Capital Visions

George III

We have long been fascinated by world history. Having wished we paid greater attention to the subject during our school days, we now go out of our way to learn of the past as one means by which we may ponder the future. The Queen's Gallery at Buckingham Palace in England features a rotating exhibit of royal history. So with a few spare hours on a recent trip, we jumped at the chance to learn about George III, the second-longest reigning British monarch, who ruled from 1760 until his death in 1820. He is the king credited with losing the American colonies. He is also well known for going mad near the time of his death (possibly from a hereditary disorder called porphyria).

Born to Frederick, Prince of Wales and Augusta, Princess of Saxe-Gotha in 1738, George III was a great man by many accounts. Yes, he was born into his position. Yes, it was due to the premature death of his father that he succeeded his grandfather, George II, at the age of 22. But through study he became an accomplished artist and scientist and via his wife, Queen Charlotte, a devoted father of 15 children. Contrary to many historical accounts, George III also possessed great financial acumen. For example, it was he who originally purchased the Queen's House in the center of London that is the origin of today's Buckingham Palace.

Many believe that George III was not at fault for the American Revolution. As detailed at the Queen's Gallery, "*George's direct responsibility for the loss of the colonies was not great. He opposed their bid for independence to the end, but he did not develop the policies* (such as the Stamp Act of 1765 and the Townshend duties of 1767 on tea and other products) *which led to war. Such acts had their origins in Parliament.*"

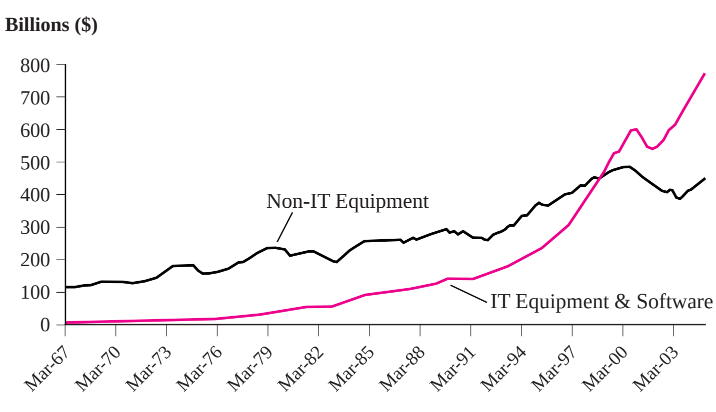
Many also believe that instead of the loss of the colonies being a negative turning point in British history, it was merely a "blip" on the country's way to supremacy. With the "shackles" of the colonies loosened and their great expenses no longer borne by it, the British Empire grew to include more than 20 percent of the world's land area and more than four hundred million people at its peak in the early 1900s. "The sun never set on the British Empire."

So, while considered a major loss to the empire at the time, the new United States, and its independence from the Crown, may have actually helped create the empire. It is in hindsight we now see the loss of America as a "blip" in British history. What parallels may we draw with recent investment history? What "blips" may lie ahead? These and other questions were raised as a result of our study of George III.

Blips

The most recent "blip" in the U.S. economy was the recession of 2001—specifically, the recession of spending on capital goods. The following chart shows that this was not a "sea change" event, but merely a temporary decline that is now over. This graph, with data back to 1967, depicts real (inflation-adjusted) spending on goods that are used to produce other goods and services. These include machine tools, robots for assembly lines and, of course, technology. While capital spending represents less than 10% of U.S. GDP, it is an important economic swing factor and often seen as an indication of the health and improving productivity in the economy. The red line represents spending on technology-related products, while the blue line represents spending on all other capital goods. Note that after the recent pause, both lines are either at or near all-time high levels.

Real Spending on Capital Equipment



Source: Lehman Brothers, DRI and FAME

There are many reasons why capital spending bounced back so quickly. One important factor is pointed out in *The Bank Credit Analyst*: "*The increased importance of technology spending means that the capital stock depreciates at an ever-faster pace and spending needs to stay strong just to replace worn-out and obsolete equipment.*" We would add that increasing global competition also hastens obsolescence. We believe that, subject to a favorable overall economic environment, such spending could continue its upward trend.

Looking ahead, we believe there are several other economic factors that could turn into "blips" or changing trends. These include the value of the U.S. dollar, energy prices, growth in emerging economies (especially China, India, Brazil and Russia) and the unabated growth of consumer spending. We touched on the first two topics in last quarter's *Capital Visions* entitled "The Meatpacking District." We will discuss emerging economies in future editions. So what about the consumer?

Many believe Stephen Roach, Chief Economist at Morgan Stanley, who has repeatedly said, "*. . . the American consumer is an accident waiting to happen.*" He cites sluggish income growth and new job creation, increased debt levels (not adjusted for changing demographics) and the high level of spending over the past four years. Will we experience a "blip" or even a change in the long-term upward trajectory of U.S. consumer spending?

We believe that the U.S. consumer does not stop spending unless ***forced*** to do so. So in order to forecast a coming "blip" or change, we monitor many factors, including the following:

➢ **Credit**. Dramatically reduced availability, or higher cost, of credit could force consumers to reduce or delay expenditures, especially on large ticket items such as homes and cars. Interest rates above 7% or large down payment requirements are such factors.

➢ **Inflation**. Dramatically reduced availability, or higher cost, of goods and services due to import restrictions or other factors could cause a shortage of goods or a need to wait until conditions improve.

➢ **Deflation**. Expectation of a sustained decline in price levels could give consumers a reason to wait to purchase goods, in anticipation of greater future bargains.

➢ **Energy**. We believe the *availability* of energy may be a more important factor than its absolute price level (within limits, of course). Thus, long lines at gas stations due to crude oil or refining capacity constraints could result in dampened consumer spending.

➢ **Confidence**. A major terrorist threat or other confidence-altering event would likely give way to a pause in spending.

➢ **Income**. A decline in after-tax household incomes would reduce the amount of money available for consumer purchases. Higher unemployment, stagnant wage growth or higher tax rates could all lead to such a drop.

➢ **Demographics**. A sudden change in demographic trends (birth rates, immigration, etc.) or a sudden need for alternative expenditures (such as illness) could divert spending from consumption to alternative uses.

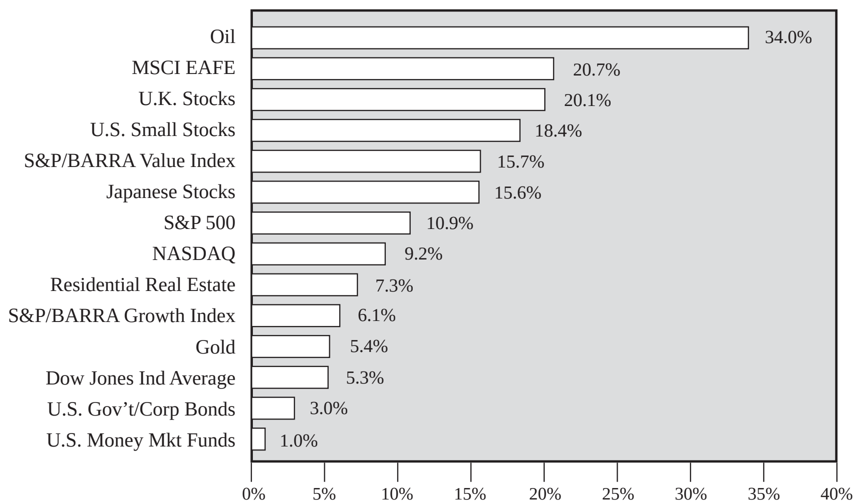
While this is not an exhaustive list, at present we see little evidence of the worries listed above. Thus, we believe that while consumer spending may slow somewhat from recent trends, consumption may **not** be the "blip" that many are looking for. So with capital spending on the rise and consumption still positive, we see the U.S. economy as healthy. Such a sanguine scenario may lead to continuing sales and profits growth at corporations and higher stock prices as a reflection of such strength.

Let's now review the financial markets for 2004 and our expectations for the future.

VALUE EQUITIES STRATEGY

As the following table shows, 2004 continued the recovery from the prior years' "blip" in stock market performance. After three down years for the broad market, stocks have now risen meaningfully for two years in a row. Commodities (especially oil) were the best-performing asset class, followed by stocks (led by international) and real estate. Fixed income assets rose on a total return basis, but just marginally.

2004 Asset Performance*

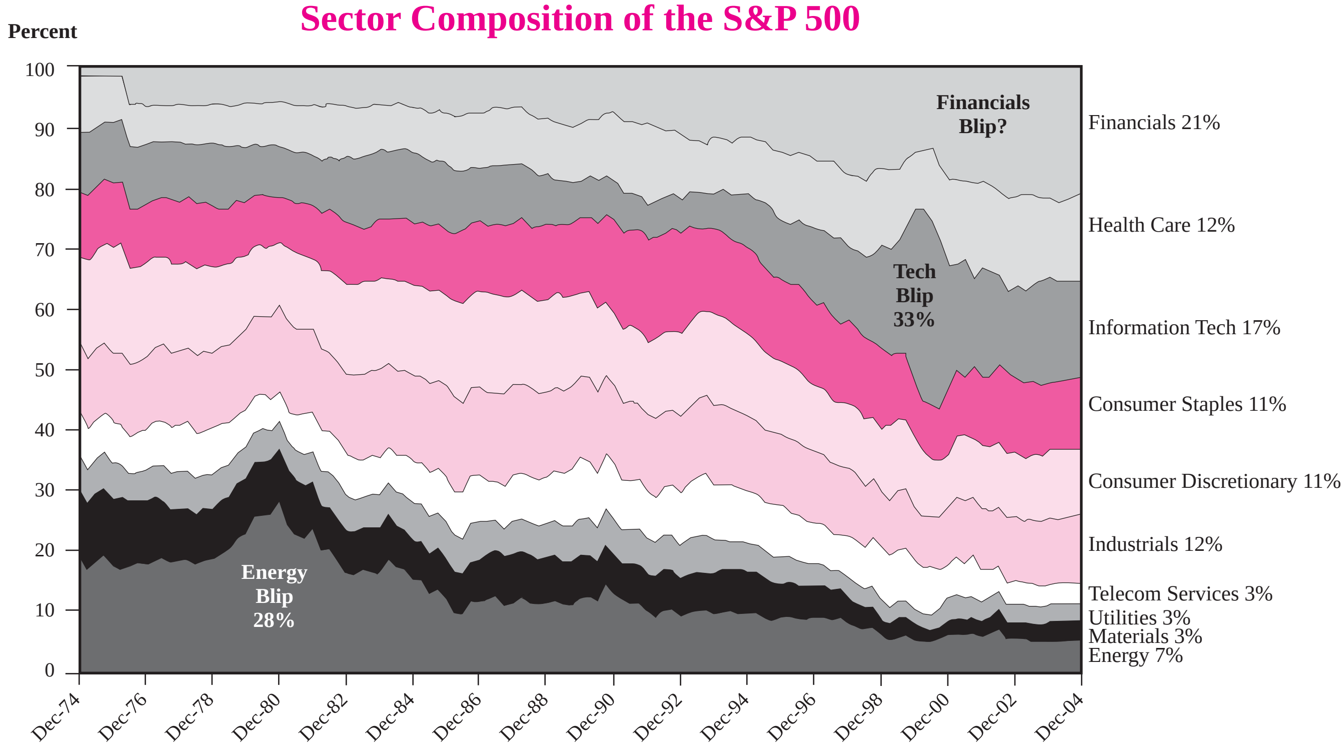


**Total returns as measured in U.S. dollars*

Source: Various

The chart on the following page shows the changing composition of the S&P 500. The changes over time largely reflect trends in sales and profits share of the sectors. Note the various "blips" over time. In the early 1980s, during the last sustained rise in oil prices, Energy represented nearly 30% of the market. Since then, Energy's share has declined and, even after strong gains in 2004, now represents only 7% of the market. Technology briefly peaked at more than 30% in 1999 but has since halved to 17% today. Health Care and Financials have been on a multi-decade rise with the latter now accounting for more than 21% of the capitalization of the S&P 500. Are Financials on a path toward becoming the next bubble?

Sector Composition of the S&P 500



Source: Goldman Sachs and Compustat

While we believe that most financial companies have benefitted disproportionately from the now-ended long-term decline in interest rates, we still see such companies as maintaining their current share of the economy and, hence, market capitalization. More broadly, we see no major disequilibrium within the stock market and thus see nearly all sectors as "fairly" valued, given current information. This is an environment that should favor MetWest Capital's bottom-up individual company-focused research. That benefit was certainly evident in 2004, as our equity results significantly exceeded most market indices and peer groups.

Prudence dictates that we must caution that such strong recent performance could lead to a temporary short-term correction. But we also point out that investment "blips" are often temporary, with unpredictable timing. Thus, a long-term focus is paramount. With this in mind, we will continue our search for hidden values while always reevaluating existing investments. So after two years of strong market gains, what may the future portend?

Always with a long-term view, and using history as a loose guide to the future, we have focused on the period 1956-1973. We view that era as most closely resembling the economic and political scenarios we see unfolding around the world. For the U.S., we expect modestly increasing inflation and interest rates, coupled with steady but consistent economic growth. U.S. companies could benefit from greater competitiveness caused by a weak dollar. This may be offset by rapidly industrializing countries—China and India today resemble Japan of the earlier period—that are bound to gain market share in selected industries. Politically, the "Cold War" is now replaced with the "War on Terror" and so growth and prosperity may be interrupted periodically by times of great uncertainty.

So, while not a "forecast" per se for the coming five to eight years, we expect a resemblance to 1956-1973, when inflation as measured by CPI was +2.8%, stocks as measured by the S&P 500 gained +8.8% per annum (with half of the return coming from dividends), U.S. long-term government bonds returned +2.3%, U.S. long-term corporate bonds returned +3.3% and "cash" as measured by U.S. T-bills gained +3.8% annually. (Note that these are multi-year compound returns, highly unlikely to resemble any one- or two-year period. Historical data was provided by Morgan Stanley, Ibbotson Associates and the Bureau of Labor Statistics.)

Recent additions to our *Intrinsic* Value portfolios include:

Portfolio Activity

- **American International Group** is one of the largest financial services firms in the world. Most of its earnings come from insurance (both life and property), while nearly half of its business is international. Recent allegations of wrongdoing have caused the stock price to decline. This gives us a unique opportunity to invest in a premier global franchise at a valuation level rarely seen for this company. While stock price volatility could remain high near term, our multi-year time horizon gives us great confidence in the prospects for AIG.

- **The Walt Disney Company** controls some of the most recognizable entertainment brands in the world. In addition to Disneyland and Mickey Mouse, Disney owns

ABC Television, ESPN sports, Touchstone Pictures and Miramax Films. Disney also has an exclusive relationship with Pixar to distribute its films, including the *Toy Story* series, *Finding Nemo* and, most recently, *The Incredibles*. Recently mired in management controversy (CEO Michael Eisner will retire in 2006) and cyclically underperforming divisions, the value of the content owned by Disney is, in our estimate, far in excess of the current stock price. As we believe that "distribution" (cable, satellite, internet) must have good content, Disney may be able to regain its position of leadership and prosper for years to come.

- **Fifth Third Bancorp** is a Cincinnati, Ohio-based bank created in the early 1900s via the merger of the Third National Bank with the Fifth National Bank. Via organic growth augmented with acquisitions, FITB now has in excess of $100 billion in assets, placing it #15 in the U.S. Through an ingrained sales culture and one of the lowest expense ratios in the industry, the bank consistently delivers high returns on assets and growth from market share gains. Recent short-term factors have caused earnings expectations to decline, taking the stock price with it. Selling at less than 13x 2005 earnings estimates, we find this a compelling investment.

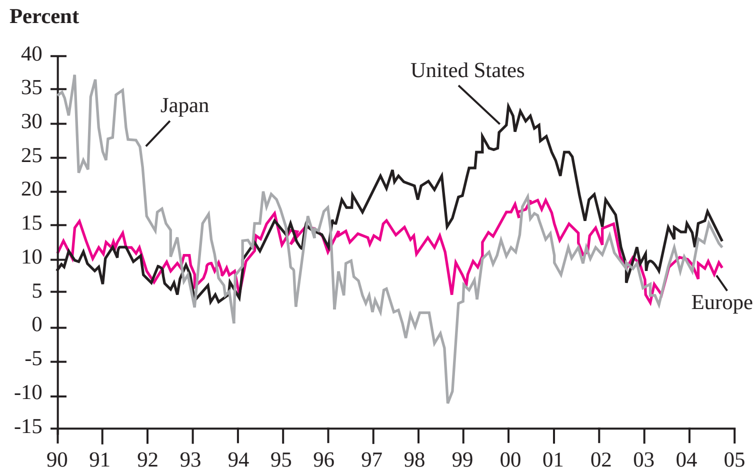
INTERNATIONAL STRATEGY

As depicted in the Asset Performance chart in the previous section, foreign stocks once again outperformed U.S. stocks last year. This was due to the strength in the value of foreign currencies, as in local currencies most of the major international markets gained +10% or less. MetWest Capital's International Core Value portfolios again outperformed the MSCI Europe Australasian Far East (EAFE) Index. These results were achieved even with our 22% exposure to Japan, whose +15.6% rise trailed the gains in Europe. Our individual stock selection methodology helped results even within laggard markets.

The following graph shows an estimate of "normalized" earnings growth for the world's three major areas from 1990 through estimates for 2005. Note the high rate of earnings growth for Japanese companies in the early 1990s that gave way to declines by decade's end. The U.S. followed an opposite path, gaining momentum as the decade progressed. Europe was somewhere between the two. As corporate earnings growth often matches a country's economic growth, this chart also shows the earlier success of Japan juxtaposed with the U.S.' more recent strength.

David Malpass, Chief Economist at Bear Stearns, was recently quoted in *The Wall Street Journal* as saying, "*. . . in the 1990s, the U.S. was practically the only engine of global growth*." While positive for the U.S. short term, this global imbalance was unsustainable. He went on to say that a new environment is taking hold whereby tight monetary policies have been loosened and persistent disinflation (almost **de**flation) is yielding to "*the most pro-growth monetary era since the gold standard . . .*" Mr. Malpass goes on to say, "*. . . though unsettling in the transition, the new era is providing a much better environment for developing-country growth*."

Normalized Earnings Growth



Normalized growth is calculated using the dividend discount model, assuming that the risk premium is constant and that the discount rate is known.

Source: SG Equity Research

We concur with Mr. Malpass' views and see the way out of many of the world's current troubles through more balanced growth (and hence sharing of the wealth) throughout the world. As we at MetWest Capital invest primarily in developed market companies, we look to participate in broadening opportunities via those firms that benefit from exposure to the faster-growing regions of the world. Japan will clearly benefit from China's expansion and Europe may gain from the opening up of the Central and Eastern European states (eventually to include Russia). Latin America, too, is not to be forgotten. In particular, Brazil is becoming the largest food and grain provider to a hungry world.

To take advantage of attractive foreign opportunities, recent new investments for our International Core Value portfolios have included:

- **Orix** is a Japan-based finance and leasing company. Its real estate-related businesses have prospered even during challenging economic times. Its focus on helping finance small- to medium-sized companies has resulted in a client roster exceeding 500,000 firms. Thus no one client or group affects Orix' profitability. Continued trends toward real estate securitization and a rebound in Japan's domestic economy are expected to have a favorable impact on profits. The stock's valuation of only 12x next fiscal year's earnings does not, in our view, reflect the strong long-term prospects of Orix' business.

- **Serono** is a large Europe-based pharmaceutical and biologic company. Its important products include Gonal-F (for reproductive health), Saizen (a growth hormone), Raptiva (co-marketed with Genentech for the treatment of severe psoriasis) and Rebif (for multiple sclerosis–MS). We had previously owned this stock but sold it when it became clear that a rival treatment for MS was coming to market. Now that Tysabri has been approved, Serono's valuation has fallen back to levels we find very attractive. While Rebif's sales growth may slow, it is still a most effective long-term treatment for MS and likely to maintain an important niche in the marketplace. In addition, Serono has several interesting partnerships that may result in new products in future years.

FIXED INCOME STRATEGY

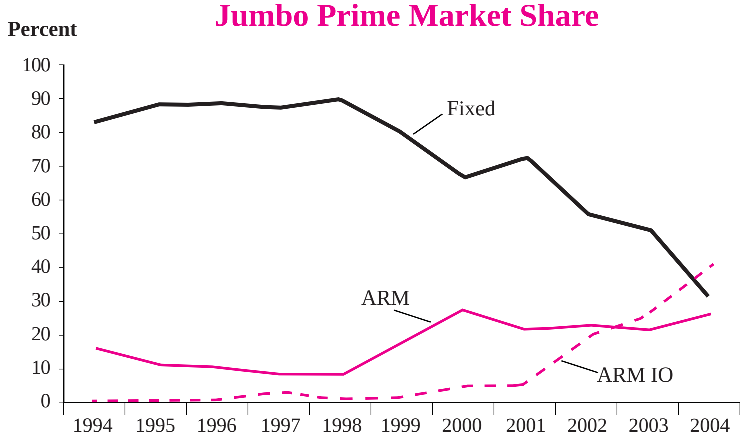
After peaking at 13½% in the middle of 1980, core inflation (as measured by the Consumer Price Index less food and energy) had steadily fallen to only 1.1% by the end of 2003. Now, just one year later, core CPI is rising 2.1% and may head higher still. We are not surprised by this. We have said for two years that the Federal Reserve Board (the FED) **wants** corporate America to have some pricing power in order to remove any chance of deflationary sentiment taking hold. We have also said that the FED usually gets what it wants.

The FED believes that with inflation trending higher than 2 percent, a 2¼% federal funds rate is still characteristic of an "accommodative" monetary policy. Thus we may consider that the five one-quarter percent increases in the fed funds rate that the FED instituted in 2004 were merely a "down payment" on its desire to work toward "neutrality." If our thinking becomes the consensus, then long-term rates may move higher as well.

We have a fear of unintended consequences as interest rates move higher. This is illustrated by the following graph. It shows the make-up of jumbo—non-conforming to Fannie Mae limits (currently greater than $359,650)—mortgages that are taken out each year. The blue line represents the percent of loans that are standard fixed rate. The solid red line represents the percent of loans that are standard adjustable rate mortgages (ARMs) with interest rates that vary periodically to reflect current market rates. The dashed red line is, to us, an alarm bell ringing out. It represents those loans (now past 40% of the total) that have adjustable interest rates **and** require interest-only payments. Thus, with ARM IOs, the principal of the mortgage is not paid down. This is fine in a low or declining rate environment, especially if the housing market is strong. But what happens as interest rates rise? The ARM rate will adjust upward, causing higher monthly mortgage payments. At the same time, the housing market may slow, making it more difficult to sell existing homes. If a homeowner doesn't pay down principal, then the penalty for "walking away" from a property is not steep because there has been little to no equity built up. We see this as very dangerous for lenders and are carefully monitoring these trends.

As discussed earlier, we believe the U.S. economy will remain healthy and consumers will keep spending. But shocks to the system are always possible. The last double-shock we had (the bursting of the tech bubble combined with a terrorist attack) resulted in only a minor economic recession. Should risky loans such as those depicted in the following graph build to a meaningful part

Jumbo Prime Market Share



Source: UBS

of the total mortgage market, the next shock may not be so easily tolerated. Just what we need, another "blip" to contend with!

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

George III was somewhat of a worrywart, inclined to ponder all the terrible things that might happen. In the end, some of his worst fears (such as Britain's loss of the colonies) did come true. But the loss was really not something that George could have prevented and actually left the British Empire in **better** shape to reach its ultimate size. We thus use the term "blip" to illustrate that his reign may have been a setback, but not a turning point, for his country.

We at MetWest Capital share the worrywart trait. We pointed out this quarter the multitude of factors that could cause a slowdown in consumer spending. As consumption is now 71% of U.S. GDP, we must be watchful of its driving forces while mindful of the long-term trends. We also fear the potential for unintended consequences of the FED's interest rate raising program and pointed out mortgage risk as but one concern. But just because we look out for negative trends doesn't mean we believe they will occur. As of this writing, we do not.

Even after two consecutive strong years for our equity portfolios, we still see many opportunities for growth and have positioned our clients' assets accordingly. If, as we expect, the coming years most closely resemble the 1960s from political, economic and market standpoints, then our style of investing could do well. Our long-term focus on individual companies will allow us to withstand "blips" as they occur and reach new heights after each one.

We wish you a healthy, happy and prosperous 2005!

Buckingham Palace
"The Queen's House"

Metropolitan West
Capital Management, LLC
www.mwcm.com

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