My Big Fat Greek Economy

"*Give me a word . . . any word . . . and I will show you how the ROOT of that word is Greek.*" So says the patriarch of the family in the 2002 hit movie *My Big Fat Greek Wedding*.

"*Take arachnophobia, for example.* ***Arachne*** *is Greek for spider. A phobia is a fear. So arachnophobia is the fear of spiders . . . and there you go!*"

"*O.K., Mr. Portokalos,*" says a challenger to his thesis. "*What about the word kimono?*"

Gus Portokalos ponders this for just a moment and, in his thick Greek accent, retorts: "*This is from the Greek word* **cheimonas** *which means winter. So what do you wear in the winter to keep warm? A robe. So . . . robe . . . kimono . . . and there you go!*"

This movie is a wonderfully entertaining true life story of Nia Vardalos (who plays the lead character of Toula Portokalos, Gus' eldest daughter). Toula, 30 years old, is unhappy about taking the traditional role expected of Greek women. That is, one of a wife, homemaker, mother and cook. She wants more out of life and finds it in Ian Miller, a non-Greek, mild-mannered, vegetarian professor. Ian, an only child with a total of two cousins, stands in stark contrast to Toula, one of twenty-nine uproarious siblings and first cousins with never a moment alone.

In love with Toula in spite of (or perhaps ***because*** of) her large, loud family, Ian asks for her hand in marriage. Despite initial objections from her father, Toula accepts. At first it's a (Greek) tragedy as the professor couldn't possibly fit into the Portokalos culture. But Ian is determined that Toula keep her family relations AND become his wife. So he gets baptized in the Greek Church, agrees to have his (quite staid) parents initiated into the clan and helps plan the finale's BIG FAT GREEK WEDDING. By the end, Ian has all but morphed into a Greek as he makes new friends, begins introducing them to his new cousins, moves into a house next door to the Portokalos family and even takes up some of Gus' peculiar habits (such as using Windex as a cure-all).

Maybe we ALL have roots firmly in Greece!

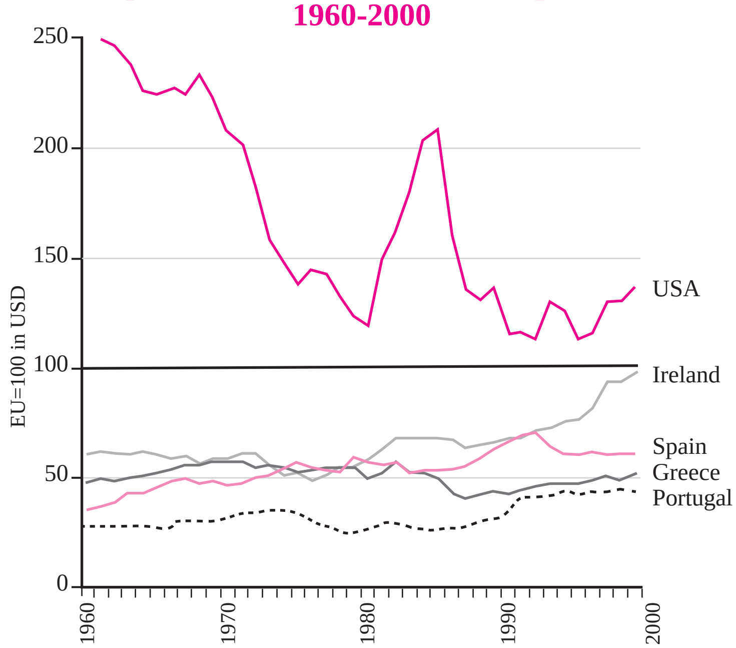
We introduce this movie here, not only in honor of the upcoming XXVIII Olympiad being held next month in Athens, but also as a way of introducing the recent expansion of the European Union.

The EU Expansion

Athens, Greece is thought to be the birthplace of European civilization. The birth of the European Union, however, did not occur until 1958, when France, West Germany, Italy, Belgium, Luxembourg and The Netherlands signed a pact of economic cooperation. The U.K., Denmark and Ireland joined in 1973, Greece in 1981, Portugal and Spain in 1986 and then Austria, Finland and Sweden in 1995. The EU mandates some constraints on its members, including budget limits, trade restrictions (actually lack thereof on trade with other EU member states) and labor laws. But its advantages have outweighed its restrictions, leading to greater foreign direct investment, reduced trade barriers, lower interest rates and (with exceptions, but as a general rule) higher overall GDP growth rates.

In May of this year, the EU was expanded with the addition of the Mediterranean islands of Cyprus and Malta plus the East European countries of the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. This expansion should be beneficial for not only those countries involved, but also for greater Europe and **its** trading partners, including the United States. The following chart shows the potential benefit of European Union inclusion.

Per Capita GDP Relative to the European Union 1960-2000



Source: The World Bank

The chart on the previous page shows Gross Domestic Product per person in the U.S., as well as in four of the EU's smallest members, from 1960 through 2000. The chart is indexed such that the average of all EU members is set at 100 for each time period. At the start in 1960, the per capita GDP in the U.S. was 2½ times that of the EU, and the whole of the EU was double that of Greece and some other members. Note that during the past four decades, the U.S.'s relative advantage has diminished. This has ***not*** been to the detriment of the U.S., as its real per capita GDP more than doubled during the time period. But the EU has grown even faster. Some countries, such as Ireland, have done best due to pro-business policies, such as low corporate tax rates. Others, such as Spain and Greece, have made some progress, but only in the recent decade have they begun to close the economic gap with the rest of the EU. In this case, could it be that Greeks may learn from their non-Greek brethren?

There are several reasons why the inclusion of ten additional countries into the EU could be beneficial:

- Many of the new entrants are former Soviet states or satellites. Now embracing both democratic and capitalist principles, inclusion into a large market may hasten their drive to close the productivity gap with their Western European peers.

- Accession to the EU may now be followed by the adoption of the Euro as the national currency for the new members. While bringing yet more restrictions (such as closer coordination of monetary and fiscal policies), this move could further integrate the new members into Europe, making the "pie" larger for all.

- Additional "low cost" countries may put additional pressure on existing EU members to restructure their economies to better compete against the new entrants. Germany, for instance, just enacted a series of measures to ease labor restrictions and toughen criteria for receiving welfare benefits. Greece may now consider stepping up its privatization plans, as six of the ten largest companies whose stocks are listed on the Athens exchange are still government controlled.

- Finally, as we have mentioned in past issues of *Capital Visions*, economic convergence that fosters faster growth in lesser developed countries carries numerous social benefits. In general, poorer countries tend to have more lax environmental rules, greater accommodation of abusive labor practices and, in the extreme, the potential for social unrest. Improving living standards by generating higher economic growth rates is one way the free world can work toward solving some of our most pressing social issues.

Many Asian countries (such as China and India) get a lot of press for their growth potential while some European countries (such as Germany and France) are seen as increasingly anti-American. However, Europe remains critical to the continued health of the U.S. economy. While an expanded EU doesn't guarantee higher growth rates, it does encourage pro-growth policies that are likely to have positive spillover effects worldwide. We are thus cautiously optimistic about this expansion and are carefully monitoring its progress.

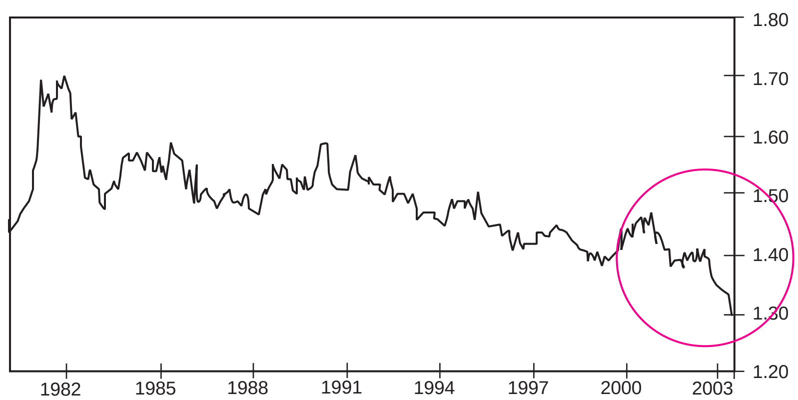
Now for a few comments on the U.S.

VALUE EQUITIES STRATEGY

The U.S. equity market followed a pattern this past quarter similar to the one exhibited in the first quarter. The market began on an uptrend, sold off in mid-quarter, but then finished strong for a modestly positive return. The S&P 500 Index (including income) is up +3.4% year to date. Value, growth, small cap, large cap, domestic and international have all performed about the same. Even market sectors have shown little differentiation. Of late, it's really been a "stock-picker's" market, one in which company-specific events have driven overall portfolio returns. This environment should benefit MetWest Capital's investment style, and we are very pleased to report that it has.

With the caveat that external shocks have the potential to cause short-term dislocations, we find little reason to stray from our current positive outlook and strategy. In addition to the spillover effect from the EU expansion, the U.S. economy, while partially recovered from its recent decline, has several imbalances that may lead to further growth when rectified. One such variable is inventories.

Inventory-to-Sales Ratio



Source: U.S. Census Bureau via Bloomberg

The graph above depicts the U.S. business inventory-to-sales ratio (including manufacturing and retail). It represents the value of goods that companies maintain in stock relative to their final sales to customers. Inventories include clothing on department store racks, cars on showroom floors and nuts, bolts and widgets in manufacturers' stockrooms, etc.

Improving technologies, focused on permanently reducing the level of inventories that companies must carry, have resulted in a long-term steady decline in the ratio of inventories to sales. But, as indicated by the circled data in the chart, because the most recent drop off is more severe than normal, we believe it to be cyclical in nature. As companies gain confidence that the current economic recovery is sustainable, they may increase inventory levels. This could add another layer to corporate demand, the result of which could be sustained economic growth through this year and into next.

Recent additions to our *Intrinsic* Value portfolios include:

Portfolio Activity

- **Polo Ralph Lauren** owns one of the most respected names in all of branded apparel. Founded by its namesake in 1967, the company now generates sales of shirts, pants, dresses and suits in excess of $3 billion annually. While Mr. Lauren (age 65) is still the CEO and head designer, new professional management, led by COO Roger Farah, was recently appointed to help improve profits while driving sales to a higher plane. New specialty retail stores, new or revamped labels and a greater focus on "image" brands are, in our view, likely to help attain the company's goals.

- **Weyerhaeuser** takes silviculture to a new level. The study, cultivation and management of forests is a science that this company, one of the world's largest private owners of timberlands, has mastered. The result is that trees the company planted 35 years ago are now maturing and will provide much more usable pulp, wood and paper than is reflected in the stock's modest valuation level. Weyerhaeuser's 2002 acquisition of Willamette Industries (a similar paper and wood products company also based in the Pacific Northwest) holds great potential to gain from the implementation of this expertise.

- **J.P. Morgan** is scheduled to close on its acquisition of **Bank One** in days. While we are often skeptical of large financial services mergers, this one seems ideal. It melds some of the best franchises in the industry with one of the best management teams. Jamie Dimon, former President of Citigroup under then-CEO Sandy Weill, will lead one of the nation's top credit card issuers, retail banks (with large presences in New York, Texas and Illinois), investment banks and money management firms. Valued at only 10x earnings, we believe this to be a compelling long-term investment.

INTERNATIONAL STRATEGY

Most international stock markets performed in line with the U.S. last quarter and thus far this year. Foreign developed markets, as measured by the Europe Australasian Far East (EAFE) Index, gained +0.4% for the quarter and are up +4.9% year to date. The few outliers thus far this year include Mexico +14.2%, Brazil (-10.8%) and India (-18.5%) (in a generally weak emerging market universe). The strong results we expect from Europe have yet to take hold and so may occur in the future. (All results are measured in U.S. dollars.)

Japan's equity market remains one of the world's best performing thus far this year. During the economic rebounds of the 1990s, as soon as the economy started to grow, the Bank of Japan (BoJ) raised interest rates and choked off the fragile recoveries. This time, most analysts believe the BoJ will wait for *both* a sustained recovery *and* a sustained rise in consumer prices–which have been declining for more than five years–before attempting to tighten monetary policy. While we remain sanguine, we are concerned with the prospect for a strengthening currency. If the yen rises toward ¥100 per U.S. dollar (it closed last quarter at ¥109.15), Japan's exporting industries could face pressure to either lower prices (and thus lower profits) or move more manufacturing out of the country to lower-cost regions. This could increase unemployment and put a halt to the (finally) resurgent Japanese consumer. We shall carefully monitor these issues.

Recent new investments for our International Core Value portfolios include:

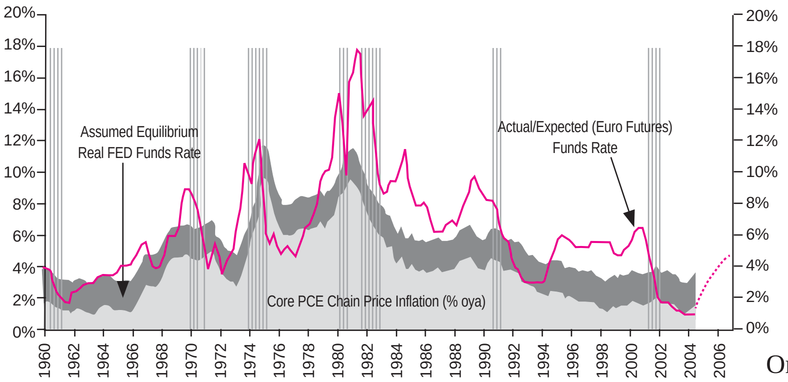
- **Nortel**, while a controversial company right now, is clearly one of the world's leaders in telecommunications equipment. We did not own this stock during its high flying days of the late 1990s. But at today's low price, we see a deeply discounted, out-of-favor stock that does not reflect the long-term *intrinsic* value of the firm. With high and sustainable market shares, **Nortel**, together with **Lucent**, are the survivors that are currently building next generation networks, including EV-DO (wireless) and Voice over IP (wireline) that service providers must build to remain competitive. We are patient investors and expect excellent returns from this company over the next several years.

- London-based **EMI Group** is the fourth-largest and sole major publicly traded recorded music company in the world. Its 13% global market share (somewhat higher in the U.S.) has been growing of late due to the success of Norah Jones, amongst other artists. The music industry has been in decline for the past several years due to the lack of a new music genre and increased piracy. The industry issues that **EMI** faces are ones we are confident can be and are being addressed. (Witness the 70 million song downloads purchased on Apple Computer's iTunes Music Store.) In the interim, the company generates greater than 7% of its market capitalization in FREE cash flow ***after*** paying out a 4% dividend.

FIXED INCOME STRATEGY

The Bank Credit Analyst points out that "*it is important to distinguish between tightening monetary policy and **tight** policy.*" The Federal Reserve Board (FED) can raise short-term rates from 1% to 2% and still be "accommodative." Thus, on June 30, as widely anticipated, the FED, led by Chairman Alan Greenspan, raised the Federal Funds rate by one-quarter percentage point to 1¼%. As evidenced by the following chart, this FED move may be the first of several to occur in coming quarters.

Actual/Expected Rates



Sources: FED, U.S. Department of Commerce and J.P. Morgan.

The light blue shaded area in the graph depicts core inflation in the U.S. from 1960 through March 31, 2004. The dark blue band represents 2% to 2½% above the inflation rate. This is the "required" real interest rate above that of inflation. The actual inflation rate added to the required rate results in the "Assumed Equilibrium Real FED Funds Rate." This is the rate deemed necessary to achieve price stability. In the most recent period, we had 1.7% core inflation plus what should be an additional 2% for an assumed equilibrium rate of 3.7%. The red line is the actual rate. Note that at only 1.0%, actual short-term interest rates are far below the equilibrium rate needed to contain inflation. Thus, the dashed line represents an estimate of where the FED Funds Rate may head. Note that for the past 40 years, the actual FED Funds rate has always returned to its equilibrium level, and we think this time will be no exception.

As we believe it unlikely the FED will move to a tightening mode (as opposed to simply moving from accommodative to neutral), the yield curve could stay positively sloped, albeit less so than today. Thus, as short-term rates move from 1% to 2% and then 3%, long-term rates may move only modestly higher from the current 4¾% (10-year bond). We find, under this scenario, that the optimal fixed income strategy is a "short bullet" approach utilizing primarily 3- to 4-year notes.

In summary, we believe it may be difficult for our fixed income portfolios to generate positive total returns in a rising rate environment. We are thus employing strategies to protect principal, awaiting future investment opportunities.

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

Originally developed as a one-woman Broadway show, *My Big Fat Greek Wedding* really could be titled *My Big Fat* (<u>fill in the blank</u>) *Wedding* as the story line has parallels in most cultures. It could be Irish, Italian, etc. . . . you name it. We highlighted the production this quarter as a means of focusing attention on Europe (and the expanding European Union) at the time of the Olympic Games soon to take place in Athens.

When Toula Portokalos complains to her mother about her father's Greek stubbornness, she points out that, to her chagrin, "*the man is the head of the house.*" But Maria, to comfort her daughter, quickly retorts "*. . . while the man is the head, the woman is the neck . . . and the neck can turn the head any way she wants!*" So too can some of the smaller EU members turn around the whole of Europe. For their businesses to remain competitive with the newest members of the EU, some of its largest members (France and Germany, in particular) must adopt more pro-business policies. Slow, definitive progress *is* being made. This will benefit Europe as well as its trading partners, including the United States.

In the U.S., economic expansion is likely to continue even as the FED begins to raise interest rates. Our company-specific investment methodology has worked very well in recent quarters and over the long run. As always, we continue to focus our *Intrinsic* Value methodology on uncovering unique and overlooked companies. We favor quality investments with a long-term view of achieving above-average returns with lower-than-average risk.

Enjoy the Games!

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