

# Capital Visions

## The Meatpacking District

It was quite by accident that we happened upon New York City's newest (and some say now its most chic) neighborhood. While in the city one evening, we went out for dinner. The choices are nearly endless in New York, but we decided to go to a "typical" East Coast restaurant. We chose the Old Homestead, first opened in 1868 and now the city's oldest steak house. It's located on Ninth Avenue near 14<sup>th</sup> Street in the Meatpacking District. This sixteen-square-block area is just north of Greenwich Village and south of Hell's Kitchen in Chelsea, on the west side of Manhattan. As Eleanor Berman, a syndicated travel arts writer put it, "the streets are where aproned butchers and truckers work by day and transvestite hookers work by night."



This quarter's neighborhood discussion serves to highlight two important elements of MetWest Capital's investment philosophy.

### A Bargain

The first point is that we believe it prudent to wait for a transition to at least start to take hold in a company before making an investment. Yes, the *maximum* returns may be attained by the very first into a new area or undiscovered company. But *optimal* (adjusted for risk) returns are often generated when the risk of being dead wrong has been diminished. There were plenty of false starts in the Meatpacking District and many retailers lost everything trying to break new ground before today's renaissance.

But wait! Where's the novel "side show" we were expecting while walking down 14<sup>th</sup> Street from the subway station? As Ms. Berman notes, "... the prostitutes are gone and the butchers are sharing their cobblestoned streets with young, well-heeled New Yorkers engaged in their perpetual quest for the city's latest in-spot." The old brick and stone buildings look much as they did back in the early 1900s when dozens of slaughterhouses and processing plants populated the area. But half of the structures now house clothing boutiques, small art galleries, night clubs and, of course, restaurants.

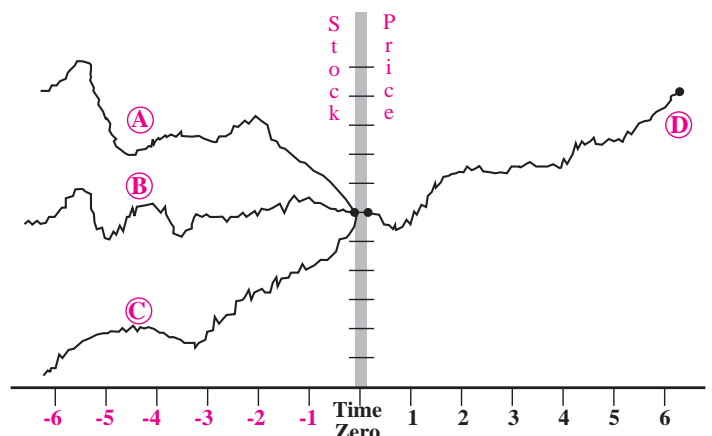
The second element of our investment style highlighted by the neighborhood-in-transition is trying to identify "bargains." So often we hear other investors discussing a company, pointing out that its stock *used* to sell at \$50 while today it's \$20. Or it *used* to sell for 19 times earnings, while now it's only 14x. It must be a bargain, right? Well, maybe "yes" or maybe "no." Property in the Meatpacking District used to sell at a fraction of what it's going for today. Would one think, after only a few years into its transformation, that the properties are too expensive now just because they used to be much cheaper? It is now a completely different neighborhood requiring updated analysis. On the other hand, internet-related companies used to be valued at multiples of what they *spent*, not what they earned. Do we believe this will recur any time soon? Why then use this type of logic to analyze equities?

Much as Greenwich Village, Soho, Chelsea and, more recently, 42<sup>nd</sup> Street have been transformed, so too is the Meatpacking District being cleaned up. It is most fascinating in its current state as exemplified by a walk down Gansevoort Street. This two-block-long street is now home to a wine bar, a French café, a 24-hour floral shop and the modern-looking 14-story Hotel Gansevoort. But at night the street is also lined with rows of parked meat delivery trucks, waiting to be loaded for their rounds on the following day. We saw many buildings under renovation, likely transforming into million-dollar lofts. But we wondered how the Audis and VW Touaregs were going to maneuver around the double-parked trucks in the morning. The transition was truly a sight to behold.

The following graph exemplifies our point.

Our fascinating stroll ended at the restaurant and being always curious investors, we spent the evening discussing the neighborhood. How could such a downtrodden area suddenly, after 100 years of near-blight conditions, miraculously change almost overnight? What was it that caused Jeffrey, an Atlanta retailer, to open its chic store in 1999 when its neighbors were "a row of musty old warehouses?" We pondered this – later researching the topic – and came to the conclusion that it mattered less where the neighborhood came from and more where it is going. We believe this conclusion to be true for the Meatpacking District and a good lesson for investors as well.

### Historical - Prospective Price



---

This graph was drawn as an historical/prospective chart of a theoretical company's stock price. We have labeled three hypothetical stock price paths as "A," "B" and "C." The endpoint, our estimate of the company's *intrinsic* value, is labeled "D." If we are today at Time Zero, then whether the stock has come **up** through path "C", **down** via path "A" or just **meandered** around path "B" should have no bearing on our investment thinking. We only consider the likelihood of identifiable catalysts to propel the stock price up to point "D" within our investment time horizon (typically around three years). This is an important component of MetWest Capital's approach to investing.

While the graph does not represent a specific company, three examples, taken from our current holdings, exemplify our points. **Lucent Technologies'** stock has followed a path similar to "A," as sales and earnings declined during the telecom bust of the past few years. **ConocoPhillips**, on the other hand, is better represented by path "C," as high oil and gasoline prices have propelled most energy stocks up. **Weyerhaeuser's** stock price has had both ups and downs and so is akin to the path labeled "B." All three, in our judgment, represent optimal investments at the present time, yet the trio have had markedly different histories.

We believe that each of these unique investments has catalysts that may propel their stocks upward. Lucent is on a clearly identifiable rebound with the company's fortunes leveraged to a pickup in telecom equipment spending. ConocoPhillips may benefit from continued merger synergies and strong FREE cash flow generation whether oil prices remain high or not. Finally, paper and wood products giant Weyerhaeuser will prosper if, as we expect, newly harvested trees yield more wood than in prior generations. In the case of each investment we make, the stock's price history is NOT a guide and oftentimes yields distorted information. The future, and our conviction of how it will come to pass, is all that matters.

**IMPORTANT:** Our illustrations and accompanying points refer only to stock price action, which we consider of little importance. A firm's fundamental history, however—earnings, cash flows, dividends, market share, etc.—is a relevant determinant of *intrinsic* value, as we will discuss further in future editions of *Capital Visions*. Now let's turn to the economy and broad financial markets.

## VALUE EQUITIES STRATEGY

Year to date, the U.S. equity market has remained range-bound around the flat line. This may be considered typical during periods when the Federal Reserve Board (FED) begins to raise interest rates. The tug-of-war between higher earnings and a higher discount factor oftentimes causes the market to pause at this point of a cycle. Compounding the FED's actions are the uncertainties caused by: (i) a close political election, (ii) unusually severe weather conditions, (iii) the continued threat (and actuality) of global terrorism and (iv) broadly higher commodity prices, particularly oil. Given the number of concerns, we believe that a "flat" market may actually signal underlying strength.

Energy markets, while less influential than in past decades, are still important. Our take on the current high price of crude oil is somewhat unique. That is, while we share others' concerns about the high price of oil, we are more concerned about its continuing

volatility. We believe that, within a wide band, both suppliers and users of energy are able to adjust to most price levels. But what will that level be two to three years hence?

We believe the longer the price of oil is kept artificially high due to transitory factors (Russian politics, Venezuelan politics, Iraqi "insurgents," hurricanes, etc.), the longer — measured in *years* — the price could be fundamentally weak. This is because today OPEC quotas are increasing, non-OPEC sources of supply are increasing, conservation is begrudgingly taking hold and strategic reserves are being filled worldwide. If these temporary factors give way to a fundamental short-term *oversupply* of oil, prices could drop precipitously and stay low for too long. This is because OPEC and non-OPEC countries are unlikely to reduce supply as quickly as they have increased it. Yes, the rhetoric of cutting production will make headlines, but the money-gushing spigots will not close easily. In addition, while conservation habits are hard to form, they are just as difficult to break (that new hybrid Toyota Prius should last at least eight years). Finally, while the strategic reserves will not come back to the market, they will not be filled further, either. These factors may serve to exacerbate price declines just as some speculative forces exacerbated the increase.

If, as a result of these factors, oil prices decline much below \$30 per barrel, incentives may not be sufficient to sustain the increased exploration occurring today. That may lead to supply disruptions and another energy price crunch a few years hence. This high-price / low-price cycle is unpredictable and not conducive to good business planning. It is also prone to even higher volatility exacerbated by speculators and so we are carefully monitoring these trends. A gradual decline of the price of oil down to \$30-\$35 per barrel is optimal, yet, unfortunately, not likely.

As for the U.S. economy as a whole, within a wide band of energy prices, our view is that we are in the midst of a gradual expansion. *The Bank Credit Analyst* sums up our outlook:

*"Our view has been . . . optimistic. It is true that aggressive policy stimulus stole growth from the future. The 2000/2001 downturn was extremely unusual in that consumer spending and housing activity did not decline, and the savings rate did not rise. There has to be some payback for that in terms of [diminished] future growth rates. But that is **different** from saying that the . . . expansion cannot be sustained."*

While growth is no doubt slowing from the heady pace earlier this year, it is still on an uptrend. Of course there will be interruptions along the way and we will continue to monitor the potential for imbalances, should they occur. With a sanguine long-term view, recent additions to our Large Cap *Intrinsic* Value portfolios include:

### Portfolio Activity

- **TCF Financial** is one of the most profitable banks in the U.S. Based in Wayzata, MN, its return on assets exceeds 2.0%. This compares to the average bank whose returns are little more than 1.0%. By focusing geographically (in the Midwest), operationally and by customer segment (primarily low- to moderate-income households), the

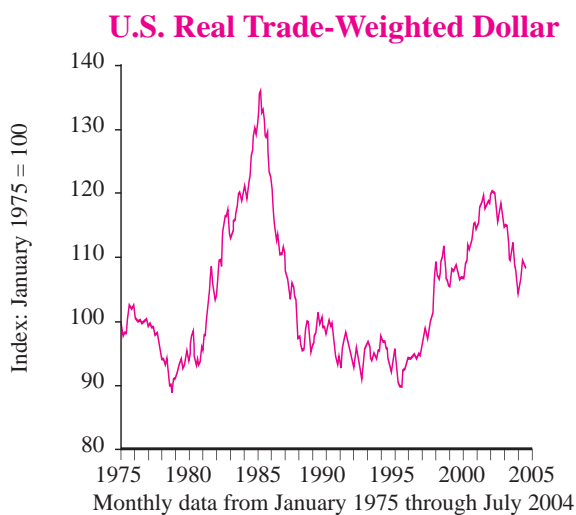
bank has become extremely efficient. As we believe this mid-sized company can replicate its model in different areas, its growth seems assured for many years to come. With the stock selling at only 16x earnings and the 2.5% current dividend growing 15%, we believe this is an as-yet undiscovered opportunity.

- **Liberty Media International** was spun off last quarter from Liberty Media Corp., the media conglomerate headed by Dr. John Malone. Headquartered in Colorado, LMI is a \$5 billion market cap company with interests in European cable TV distribution as well as Japanese cable TV and programming. Many foreign markets (including most of Europe) are a decade behind the U.S. in developing cable infrastructure. LMI is replicating overseas the successful strategies employed by Dr. Malone here in the U.S. The stock sells at a substantial discount to the sum of its parts, a great fundamental “bargain.”

## INTERNATIONAL STRATEGY

Similar to the U.S. market, most international stock markets have generated only modest gains for the first three quarters of 2004. Some of the developing markets of Asia, Latin America and eastern Europe have performed better, but they have been overshadowed by low- to mid-single digit returns in France, Germany, Spain and the U.K. (All results are measured in U.S. dollars.)

One reason for our continuing optimism on international markets is our expectation for a weakening dollar. All else being equal, a weak dollar results in higher foreign stock prices when translated back into U.S. dollars. But we think this weakness will be gradual and may even be interrupted by periods of modest strength, as we’ve seen thus far in 2004. The following chart depicts the value of the U.S. dollar relative to our major trading partners since 1975.



Source: U.S. Federal Reserve and Goldman Sachs

Note that on this basis, the dollar is currently at about the average level seen over this time period. This graph is **not** a measure of the dollar’s over- or under-valuation, but merely a depiction of trends. As always, there are many crosscurrents affecting the demand for

dollars. Some of these factors imply the dollar may rise while others indicate it may fall.

Demand for dollars comes from many sources including:

### Rising commodity prices

Most global commodities, such as oil, trade in dollars. As commodity prices have risen, more dollars are required to settle these trades.

### U.S. current account deficit

China has, just in the past ten years, accumulated almost \$500 billion in foreign exchange reserves. Part of this is due to the Chinese currency’s “peg” to the dollar. These funds (as well as other excesses due to the U.S. current account deficit) are invested largely in U.S. Treasuries, creating demand for dollars.

Offsetting dollar demand, weakness of the currency may come from:

### U.S. budget deficit

The U.S. federal budget deficit continues to expand and, under any presidential administration, there appears to be little hope of its contracting any time soon. This could cause investors to diversify their holdings out of dollars as a hedge against future inflation or (unlikely) default.

### Decreased appetite for U.S. financial assets

For more than two decades, foreign entities have been large net purchasers of U.S. assets (stocks, bonds, Treasuries, real estate and entire corporations). While only 10.5% of U.S. stocks are foreign owned, more than 25% of corporate debt and nearly 40% of Treasuries are now held abroad. If, for any reason, foreigners reduce their enthusiasm for U.S. assets (or simply believe they can earn higher returns elsewhere) and halt their net purchases, the decline in the value of the dollar could be severe. We are **not** predicting this, but merely pointing it out as a risk to monitor.

So, on balance, we expect the dollar may weaken over coming years. To take advantage of attractive foreign opportunities, recent new investments for our International Core Value portfolios include:

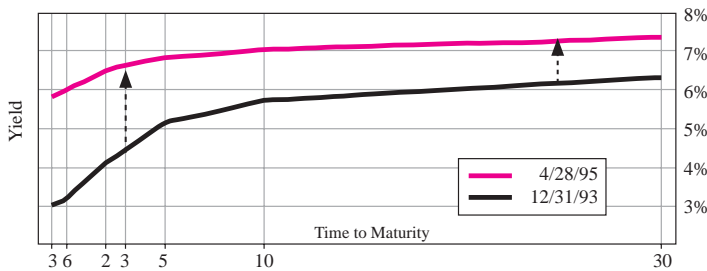
- **HVB Group**, the second-largest bank in Germany, should benefit from resurgent German and eastern European economies. David Malpass, an economist at Bear Stearns & Co., echoes our views by saying, “...the shift toward deflation, low real interest rates and higher commodity prices is a much better environment for developing countries than the 1980-2000 combination of disinflation, high real rates and lower commodity prices.” Through its holdings of Bank Austria and Bank BPH (based in Cracow, Poland), HVB is a prime beneficiary of the developing prosperity we foresee.
- **Toray Industries** is a Japan-based diversified global chemicals and textiles firm. With total sales of \$10 billion, its broad array of products includes nylon fibers, engineered plastic films, LCD filters and carbon fiber. Toray recently won a \$3 billion contract to supply composite materials for

Boeing's new 7E7. The stock's valuation of less than 0.6x sales reflects the recent volatility of earnings, but not the reduced *future* cyclicality of the company's businesses.

## FIXED INCOME STRATEGY

As expected, the FED raised short-term interest rates twice last quarter and three times thus far this year, leaving the Fed Funds target rate at 1.75%. Continuing the theme that little during the current economic cycle is "normal," the yield curve has shifted in an atypical way. Paddy Jilek of Credit Suisse | First Boston Research says, "Bonds are from Missouri, a cliché perhaps, though no less true for being so. The typical reaction to an economic recovery is 'show me' inflation can stay low, resulting in a bearish flattening [long rates move up modestly while short rates move up significantly]." This is exemplified by the following chart of the yield curve shift in 1994, the last "typical" cycle.

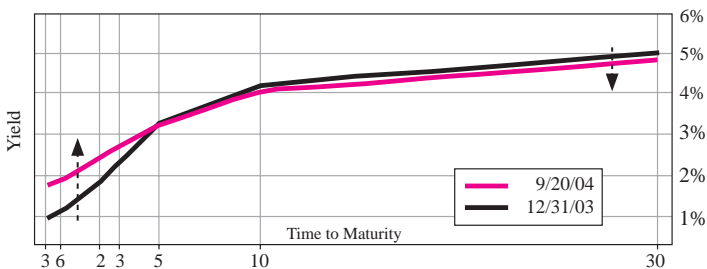
### Historical Yield Curve - Typical



Source: Bloomberg Financial Markets

But Mr. Jilek continues, "The reaction right now, however, is 'show me' you can grow, hence a bullish flattening [short rates move up modestly while long rates stay flat or move lower]." This is what has occurred thus far in 2004, as depicted by the following graph.

### Historical Yield Curve - Current



Source: Bloomberg Financial Markets

**To help us to identify the future "Meatpacking Districts" of investing, we welcome Pranav Rawal as the newest member of our research team.**

Just as we won't take our cues about the Meatpacking District from its past, so too do we look beyond current factors in analyzing the bond market. As such, we believe the FED remains accommodative. Even if inflation were only 2%, short rates could easily be raised to at least 3% without denting the economic recovery. It's likely that the unusual reaction by fixed income investors to FED tightening is temporary and largely due to non-fundamental factors. So we remain cautious in our outlook for fixed income securities. While we do expect the yield curve to remain positively sloping (long rates higher than short rates), we foresee the entire curve shifting modestly upward over the coming quarters.

*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

So how is it that the Meatpacking District of Manhattan is transforming itself from a forgotten area of brick-clad warehouses to one of the city's hot spots? The answer lies in "creeping gentrification." The neighborhoods directly south and east have been changing, first to accommodate young artists and students and now filling up with middle-class professionals who prefer city dwelling to the suburbs, but cannot yet afford pricier areas. Bound on the west by the Hudson River, it is easily accessible by the city's subway and bus systems and within walking distance from some tourist areas, including Greenwich Village and Little Italy.

Early investors in the region have made handsome returns in exchange for extreme risk. After all, Gansevoort Street has shown great promise for most of the past 100 years. But if the neighborhood transition continues, then more gains may be had by opening new stores or renovating lofts.

We highlighted the Meatpacking District this quarter to draw parallels to MetWest Capital's philosophy of investing. Two lessons may be drawn. First, while the early "easy" (in hindsight) money has been made in the area, future, less speculative, positive returns are still available. Second, it is usually a mistake to look at where a neighborhood has come from; it is better to consider where it is headed. So too in investing.



610 Newport Center Drive, Suite 1000  
Newport Beach, CA 92660  
949 718.9701  
949 718.9122 fax

Capital Visions is published quarterly by the investment management team at Metropolitan West Capital Management, LLC. This report is published solely for informational purposes and is not to be construed as the solicitation of an offer to sell or of an offer to buy any security. The report is based on data obtained from sources believed to be reliable but is not guaranteed as being accurate and does not purport to be a complete summary of the available data. Officers and employees of the Metropolitan West Financial group of companies or members of their families may have a position in securities mentioned herein.