

# Capital Visions



## Bocce Ball (All for Naught)

Every good investor should study the past. As we strive to become better investors, we look back further and further into history. This quarter, we wish to take you back about 7,000 years to ancient Egypt, circa 5200 B.C. Here, enshrined in an Egyptian tomb, was found a painting of two children playing a game with a ball. The popular game, beneficial for both social and health reasons (it was thought to be good for arthritis), flourished and over the millennia made its way around the world. From Egypt to Greece and eventually Rome, the game became so popular that it was banned for taking too much time away from the activities of the day (such as archery and other military exercises). But, as history repeatedly teaches us, nothing popularizes anything as much as a ban (and what parent hasn't learned *this* lesson?).

So, the game known as Bocce spread throughout the modern world and eventually was brought to the United States by Italian immigrants at the turn of the last century. More recently, the World Bocce League was formed in Chicago to “change the perception that Bocce is only a game played by little old Italian men, getting drunk on red wine.” Known by other names such as lawn bowling and skittles, Bocce is mimicked by other games, including horseshoes, shuffleboard and even ten-pin bowling. Never making it into the Games, Bocce's closest Olympic sport is curling, first officially appearing in the 1998 Nagano Winter Games.

As detailed by the World Bocce League, the game's rules are fairly simple: “There are two teams of one to eight players. Each player is given two ‘boccia’ balls. One at a time, players ‘lag’ (roll) a ball toward the opposite end of a dirt bowling lane-sized court aiming for the ‘pallino,’ the smallest of the balls. Points are given for coming closest to the pallino. In one of the few thrilling aspects to the game (other than the red wine, of course), players may also throw the ball in the air (‘a volo’) attempting to knock away the opponents’ balls.” Here is where our investment lesson comes in.

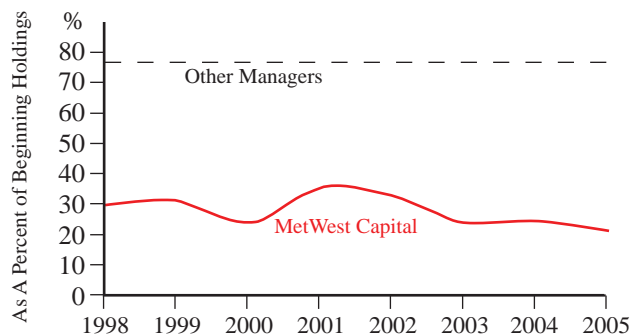
One of our analysts had the recent occasion to play Bocce. While the game looks simple, it turns out that much skill is required to excel at it. One must roll the ball with just the right amount of energy and spin in just the proper direction. Care must be taken to allow for an uneven court, just as on the putting green of a golf course. But even if one precisely rolls the bocce ball so that it comes to rest just next to the pallino, it could be ALL FOR NAUGHT if the next player barrels his ball right into yours, knocking it away. So, too, in investing can months of work appear to be all for naught. Or are they?

## Trading versus Investing

We at MetWest Capital have long said that we don't *trade* stocks, we *invest* in companies. Our philosophy requires a process employing detailed company analyses that results in low portfolio turnover. This subject has been mentioned in past *Capital Visions*. We must emphasize that our “buy and hold” philosophy is not a “buy and forget” process. On the contrary. But more often than not, in investing, the best action might well be *no action* at all. So while it seems like nothing is happening with a portfolio, great effort is constantly expended to ensure that all existing investments are optimal and performing according to our theses.

Note from the graph below that MetWest Capital's Large Cap *Intrinsic Value* portfolio turnover rate has averaged less than 30% annually. That is, of the 35-40 investments comprising our portfolios, only about ten are initiated or sold per year.

### Portfolio Turnover



Source: Internal (comparative statistics provided by Callan Associates)

The graph shows that our approach has been consistent over time and is typically not impacted by strong or weak markets. This compares with the nearly 80% turnover for the average equity manager. So while our average holding period (the inverse of turnover) is more than three years, others hold stocks for barely more than one. Thus, we see most competitors as “traders” and ourselves as investors.

What are the benefits of low turnover?

- > The first and most obvious is low transaction costs. Each time one trades, not only could brokerage and custody commissions

be charged, but the simple act of buying or selling may cause stock prices to move in adverse ways. This is known as “market impact” and, while less obvious than commissions, can be far more costly.

- For a trade to be worthwhile, one needs to make **two** correct decisions: The first being the choice to SELL, followed by another one to BUY. A choice made to HOLD an investment involves only one decision and thus the chances for error could be thought of as reduced by 50%.
- History with a company and its management team are an important element in our investment process. It could take quarters or even years for us to fully develop the trust and confidence required for an investment. Shortening that time frame will most likely result in less-informed decisions.
- For our taxable clients, low turnover often results in more tax-efficient portfolios.

While we cannot guarantee, or even predict, higher returns from this low turnover approach, it is an important component of our methodology and has worked well for us over time. So, in Bocce, if skill and precision are employed to get the ball closest to the pallino, then, while occasionally the winning ball will be knocked away, more often than not accuracy will prevail and win the game. So, too, with investments is care and precision more valuable than change.

Now let’s turn our attention to the financial markets, the results of 2005, and what may lie ahead.

## VALUE EQUITIES STRATEGY

As the following table shows, 2005 was another positive year for nearly all asset classes. For the third year in a row, total returns (including income) as measured in U.S. dollars were positive for stocks, bonds, gold, oil, real estate, domestic and international. Oil prices again led the charge in 2005, both with foreign stocks

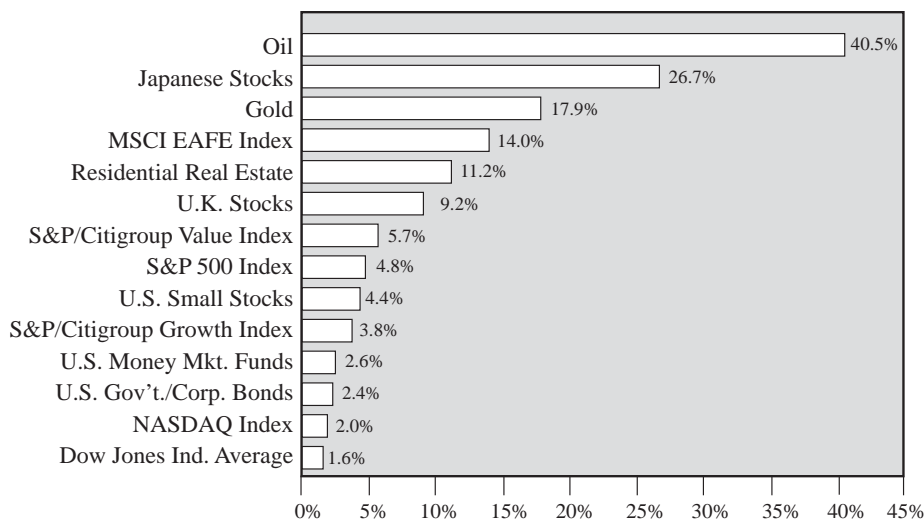
(particularly the heretofore laggard Japanese stock market) close behind and residential real estate up double digits.

While overall residential real estate prices shot up more than 11% for the year, by year-end, new single-family house prices were actually a touch *below* the level of late 2004. Both figures are for the U.S. as a whole, with clear differences from region to region. We are reminded that nationwide, since at least WWII when such statistics are available, house prices in the U.S. (combined new construction and resale for the nation) have never declined. While we are in the majority expecting housing prices to level off (*not* plummet), we are cognizant of the potential negative consequences of being either too optimistic or pessimistic in our thinking and are thus monitoring housing trends closely.

As for our outlook, with the housing caveat just mentioned, we remain sanguine for the U.S. and global economies and thus for equity markets worldwide. One reason not yet mentioned for employing a low turnover approach is that most worthwhile investment trends are long term in nature, lasting five years or more. This gives us the luxury of identifying these trends and ensuring they are firmly in place (often missing the first year or two of their duration) before investing. One such trend we see is a resumption of global productivity growth spurred on by investments in technology. Dr. Ed Yardeni of Oak Associates, Ltd. sums up our thoughts as follows:

*“I believe we are on the threshold of the second stage of the High-Tech Revolution. Like the first stage during the 1990s, it should boost productivity, profitability and prosperity. It is likely to be much more global than the first stage, benefitting more consumers around the world. [As one example] it is already enabling entrepreneurs and small businesses to find customers for their goods and services on every continent. It is inherently a democratic revolution . . . because it eliminates barriers to entry in most markets and barriers to political enlightenment.”*

### 2005 Asset Performance\*



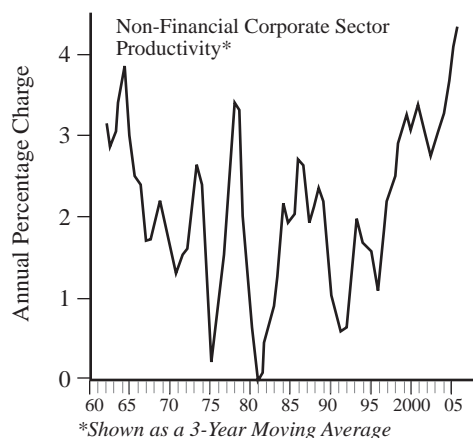
The chart on the following page shows productivity growth for the non-financial corporate sector since 1960. Note that during the late 1990s, productivity actually *slowed* as the implementation of new technological advances took some effort and the nation was operating near its peak capacity. Think of the first few hours after you bought that new DVD player (or iPod!) then followed by the years of enjoyment. Today, as the investments made in prior years are utilized, productivity is surging. We think this may continue.

As productivity advances, real incomes grow, consumers have the ability to increase spending (even without additional home equity gains), factories need to churn out additional goods, companies invest in new productivity-enhancing tools, and the cycle begins anew.

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

Source: Various

## The U.S. Productivity Surge



Source: *The Bank Credit Analyst and the U.S. Dept. of Labor*

Our investment approach is somewhat unique relative to our Value peers as we have often found appropriate investments in the technology sector. Thus, current holdings of **Lucent Technologies, IBM, Molex, Texas Instruments** and others should benefit from the additional productivity-enhancing projects that corporations globally are now embarking upon.

With diversification another distinguishing characteristic of our investing style, two recent (non-tech) additions to our *Intrinsic Value* portfolios include:

## Portfolio Activity

- **Clorox**, best known for its icon brand of bleach, sells other consumer and household products including Kingsford charcoal, Hidden Valley salad dressings, Glad wraps and bags and a suite of household cleaning products. CEO Gerry Johnston has set the company on track to increase profitability in existing businesses while adding at least one “game-changing” new product (like Clorox Toilet Wands and Glad ForceFlex bags) each year. The stock’s modest valuation does not reflect its long-term sustainable high returns on capital nor its positive cash-generating business model.
- **Morgan Stanley** is a product of the 1997 merger between a high-end investment bank and a mass market brokerage firm (Dean Witter) with a large credit card business (Discover). Having floundered under previous management, Morgan Stanley has a newly appointed CEO, John Mack, who returned to the company this past June and provided us the *catalyst* for this new investment. Long-term industry trends are favorable as companies around the world will continue to merge, acquire, restructure and raise capital. Meanwhile, individuals will require greater advice as “baby boomers” become more active in managing their retirement assets. Morgan Stanley has the size, strength and financial wherewithal to aid their customers on these and other matters. We believe our downside in this investment is limited because if Mr. Mack cannot turn around the company on his own, shareholders are likely to insist on a strategic partner or other shareholder value-additive actions.

## INTERNATIONAL STRATEGY

As mentioned earlier, international stock market returns rivaled those of the oil market last year, as measured in local currencies. The MSCI European Australasian Far East Index (EAFE) gained 29.5% in 2005, as measured in local currencies. Often-volatile short-term currency movements took more than half of this gain away, and thus EAFE in dollars rose 14.0%. Japan led the charge (26.7% in dollars and 44.9% in yen), gaining steam in the fourth quarter after Prime Minister Koizumi won a political mandate to continue his successful economic reform programs. Japanese stocks had their biggest annual advance in 17 years.

The U.K. and continental Europe, while still very strong, had more muted gains as their economies remain weak, yet interest rates were raised to head off the threat of inflation. Many emerging markets continued their strength of recent years as low inflation, stable currencies and strong, primarily export-driven economies attracted new capital to the regions. Thus, many Asian stock markets gained more than 50%, while Central and Latin American equities rose as much as 40% (all figures as measured in U.S. dollars). Even though China’s markets (plus those of Hong Kong and Taiwan) did not participate in 2005, the country’s rapid economic growth may still bode well for the future.

We remain firmly convinced that opportunities for investments outside North America are plentiful. To that end, recent new international investments include:

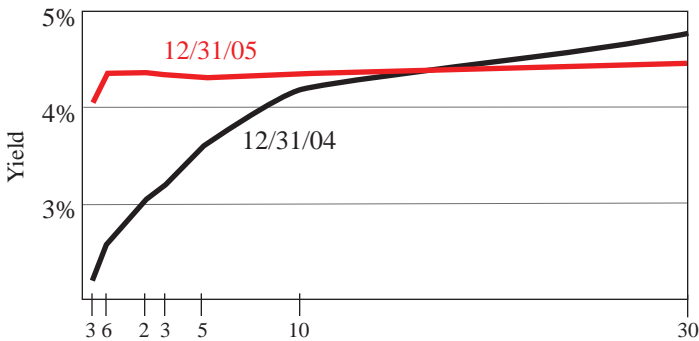
- **Unicredito** (UC) is one of the largest pan-European banks, with a significant presence in Central and Eastern Europe. Our international portfolios received this stock in exchange for tendering holdings of **HVB Group** as part of their merger. Serving more than 28 million customers, UC is expected to benefit from: (i) a consolidating Italian banking market; (ii) a less competitive German market, and (iii) rapidly growing Polish and other “new” European markets. At 1½ times reported book value, 12½ times ’06 earnings and a dividend yield of nearly 4%, we see the current stock price as not reflective of the value being created by the company.
- Swiss-based **Novartis** is one of the world’s largest pharmaceutical and health care companies. It is well balanced between proprietary prescription (65% of sales), generic (11%) and over-the-counter (22%) medicines. Its large stable of products faces little regulatory or patent expiration risk, while its recently announced purchase of Chiron Corp. could provide additional biotech research that may result in new treatments for hard-to-cure diseases. The company’s financial profile is pristine, with very little debt and net after-tax profit margins approaching 20%. Selling at 17½ times next year’s earnings, the stock reflects neither the strength nor the profitability of the enterprise.

## FIXED INCOME STRATEGY

Yet again the Federal Reserve Board (FED) raised interest rates by one-quarter percent in each of its two meetings this past quarter.

The 4.25% Federal Funds rate was raised eight times, or two full percentage points, for all of 2005. It stands far above the 1.00% level of June 2004 when the Fed started raising rates and is now more than halfway to the 6.50% level when it last began lowering rates in early 2001. Mr. Greenspan will preside over one more Fed meeting in late January 2006 and then retire. New Fed Chairman Ben S. Bernanke is likely to continue Greenspan's policies, at least at first, so as to give confidence to the financial markets. We believe the Fed is beginning to see its current policies as approaching "neutral" – as opposed to what had been seen as "accommodative." We may thus, at some point in 2006, witness a pause in the rise in interest rates, awaiting further data and evidence of economic progress.

### U.S. Treasury Yield Curve 12/31/04 versus 12/31/05



Source: Bloomberg

The chart above depicts the shape of the U.S. Treasury yield curve at both the beginning and end of 2005. Note that extreme steepness at the beginning of the year (short rates much lower than long) turned into a slight inversion of the yield curve – in the two- to five-year range – at year's end. Thus, for the first time since late 2000, shorter-term yields are higher than some longer-term yields.

The meaning of this is a current hot topic, as historically this has meant an economic recession is on the way. But Fed Chairman Greenspan has warned that "this time may be different." We must remind investors that the extreme steepness of the curve from late 2000 until earlier this year is the exception and **not** the rule historically. We also note, as detailed by Bear Stearns economist David Malpass, there may be a "reservoir of liquidity left over from 1% interest rates" still causing a tailwind for the U.S. economy.

We thus may expect the yield curve to remain flattish for the foreseeable future (another long-term trend to take advantage of), with Treasury yields across the curve varying between 4% and 5%. These rates could be high enough to stave off inflation (even during periods of high energy prices), yet low enough to keep the economy on its positive trajectory. We must also consider that some parts of the world have

just exited (or may even still be in) a moderate deflation, the spillover effects of which could still impact the U.S.

As with equities, Bocce Ball has taught us to be patient with fixed income strategies. Thus, our strategy for the fixed income portion of MetWest Capital's balanced portfolios has changed little during this time of Fed tightening. We have kept the duration (sensitivity to changes in interest rates) low while emphasizing quality. Mortgage-backed bonds (including AAA-rated government-backed GNMA securities) have been, and remain, favored as slowing prepayment rates have caused these securities to appreciate relative to equivalent corporates and Treasuries. As with all investments, while we continuously reevaluate our strategies, we make changes only when appropriate for our long-term view.

*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

We are often asked, "What is the difference between **trading** and **investing**?" Our answer: Trading is the act of seeking profit from the purchase and sale of a good or service (including securities). The profit is not recognized until a round-trip occurs (both a purchase and sale), as the act is seen as fleeting and not easily replicable. Investing, on the other hand, is the attainment of long-term objectives via the ownership of an income-producing asset.

This quarter we went back 7,000 years to find a parallel between our investment approach and the game of Bocce. We pointed out the benefits of investing over trading and likened it to the precise "lag" of a bocce ball toward the little "pallino." All of the strategies employed at MetWest Capital (Large Cap, Small Cap, International and Global equity and Fixed Income) employ a long-term, low-turnover approach and all have performed well, both of late and over time.

Low turnover in and of itself is not a stated goal of our approach. Rather, it is a by-product of careful research. So while we are highlighting low turnover this quarter, it has increased in the past and could, once again, increase modestly. Our sanguine view of global economies and markets has led us to uncover many interesting investment opportunities. As we complete our analyses, surely some of them will appear optimal relative to current holdings. We will never hesitate to act when such circumstances dictate.

*We'd like to welcome the newest member of our "Bocce Ball" team: Jay Cunningham, CFA joined us to focus on our universe of global financial services opportunities.*



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