banking, etc., are either underweighted or not measured at all. As services continue to play a greater role in the economy, we believe that government statistics must

improve so as to provide an accurate assessment of the prices of both goods and services.

With our expectation for a pickup in inflation and hence interest rates, we have maintained a fairly short posture for the fixed income portion of MetWest Capital balanced portfolios. In this case, our “avoid the middle seat” thesis has us concentrated almost entirely in the very short end, avoiding most of the rest of the yield curve. While we cannot be certain when interest rates will rise, we believe it best to accept slightly lower rates now, protecting fixed income portfolios from larger price declines should rates rise in the future.

*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

Apple had a great fifteen-inch PowerBook, yet felt the need to introduce twelve-inch and seventeen-inch models as consumers continue to gravitate towards the very largest and smallest notebook computers. We highlighted this phenomenon this quarter as an example of what we perceive to be a bifurcating U.S. society and economy. Investment implications could be meaningful as products and services targeted at the broad middle market may lose ground to those that appeal to consumers favoring the largest, smallest, cheapest and dearest merchandise. The bifurcation trend may be due, in part, to increasing income inequality in the U.S., as evidenced by the Gini Coefficient.

As investors, we take note of such trends. While we emphasize detailed research on **individual** companies, broad macro factors must at least be understood and considered as part of our analysis. The economy, inflation and interest rates are other factors to bear in mind. The “Bank Credit Analyst” has pointed out that “*for the first time in the post-WWII period, the FED is targeting higher inflation and investors should assume that it will succeed.*” We concur and look for modestly higher inflation to be followed by higher interest rates over the next several years.

As always, we remain diligent in assessing macro, micro and individual company trends. Our goal is to provide our clients with much more than “middle seat”-like investment returns and our methodology has thus far proved successful.

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