

Capital Visions

The Yellow Brick Road



*“Follow the Yellow Brick Road, Follow the Yellow Brick Road.
Follow, follow, follow, follow,
Follow the Yellow Brick Road.
Follow the Yellow Brick, Follow the Yellow Brick,
Follow the Yellow Brick Road.”*

*“We’re off to see the Wizard, The Wonderful Wizard of Oz.
You’ll find he is a whiz of a Wiz! If ever a Wiz! there was.
If ever oh ever a Wiz! there was The Wizard of Oz is one becoz,
Becoz, becoz, becoz, becoz, becoz.
Becoz of the wonderful things he does.
We’re off to see the Wizard, The Wonderful Wizard of Oz.”*

We’re all familiar with the above song from the 1939 movie *The Wizard of Oz* based on the novel by L. Frank Baum. Dorothy, after having been swept up in a twister, lands in Munchkinland. When she asks how to get back home, she is sent on a magical journey down the Yellow Brick Road in search of the Wizard who lives in the Emerald City (supposedly somewhere along this path). But after a short while, she (and her dog Toto too!) encounter a fork in the road. Perplexed as to which path to take, she pauses for a moment and then hears,

“... *some people go this way* . . .” as a Scarecrow points down one of the paths. But then
“... *some people go that way* . . .” as the Scarecrow now points down the other path. Finally,
“... *some people do go both ways!*” as the Scarecrow points cross-armed down both roads.

The actor Ray Bolger then goes into his memorable “If I Only Had a Brain” song and dance, and both he and Dorothy head down one of the paths. As satisfied movie goers, we never ask about that other path and what would have been ahead had they chosen that route instead. Would they still have met up with the Tin Man and the Cowardly Lion? Would they ever have gotten to see the Wizard? Was the Wicked Witch able to see down the other path using her crystal ball just as she did on the road taken? Where did this second path lead?

On the “road” of life and journeying down the “path” of investments, one often encounters choices. In this quarter’s letter, we will examine the ramifications of those choices and MetWest Capital’s search for “FREE” options.

In reality, we don’t know where that other Yellow Brick Road might have led. It could have gone off in a direction opposite from the Emerald City. It could have simply paralleled the road taken, but

possibly on more- or less-treacherous terrain. Or, it could have simply been a detour, meeting back up with the original road after just a short distance. Surely the Munchkins knew of this dilemma and, if an important issue, would have steered Dorothy correctly – right? As we see, the ramification of these outcomes could be severe. So, too, in investing.

Free Options

Dorothy and the Scarecrow’s road choice did **not** represent a free option. Taking the wrong Yellow Brick Road may have been disastrous. We as investors, on the other hand, do uncover “free” options, and we are always on the lookout for them.

In a financial sense, an option is a right, but not an obligation, to take an action. Thus a CALL option on a stock gives the holder the ability (but not the requirement) to purchase that stock at a predetermined price at any time up to the expiration date of the option contract. Thus, if IBM were trading at \$78, one could purchase an option to buy IBM stock at \$80 for an option price of \$2.50 per share. The beauty of the arrangement is that if IBM’s stock price falls, then you would not exercise the option, meaning you would not buy the stock and therefore would lose only the \$2.50 already paid. But if IBM stock rose past \$80, one could profit in an unlimited way. This results in a very favorable risk/reward tradeoff of \$2.50 downside for unlimited upside. Sound good?

The problem with financial option contracts is they are typically

an expensive way of long-term investing. The \$2.50 example above is for an option that expires in four months, resulting in a 9.6% annual cost ($\$2.50 \times 3 \div \78). So we rarely choose to employ this financial strategy. Instead, we look for the same type of risk/reward tradeoff detailed above, but with a much longer time horizon (say, three years on average) without the use of the option instrument. How do we do this?

We will illustrate with an example. Four years ago, we uncovered an “unloved” company whose prospects others saw as dim. We disagreed. We saw the company as in transition from being a supplier of commodity-oriented hardware to becoming a provider of differentiated “must have” products with unique content. A new, yet proven, management team, with a large part of their net worth invested in the business, was at the helm leading this process. So, we had clearly identified the *catalysts* for upside appreciation. But what if our analysis was flawed and our perceived potential was not realized? In this case, the company had cash and readily marketable assets greater than the market value of the enterprise. So the company theoretically could liquidate itself and make shareholders more than whole. This was a FREE option, and the name of the company is **Apple Computer**.

In another example, a year before we identified **Apple**, we uncovered an “out-of-favor” company whose products were so vastly superior to its competitors’ that it routinely earned 40% operating margins. However, the company stumbled with several unwise acquisitions that, at least until then, hadn’t worked out as planned. But the base business hadn’t missed a beat. So, here the FREE option was our conviction that the company had learned its lesson and would embark on no new acquisitions. Should that occur, the base business would generate profits capable of vaulting the stock price materially higher. Were we incorrect in our assumption, then while **Gillette’s** razor and blade business continued to do well, profits could be misused in further diversifications and the stock price would likely be range bound. Again, a great upside (as was realized) should we be correct with little downside risk.

While not every investment we make has such advantageous option-like characteristics, many do. Some of our current “forgotten” holdings have, we believe, FREE options imbedded in them. Thus, **Lucent** may be worth near its current valuation just from its **Bell Labs** research centers, giving scant value to its ongoing operations. Or, an investment in **Boeing** (certainly at the time of our original purchase, but largely still true today) is like buying a defense contractor and getting the world’s largest commercial aircraft manufacturer thrown in for FREE.

So while we may never know if Dorothy and the Scarecrow had a FREE option down that Yellow Brick Road, we do know that in the investing world, there are opportunities that, while we know are not purely “free,” do have very attractive risk/reward characteristics. We will work diligently to continue to uncover them.

Now let’s turn our attention to the financial markets and our expectations for the “road” ahead.

VALUE EQUITIES STRATEGY

Each quarter in this section, we present a glimpse of our economic and strategy thoughts. The themes we develop over time are largely driven by individual bottom-up company analyses. That is, as we scour the world for investment opportunities, we find hidden values one at a time and add them to portfolios if deemed optimal. While we focus on businesses that span different industries and

sectors, sometimes a theme develops. So, today, for instance, we may look back and see that several years ago we had no exposure to media-related companies, while today we have three (**Disney**, **Clear Channel** and **Liberty Global**). We did not decide to “go after” media as the result of a microeconomic analysis. Rather, after the fact, we reflect on the theme that media companies are adding value for shareholders, long-term prospects appear bright and current stock prices do not reflect the reality we envision.

Taken to a broader level, our market views are similarly influenced by the company-specific work that we do. Hence, economic and overall market themes come from the same company analyses as do our sector viewpoints. We have noticed that just as other investors have become more short-term focused, so has even “big picture” work. Most of the discussions we sift through compare today’s market behavior to that of the past five or ten years (at most). While we agree that markets “cycle” through various trends, we disagree that looking at recent history is of any help at all. Companies tend to learn from recent mistakes but, unfortunately, have little patience for delving into the errors of prior generations of management. This is why, so often, history repeats itself (a topic for a future *Capital Visions*).

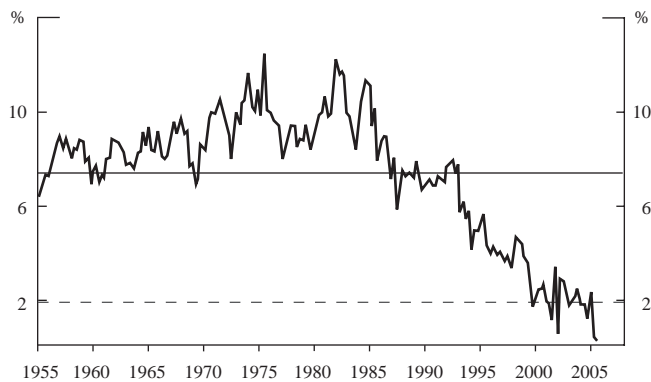
While no two economic or market cycles are exactly alike, we believe that the environment we envision for the next few years may most closely resemble that of the mid- to late-1960s. Similarities between that period and the one we may now be entering include:

- > The U.S. yield curve was (and is now again) relatively flat, with little difference between short- and long-term interest rates.
- > Politically, there was the constant fear of external “attack” accompanied by periodic scary episodes. The “Cold War” of the 1960s has been replaced with the “War on Terror,” and so growth and prosperity may be interrupted by times of great uncertainty.
- > An ongoing unpopular war.
- > Investments in infrastructure (the nation’s interstate highways were built in the 1960s, and they will have to be refurbished in the coming decade).
- > The “Baby Boom” ended during the decade of the ’60s, partially offset by strong immigration. The “Echo Boom” is now under way.
- > Rapidly growing Federal budget deficits.
- > The emergence of the Chinese economy today is very similar to that of Japan in the 1960s. Tokyo even hosted the Summer Olympics in 1964, while Beijing will host them in 2008.
- > A very long-term FED Chairman about to retire.

But there are also differences between the 1960s and today, noting that in the prior era there was strong growth in manufacturing, a current account *surplus*, higher federal income tax rates (somewhat offset by lower state and local taxes) and – partly because the Depression Era was not yet forgotten – one notable difference between now and the 1960s is the U.S. personal savings rate.

The U.S. Department of Commerce and the Bureau of Economic Analysis calculate the personal savings rate by subtracting all personal expenditures (including interest payments and gifts) from after-tax personal income. This number is then converted into a percentage, as shown in the graph on the following page. In 1965, \$43 billion was saved, representing 8.6% of after-tax income of \$500 billion. In 2004, a mere 1.0% (\$90 billion) of the \$8.6 trillion in income was saved.

Personal Saving Rate



Source: *The International Bank Credit Analyst*

But this graph may highlight some of the differences between consumer savings and spending patterns in the 1960s compared to today. In the earlier years, the personal savings rate shown in the chart represented a large part (other than government Social Security) of an individual's entire net worth. Today the scenario is vastly different. In addition to savings in the bank, many people have 401(k) accounts, insurance annuity policies and, of increasing importance, home equity. This has become known as the "wealth effect," making people feel like they have the wherewithal to spend most of their *current* income, as they believe their *future* needs are taken care of.

We often comment that the U.S. consumer does not stop spending unless *forced* to do so. As we see little evidence of such a compulsive curtailment, we believe that the 70% of U.S. GDP that represents consumer spending will continue to grow (albeit at a somewhat muted pace). We therefore maintain our sanguine view of the U.S. economy and, as a reflection of such, the stock market.

As discussed earlier this year in the *Capital Visions* entitled "George III," investment results for the period encompassing the 1960s were modest but positive. Stocks, as measured by the S&P 500 Stock Index including dividends, gained 5% to 9% annually, while fixed income returns were about half that rate. While not a forecast per se, we believe that U.S. financial markets may experience similar returns for the next several years (on average—NOT each and every year). The results for the market thus far in 2005 have slightly lagged this trend, with MetWest Capital equity portfolio returns somewhat better.

Recent additions to our *Intrinsic Value* portfolios include:

Portfolio Activity

- **Diageo**, owned in our International portfolios for two years, has divested its interests in hamburger chain Burger King and food conglomerate Pillsbury to focus on its world-leading spirits business. Its well-known brands include Johnnie Walker, José Cuervo, Smirnoff, Baileys and Seagram's. It is also growing in the table wine business. With a new exclusive U.S. distribution strategy and marketing campaigns aimed at perpetuating steady market share gains, profits are increasing. Yet with a P/E ratio less than 15x and a 4% dividend yield, the current stock price does not reflect the positive prospects we envision.
- **East West Bancorp** is a mid-sized regional bank based

in Los Angeles. It is the largest of the area's financial institutions focused on the ethnic Chinese community. As its name suggests, the bank aims to bridge the financial needs of that part of the eastern hemisphere's population that has chosen to move west. Attracting clients who value a close relationship with their bank, East West is known for that rare combination of a loyal and highly profitable customer base. The bank's stock previously traded at a significant premium to its peers, but recently corrected to levels that we see as attractive.

INTERNATIONAL STRATEGY

International stock markets have outpaced that of the U.S. thus far in 2005. The MSCI Europe Australasian Far East (EAFE) Index is up 9.5% through the first nine months (including income and measured in U.S. dollars). This compares favorably with the S&P 500 which is up less than 2.0% for the same period. Country participation has been very broad based, with all major markets up at least 12.0% in local currencies and more than 5.0% after accounting for the strong U.S. dollar.

Even Japan, a long-time laggard, has kept up with its international peers. For the first time since just prior to 9/11, Japan's Nikkei average traded above ¥13,000. With the caveat that we still have one quarter left in the year, 2005 could mark the first time since the bursting of Japan's bubble that the stock market has risen materially for three consecutive years.

We see Japan as one of the best international examples of a "FREE option." We admit to being early in expecting an end to Japan's malaise and a resumption of growth of its economy, corporate profits and the stock market. Yet MetWest Capital's International Core Value portfolios have outperformed EAFE and their peers *in spite of* the headwind of Japan. This has been due to our emphasis on stock selection and our success at identifying unique companies that can prosper even in a less-than-ideal environment. Past holdings such as **Nissan Motor** and **NKK Corp.** (now part of JFE Holdings, a large steel maker) plus current positions in **Toray**, **Kao**, **Orix** and others have outperformed their global counterparts. In some ways, the weak Japanese economy may have actually *helped* these companies focus on improving profitability, as they knew they would get little help from the market environment.

Today, the Japanese portion of our portfolios is focused on companies that rely more on domestic demand (retail, financial, construction, etc.) than on the traditional leading exporters. Tokyo land prices increased in the latest month for the first time in fifteen years! This, along with other factors we monitor, gives us confidence that our *early* expectations for Japan were not necessarily wrong, but merely "off" due to a timing difference. If we can continue to identify unique companies in that market, then the FREE option may persist. If Japanese growth resumes, then even stronger performance may be attainable.

But not all roads lead to Tokyo! As always, we look globally for investment opportunities with an eye toward heading down the paths of likely FREE options. To that end, recent new international investments include:

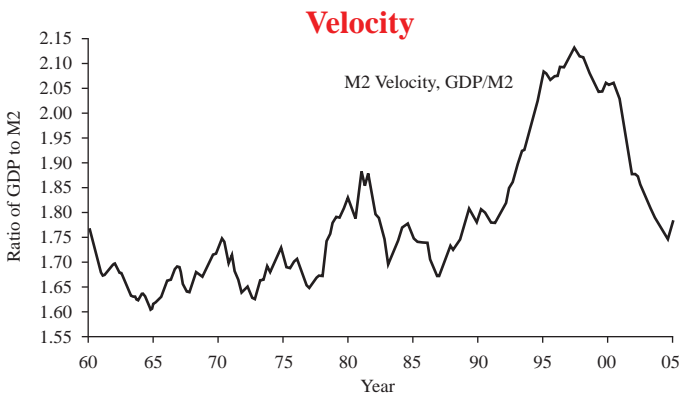
- **Carrefour** is the world's second-largest retailer. Known as the "Wal-Mart of Europe," it is based in France, generating half of its sales in that country. Most of its stores are hypermarkets, selling everything from food to household products to cosmetics. While strict

French laws have limited Carrefour's larger stores from competing too aggressively with local independent shops, the company is nonetheless able to grow profitably. Better prospects are afforded outside France, especially in Asia, where the company is taking leading shares in Taiwan, China, Korea, Indonesia and Thailand. New CEO José Luis Duran came from a Spanish retailer acquired by Carrefour four years ago. His past successes are, in our view, evidence of the company's ability to compete effectively in France while (as a FREE option) expanding throughout the rest of the world. Who knows, maybe some day we'll see a Carrefour in Little Rock!

FIXED INCOME STRATEGY

Like clockwork, the Federal Reserve Board (FED) again raised interest rates by one-quarter percent in each of its two meetings this past quarter. The 3.75% Federal Funds rate has now been raised six times, or one and one-half percent, thus far this year. It stands far above the 1.00% level of 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. We believe the FED still considers its monetary policy to be "accommodative," that it needs to move closer to "neutral" and that a mid-4% Fed Funds rate is warranted.

Thus far, higher short-term interest rates have not had a major effect in slowing the U.S. economy. While we do expect that there could be some delayed reaction to higher rates (especially if longer-term interest rates increase materially from current levels), we believe the economy could continue on its uptrend. This could lead to a sustained higher level of interest rates and a flattish yield curve, as we outlined earlier. One of the reasons for our views is the understanding of money supply *velocity*.



Source: JP Morgan, Bear Stearns and the Federal Reserve Board

This graph depicts the ratio of Gross Domestic Product to the M2 money supply in the U.S. This ratio is called the *velocity of money*. Note that during the tech and market "bubble" period in the late 1990s, each dollar of M2 produced more than two dollars of economic activity. Thus money was "turning over" faster as quick profits were sought. During the past few years, money velocity has

slowed dramatically, so even though M2 growth has remained rapid, the economy entered a brief recession and growth has been sub-par since. But now that velocity has returned to its "normal" level, GDP growth may more closely match the growth of the money supply.

David Malpass, Chief Economist at Bear Stearns, sums up our thoughts well:

"The velocity of money has increased [of late]. This indicates that money is turning over faster in the economy, a welcome exit from deflation and cash hoarding. We expect faster velocity as interest rates rise higher and people use money more effectively."

We have thus remained cautious, and the fixed income portion of MetWest Capital's balanced portfolios has changed little this year. We are allowing the maturity and duration to drift lower as, in the world of fixed income, we do NOT see a FREE option. On the contrary, those who seek to prosper by holding long-maturity instruments get a low current yield (4¼% on the 10-year), yet face the risk of principal loss should interest rates trend higher. As always, we continue to reevaluate the prospects for all investments and will make changes as new developments warrant.

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

This quarter we have introduced the concept of FREE options and how we seek them out as part of our investment methodology. We juxtaposed an investment containing a FREE option with the fork in the Yellow Brick Road that Dorothy came upon in *The Wizard of Oz*. The Scarecrow led Dorothy and Toto down one path, and we never found out what lay ahead down the other. FREE options, we believe, reduce the risk profile of portfolios while maintaining the full upside potential should our analyses prove correct.

We also highlighted the many parallels between the environment of the 1960s and that of today, leading us to believe that the next few years may hold in store returns similar to that earlier period. But not all is identical between now and then. The U.S. savings rate is very different today, although that may be explained by other factors and so is possibly not of particular concern. The U.S. housing market, however, is not a topic we explored but could become a source of imbalance should recent strength continue unabated.

In summary, while we think every good investor should be somewhat of a worrywart, we remain sanguine on our future outlook and will continue to employ the investment methodology that has proven successful over the years.

We Wish You a Most Pleasant Upcoming Holiday Season!



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