

Capital Visions

HUMPTY DUMPTY

*Humpty Dumpty sat on a wall,
Humpty Dumpty had a great fall,
All the King's horses,
And all the King's men
Couldn't put Humpty together again!*

Continuing the theme from last quarter's *Capital Visions* entitled "George III," this quarter we recount a nursery rhyme with its roots also in England, in the mid-1600s.

While there are several accounts of the origin of this short verse, they all relate to a King (possibly Charles I) and his "tumbling" from power. The familiar image of Humpty Dumpty depicted as an oversized egg came to symbolize the fragile nature of power. As described by Wakeley Paul in "The Nursery Rhyme: A Sharp and Cutting Weapon of Political Dissident,"

Humpty Dumpty was the name given to a very large cannon that was mounted on the protective wall of a church in Colchester, England. It was intended to protect the Royalist (the King's) stronghold from the Parliamentarians (the people). But a shot from the people's cannon hit and damaged the wall underneath Humpty Dumpty causing it to fall to the ground. 'All the King's men' tried to raise Humpty Dumpty onto another part of the wall but even with the help of 'all the King's horses' failed in their task and Colchester fell to the people.

The event symbolized popular rule over Royal decrees. King Charles I was overthrown and ultimately executed.

Our point in recounting this tale is not so much political as business oriented. To us, Humpty Dumpty symbolizes a large corporation sitting atop a fragile wall. One well-placed shot and all could come tumbling down. But it also represents stability in that Humpty Dumpty wasn't "hatched" on the top of that wall. In all likelihood he started small at the bottom, working his way up to the top, climbing one brick at a time. Now at the top of that wall, he can easily see his enemies approaching and it is quite difficult to dislodge him from his perch.

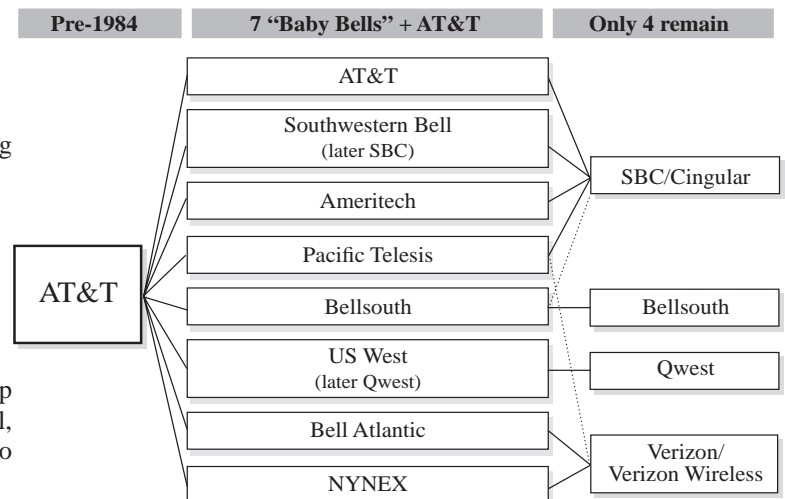
Once atop the wall, there is a tendency for companies to become complacent. "We're number one!" is too often followed by resting on one's laurels. It is also easy to become "fat as the egg" as each person or function added makes a minimal contribution relative to the entire organization, yet all together could make for a bloated firm. Many well-managed companies, understanding the potential pitfalls of large, staid companies, choose to employ a spin-off

strategy. That is, they identify which parts of the organization are "core" and which may be more productive on their own. In this way, instead of being "shot" off that wall and breaking into pieces by force, smart firms selectively break off their own pieces while the yolk of the egg remains intact. The spin-off strategy has led to many good investments and is one we monitor closely.

Spin-offs

We have observed that in many instances, spin-off companies are even better investments than their former parents. The premier example of this is AT&T. This company, founded by Alexander Graham Bell in 1875, has been broken into so many pieces that it truly would be impossible to put it together again—though some are trying.

AT&T - Back Together?



Source: Company filings

The chart above depicts the successful antitrust suit by the U.S. government that split the single telecommunications monopoly into eight pieces back in 1984—one piece for each of the seven Bell operating companies (known as "Baby Bells"), with the original AT&T containing the long distance business as well as an equipment

company (today known as **Lucent**). For the first decade after the breakup the status quo was maintained. But subsequent to the U.S. Telecommunications Act of 1996, the babies began to combine.

This past quarter, in a display of the power of spin-offs, SBC Communications, one of the smallest of the original Baby Bells, offered to acquire its former parent. By the time of this event, the former parent (AT&T) was less than 20% the size of its “child,” SBC.

Why are spin-offs so successful? The many and varied reasons include:

- **Focus.** There are only so many hours in a day and only so many tasks *any* CEO can perform. A company spin-off is often managed by the same divisional heads who were present under the former parent company. Now, however, the management of both the original trimmed-down firm as well as its spin-off have only *their* businesses to worry about and can focus all their attention on smaller product or service lines without worrying about the potential impact on parent or sister divisions. Do you think Tide with Bleach would ever have hit the shelves had Proctor & Gamble still owned Clorox?
- **Capital Allocation.** When **Cytec** (a chemicals company) was part of the healthcare conglomerate American Cyanamid, it had difficulty attracting capital to its businesses. New drugs, while costly, can generate very high returns. Chemicals, on the other hand, are seen as cyclical and slow growing. But on its own, Cytec allocated capital to acquire some of its peers and built significant market shares in several highly profitable chemical niches. This would never have occurred as but one small piece of a much larger whole.
- **Entrepreneurial Drive.** In many instances, managements of new spin-offs have material ownership in their companies and are highly motivated to make them successful. They are often reinvigorated and determined to take their “new companies” to a higher level.
- **Valuation.** With rare exception, companies that are in multiple business lines see their stocks priced with a “conglomerate discount.” **Liberty Media** owned several private businesses in addition to several large holdings of public firms (including News Corp.) It was easy to calculate the *intrinsic value* of the enterprise as all the businesses were media related. Yet the stock almost always traded at levels as much as 45% below its sum of the parts. Spinning off **Liberty Media International** and more recently, Discovery Communications, has resulted in a material narrowing of that valuation discount.
- **Reacquired.** Finally, while one should not invest solely based on this possibility, oftentimes spin-off companies find themselves back as part of larger organizations. When Edgar Bronfman Jr. sold Universal Studios to Vivendi, his Seagram Company was left with a nice, focused liquor business. But the company found that while having a movie studio as a “sister” provided few synergies, merging with another beverage company (in this case **Diageo**) resulted in a global spirits powerhouse.

While the list above is not exhaustive, it does highlight several of

the reasons we look favorably upon spin-off companies. While we will not invest in a business solely because it was spun out of a larger company, the more focused nature of the new enterprise, together with better capital allocation, added entrepreneurship and the prospect for higher valuations are all *catalysts* used as factors in our analyses. Yes, one can never put Humpty Dumpty together again—and that’s a good thing!

Let’s now review the financial markets for the first quarter of 2005 and touch on our expectations for the future.

VALUE EQUITIES STRATEGY

Given the many headwinds it faced, and while modestly weak overall, the U.S. stock market held up well during the first quarter of 2005. Energy prices remained volatile, gaining more than 20%. The Federal Reserve Board (FED) raised interest rates twice more, causing most fixed income security prices to decline. Headlines relentlessly proclaimed continued difficulties in the world’s hot spots. Corporate profits, while still advancing, have slowed from their heady pace of 2004. Still, most broad market indices were within a few percentage points of even for the quarter.

By sector, Technology has been a laggard for much of the past five years and last quarter was no exception. Many of the stocks within the sector declined nearly 10%. Joining the laggards for a change was the Financial Services sector. This interest-sensitive group declined based on expectations that rising rates, along with a flattening yield curve, may crimp profit growth for companies within the sector. The Telecommunications sector and nearly everything auto-related also declined, but most industries seen as beneficiaries of rising inflation rose. Thus Energy, Basic Materials and select Industrial companies saw their market values gain about 10% on average.

When the final numbers are tallied for the quarter, we are likely to report that MetWest Capital’s Large Cap *Intrinsic Value* Equity portfolios performed about in line with large capitalization Value indices and significantly ahead of the broader market, as measured by the S&P 500 Index. As always, we focus more on individual companies than broad macro- or microeconomic trends. As we believe the overall stock market will rise, but only modestly, over the coming years, we find that our unique focus on company-specific investments is well suited to outperform in the environment we envision.

Recent additions to our *Intrinsic Value* portfolios include:

Portfolio Activity

- **Baxter International** is a large global medical products company. In many ways BAX reminds us of an investment we made sixteen months ago. Similar to **C.R. Bard**, Baxter’s new product pipeline had hit a lull; sales stagnated and margins were hurt by competitive pressures. But new products (such as its Advate blood-clotting agent for the treatment of hemophilia) are gaining market share and management is closing unproductive plants and focusing on increasing its already-respectable return on invested capital. With the stock at only 16x

next year's earnings, we find it a compelling long-term investment.

- **Texas Instruments** produced the first commercial silicon transistor, the first commercial transistor radio, the first integrated circuit, the first handheld calculator and, more recently, the first DLP large-screen projection television. To this day, it either sells or collects royalties on many of those products. But more important to today's investors, TI has made the transition from a commodity semiconductor company (it sold its DRAM memory business) to a value-added component producer. For instance, while TI chips are found in many cell phones today, the next generation of wireless handsets (using "3G" technologies) will use twice the content from TI as today's versions. This will provide for higher profitability, a factor not embedded in today's stock price.

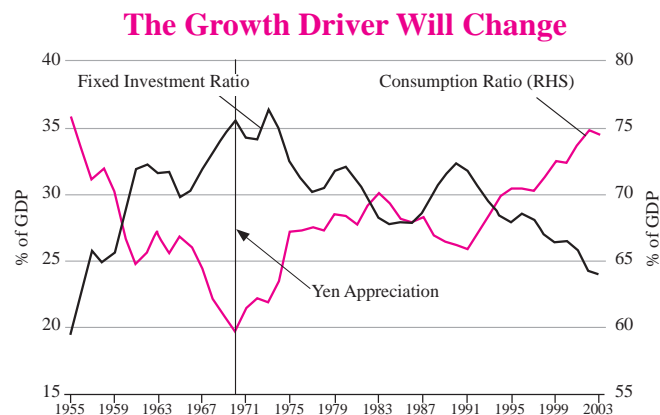
INTERNATIONAL STRATEGY

International equity markets were stronger than those in the U.S. for the first quarter of 2005. Most developed equity markets gained 2%-6% as measured in local currencies. But after three years of significant weakness, the U.S. dollar strengthened last quarter and so international stocks, when measured in dollars, declined slightly. Most indicators (including trade balances, interest rate differentials and capital flows) point to longer-term dollar weakness, but short-term currency fluctuations may periodically go counter-trend, as happened last quarter.

The Japanese stock market remains important to the results of MetWest Capital's International Core Value portfolios. We are slightly overweighted in Japan relative to broad international indices and even more so relative to most other investors. In past *Capital Visions*, we have enumerated reasons for our optimism. The primary reason, however (as it is for every investment we make), is not as much macro-related as it is individual company specific. In short, we have uncovered many attractive investments that just happen to call Japan "home."

When U.S. investors think of Japanese companies, they often consider those most familiar to them. Thus, the major exporters such as Sony, Toyota, Toshiba, Honda and Canon are favored investments. Ours is a different approach. While we don't exclude exporters (we currently own **Matsushita**, maker of the Panasonic brand), of late we have found better value in companies focused more on internal Japanese consumption. **Toray** (a textiles company), **Marui** (a retailer), **ORIX** (financial services) and **Kao** (consumer products and cosmetics) are all domestically focused Japanese firms with unique characteristics that make them optimal investments at the present time. In addition, should the Japanese consumer come out of hibernation, this could provide a significant "kicker" to the fortunes of these companies. Why focus on consumption?

The following chart shows the relative growth drivers of Japanese GDP from 1955 through 2004. The blue line is the percent of GDP generated by fixed investments (including buildings, factories and machinery). The red line represents consumption (including food, household products, cars and appliances). Note that the two



Source: Credit Suisse First Boston, CEIC

combined make up the bulk of the economy (with the rest coming from government spending and net exports). Note also the changing composition of Japan's GDP since the early 1970s. As the Yen has appreciated from ¥350 per U.S. dollar in 1970 to nearly ¥100 per dollar today, Japanese companies have found it more difficult to remain competitive by simply building "stuff" in Japan and shipping it elsewhere. New competition from Korea, Singapore and, recently, China has also diminished Japan's exporting prowess. Thus, a larger share of growth has come internally.

As we detect few signs that the Yen will depreciate meaningfully or that new competition will diminish, we believe continued growth in Japan will be more dependent on internal consumption than on increasing exports. As always, we will continue to monitor these trends and base investment decisions primarily on the merits of individual companies.

To take advantage of Japan's strengthening consumer, as well as other attractive foreign opportunities, recent new investments for our International Core Value portfolios include:

- **Aeon** is one of Japan's largest retailers. Headquartered near Tokyo, Aeon operates department, discount and supermarket stores throughout the country. The company has embarked on a dramatic restructuring that, together with others in the retail sector, could result in improved profitability and higher returns, even if consumption remains weak. Aeon also owns 57% of U.S.-based Talbots, a career woman-oriented clothing retailer.
- **Air Liquide** is one of the world's largest providers of industrial gases. Pure forms of nitrogen, oxygen, helium and hydrogen are used in manufacturing processes from paper to chemicals to electronics to gasoline. It is a capital-intensive business, but in an industry in which only a few participants (we own **Air Products** in our *Intrinsic Value* portfolios) have consolidated to allow for predictably high returns. Stable growth and cash flows have allowed Air Liquide to grow dividends 10% annually for 30 years. We believe it is poised for similar growth into the future.

FIXED INCOME STRATEGY

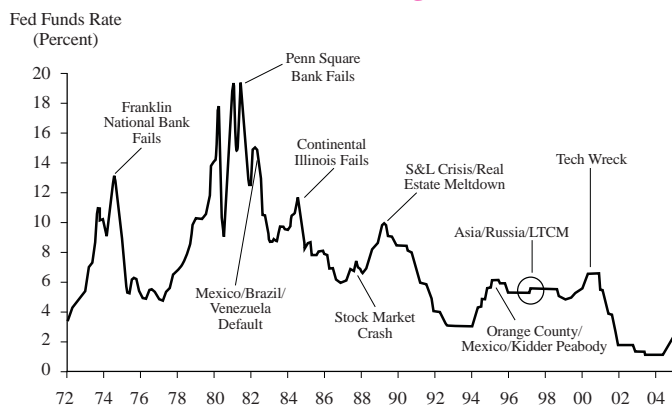
As expected, the FED raised interest rates by one-quarter percent

in each of its two meetings this past quarter. The 2.75% fed funds rate is now 1.75% above its level a year ago when the FED started raising rates, but still well below the 6.50% level when it last began lowering rates in early 2001.

Stephen Roach, a longtime naysayer at Morgan Stanley, has said, “the U.S. central bank appears to have thrown its full weight of support behind the Asset Economy and its foundation of unsustainably low real interest rates. That implies a hypersensitivity of the real economy to interest rates. Not only could that pose great risk to residential property markets and the refi bonanza that supports income-short American consumers, but it would take away the ‘candy’ of the carry trade – possibly leading to sharp sell-offs in corporate bonds, high-yield securities, and/or even emerging-market debt. [Author’s comment: This could be particularly damaging to hedge funds.] This is not an outcome the market-driven Greenspan FED would stomach, in my view. Consequently, I fear that at the first sign of weakness in the U.S. economy or at the first hint of pyrotechnics in the financial markets, the FED will flinch and abort its normalization campaign.”

While we often disagree with Mr. Roach’s negative views and also disagree with most of his reasoning in the above statement, we do concur with his conclusion. That is, Alan Greenspan believes the world’s financial markets are still on shaky ground, still vulnerable to structural deflationary forces and still full of too much speculation. We therefore contend that while interest rates could still trend higher, short-term rates will merely reach an equilibrium rate (probably between 3% and 4%) and then stop climbing. Barring a significant increase in inflationary expectations, rates are unlikely to overshoot, as in prior cycles. The graph below backs up such a view.

When The FED Tightens ...



Source: Federal Reserve Board, Merrill Lynch

Note from the graph that significant (meaning sharp and quick) changes in FED policy almost always result in unintended financial crises. This is why we believe the FED is so constant in its use of the “measured” phrase and is going to great lengths to telegraph its every move. This is likely to be Alan Greenspan’s last stand over the economy as Federal Reserve Chairman. His term as governor expires next year and his age will likely preclude reappointment. We do not believe he wishes to leave the FED with major problems and thus, if need be, he will err on the side of accommodation rather than excess tightness.

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

There’s a famous (and fun to read) book entitled “All I Really Need to Know I Learned in Kindergarten.” As nursery rhymes can teach a lot too, maybe we could author a sequel called “All I Really Need to Know I Learned *Before* Kindergarten!”

This quarter we chose to use Humpty Dumpty to illustrate the value of corporate spin-offs. We have successfully invested in many such companies over the years, including the ultimate spin-off, SBC Communications, which is in the process of acquiring its former parent, AT&T. Not all spin-offs work out, and larger diverse enterprises have their advantages too. But we have pointed out that the unique focus, capital allocation, entrepreneurship and valuation potential of spin-offs may serve as potential *cat*alysts in our analyses.

In this report we have also reiterated our belief that many Japanese companies are worthwhile investments, especially those that focus on domestic consumption. This is a contrarian view and we may be early in our thinking. But we’ve been early before (as VALUE investors often are) and our clients have been rewarded for sharing our patience.

Finally, we pointed out that while the FED continues its measured pace of interest rate increases, it will follow this course only so long as the economy continues its upward trajectory and strains do not build up in financial markets. Alan Greenspan’s last stand over our economy will, in our opinion, be a continuation of his masterful long-term tenure. Hopefully, the global economy of the future will be one “egg” that just won’t “crack.”



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