

# Capital Visions

## THE MOSAIC

We lined up early in the morning, just outside the walls of the Vatican. It was a drizzly day in Rome—perfect, we thought, to tour St. Peter’s Basilica. Once inside the world’s smallest nation (it occupies about one square mile), we noted that this country has its own stamps, currency, radio station and railway. It has no army, but the Swiss Guard keeps watch while scores of docents attempt to keep the crowds orderly, but mostly quiet (especially in the Sistine Chapel).

The Basilica was built over the tomb of the apostle Peter, crucified circa year 67. The first church was erected in the fourth century by order of Emperor Constantine. One thousand years later, in 1377, the Vatican became the official residence of the Pope.

By that time, the Basilica was in poor condition and had to be torn down. It took a little while (two hundred years, give or take a few) to design and construct the new church. With the help of a young artist by the name of Michelangelo, among others, what is today the world’s largest church was inaugurated in 1593.

As we marveled at the columns, statues and numerous altars, we were struck not only by the enormity of the building, but also by its perfection. It is told that after Michelangelo’s death in 1564, it took twenty years to find another architect to complete the dome, as many feared they would suffer in comparison to the great one. The huge bronze entrance doors are 550 years old, yet they shine like a mirror. Where an aged look is appropriate, that, too, comes through. So the Porta Santa, the Holy Door that opens only during Jubilee Years (the last one being 2000) is wooden but appears almost stone like.

We were in awe of the myriad of paintings throughout the church, likening it more to a museum than a place of worship. One in particular caught our eye as we passed by—Raphael’s *Transfiguration*. The Italian artist (1483-1520) was commissioned to paint a piece to hang above the altar. It’s an extremely complex work depicting two episodes of the Gospel. The top portion shows Christ between two prophets, while the bottom portion shows a meeting of the Apostles, all placed in a “live action” setting. We have included a small part of the work here, but such a reproduction cannot do the work justice.

At first we stood 50 feet away from the artwork to take in its entirety. As we moved closer to examine the subplots of the picture, we began to notice that this wasn’t a *painting* at all. It was a reproduction of the original done in *mosaic*. Thus all the tiny, intricately arranged pieces of stone, tile and glass placed into a cement backing created this amazingly clear picture. Each small piece of tile alone, while necessary, does not convey the meaning or beauty of this creation.



Raphael's Transfiguration - Raffaello Sanzio

But when looked at together, especially with the benefit of the appropriate distance, a clear and beautiful image emerged. Such was the case for Raphael’s masterpiece and such may be the case in investing. Let’s take a step back and explain via two examples.

### Two Examples

We are often asked about our perspective on financial markets, the economy or specific industries. Will the recent strength of the Korean won buoy the competitiveness of U.S.-based manufacturers? Will continued growth in the money supply cause higher inflation? Will the slowdown in new home sales impact consumer

spending? It’s easy for “experts” to study these factors and come to opposite conclusions. So investing with a “top-down” view is inherently flawed, in our opinion. Instead, we at MetWest Capital gather intelligence from the bottom up. Akin to assembling a mosaic, we analyze individual companies, developing various themes in the process.

Let’s use two examples: European equities and U.S. banks.

**1. European equities.** Similar to what Japanese companies did during most of the past fifteen years, European companies are shoring up their balance sheets, conserving and building cash and becoming more innovative developers and leaner manufacturers. They are doing so because they MUST; their sluggish economies will not help them.

Take, for example, the world’s second-largest retailer, **Carrefour**. Its hypermarkets are similar to Wal-Mart Supercenters. Owned in our international portfolios since July 2005, the company has been hurt by some very strict retailing laws in its home country of France, coupled with inroads made by discount retailers. This is a common theme among many European consumer-related companies. At first, the macro factors overwhelmed the company’s ability to cope. Then we saw the beginnings of strategies for improvement.

Within France, the company lowered prices and offered better selections. It assured shoppers of higher-quality branded products in a more inviting environment at nearly the same price points as the competition. Next, it further expanded its international operations (now accounting for greater than half its sales) by focusing on a few key markets (such as Spain, China and Taiwan) where it held competitive advantages. Finally, it focused on shareholder-friendly profitability metrics such as return-on-capital to boost its returns and share price.

While Carrefour is but one company, we have noticed others following similar strategies. Suez, a utility also based in France, HVB Group, a bank in Germany, Unicredito, a bank in Italy and even what some may view as structurally disadvantaged companies—such as KLM Royal Dutch Airlines—all followed like plans. The “mosaic” being created (a single “tile” at a time) is one very different from that fashioned by looking only at the macro factor of sluggish consumer spending. We believe that oftentimes macro statistics are **lagging** indicators of prosperity. By the time the macro indicators turn positive, companies such as those described above will have higher profit levels and thus, higher stock prices—too late for investors to benefit from the improvements.

**2. U.S. banks.** Our first example was one of improving fortunes of companies not yet reflected in regional statistics. Next we show why we may be underweight in a particular industry—in this case, U.S. banks.

In 2000, banks represented about 14% of the value of MetWest Capital’s equity portfolios. Today, banks represent only 7% of portfolios. What happened? Again, we have employed an individual company, bottom-up analysis methodology. One-by-one over the past several years, we have sold some of our banking investments and have not always replaced them with others. From the casual observer’s perspective, it may appear that we made a macro call and liquidated positions in bank stocks. But just like the mosaic in St. Peter’s, one must get closer to see that the picture is comprised of many individual pieces.

Back in 2000 we owned Comerica, Fleet Boston Financial, Washington Mutual, among other banks. One by one, either *catalysts* were fulfilled (as with Comerica), valuation targets were realized (as when Fleet Boston was acquired by Bank of America) or our expectation for long-term fundamental prospects deteriorated (such as with the consumer mortgage-heavy WaMu). Sometimes we found a more optimal bank in which to invest, and thus we purchased **TCF Financial** and **J.P. Morgan** along the way. But mostly we discovered what we consider to be better investment opportunities in other industries.

As the previous chart shows, these sales occurred as stock prices of the group in general were moving higher. The chart is a ratio (of prices only) of the Standard & Poor’s Banking Index relative to the S&P 500 Index from January 1980 through February 2006. Note that bank stocks tend to go through long cycles of under- and then out-performance. This is typical of many industries. While fundamental prospects, rather than stock price movements, have always driven our investment decisions, the latter sometimes confirm the business environment as it develops (often *after* the fact).

It is usually only after the “pieces” have been put in place that we can take a step back and observe the themes that are consistent across various investment decisions. Banking themes today include:

- Many banks’ reported earnings may currently *overestimate* their earnings *power* due to unsustainably low bad-debt expenses. While Comerica may report earnings of \$4.80 per share this year, when one normalizes bad debts, its earnings may be closer to \$4.30 per share. This lower earnings figure may not yet be factored into the current stock price.
- In recent years, with interest rates remaining very low, consumer banks have had a relatively easy time raising low cost deposits. This may have allowed their net interest margins (the difference between what they can earn on loans and what they must pay to attract deposits) to widen to an unsustainable level. Washington Mutual may be an example of such a bank.
- While the low absolute level of interest rates helped in deposit gathering, the very steep yield curve (until recently) allowed for wider “carry trades” (lending long while borrowing short) than we are likely to see for a while.

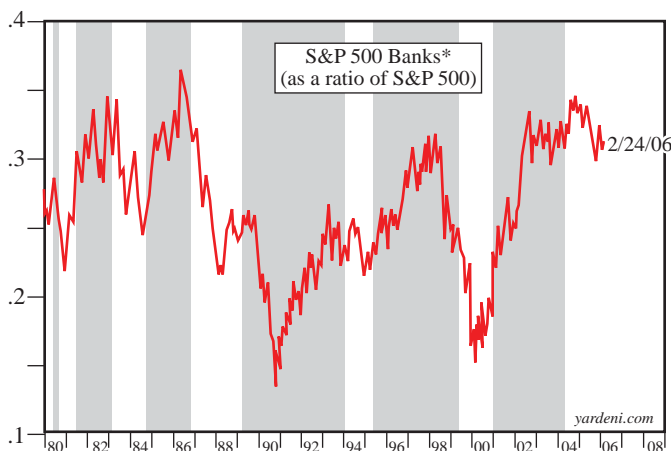
These and other factors may play out over the coming years (not necessarily quarters) and may, for certain banks, be offset by more positive factors. This is why we are constantly evolving the “mosaic” of our thinking and always maintain a longer-term perspective.

We will therefore continue our disciplined approach to investing based upon the fundamental prospects of individual companies, allowing for some storytelling only after the fact. Now let’s turn our attention to the financial markets, the results of the first quarter of 2006 and what may lie ahead.

## VALUE EQUITY STRATEGY

Occasionally, the picture doesn’t look at all like the individual tiles that created the mosaic. U.S. equity markets during the first quarter of 2006 are one such example. Oil and other commodity prices gyrated with international politics, interest rates marched higher almost daily (just when we started getting used to the “conundrum” of low long-term rates) and many companies signaled caution in their near-term business outlooks. While it seemed like the overall market should have been weak, U.S. equities had a good quarter. The S&P 500 Index including income gained 4.2%. Smaller **and** larger companies did even better, with the Dow Jones Industrial Average slightly outperforming the S&P 500 Index and small cap equities jumping nearly 14.0%.

### Banks

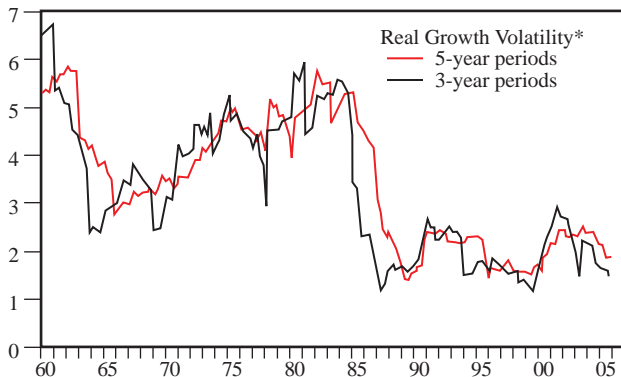


Note: Shaded areas show periods of monetary easing.  
\* Monthly through December 1990, then weekly.  
Source: Standard & Poor’s and Oak Associates, Ltd.

Our long-term outlook for stocks remains positive. While “noise” could always move markets in the short term, and the world always appears in a precarious state, many of the companies we follow show no indication for a change from the positive trends driving equities higher longer term.

One reason for our optimism harkens back to our thesis that the coming decade looks similar in many ways to that of the 1960s. The following chart is another “tile,” or data point, to support that theory.

### Volatility in Real GDP Growth Has Moderated



\*Standard deviation of quarterly annualized growth rates.  
Source: U.S. Department of Commerce and Goldman Sachs

This graph measures the volatility of U.S. real GDP growth from 1960 through today. Note that the high volatility of the 1950s gave way to more predictable growth in the 1960s. Today, we remain at the low volatility levels witnessed during much of the past decade. Low economic volatility means that individuals and corporations can have confidence in planning assumptions. If business leaders have greater certainty in their investment assumptions, then they may be more likely to move forward with those investments. If, for example, semiconductor companies *knew* that chip growth would be steady and predictable, then they may invest in new fabrication equipment. If, on the other hand, technology sales were unpredictable, then the new plants may never get off the drawing board.

While we may expect some pickup in the volatility of economic activity, should it remain near current levels, investment and spending patterns may continue on their current upward trajectory. This is what the individual data points are currently telling us. With the goal of continuing to uncover unique and attractive businesses, recent additions to our *Intrinsic Value* portfolios include:

### Portfolio Activity

- **UST, Inc.** is the world’s-largest producer of moist, smokeless tobacco (also known as snuff). It is a relatively small market existing mostly in the U.S., Sweden and a few other countries. Only 5% as many people in the U.S. use snuff as smoke cigarettes, but unlike the latter, snuff use is growing. *Skoal* and *Copenhagen* are by far the two leading brands and UST owns both. Recent inroads by cheaper brands have caused the stock price of UST to come under pressure, allowing us the opportunity to invest. With substantial cash flow and marketing prowess, we are confident that UST will stem the loss of market share over

time. While we wait, the stock offers a 5½% dividend yield and the company has grown the dividend consistently for nearly twenty years.

- **Oracle Corporation** is the second-largest software company in the world (after Microsoft and ahead of Germany’s SAP). Historically focused on the database segment, recent acquisitions have vaulted the company to become one of the top applications providers. Corporate customers can now use Oracle software for gathering, storing, organizing and analyzing all of their data. New license sales have slowed, causing the stock price to decline. But we see the real value of the company to be the recurring revenue stream from existing clients. With greater than 40% operating margins, we believe Oracle is worth much more than the 14x earnings for which it sells.

### INTERNATIONAL STRATEGY

With the value of the U.S. dollar little changed for the past quarter, foreign developed stock markets, as measured both in local currencies and in dollars, rose more than U.S. stocks. The MSCI Europe Australasian Far East Index (EAFE) gained 9.5%, with Japan somewhat lagging (after strong outperformance in 2005). Emerging markets, historically “spooked” by higher U.S. interest rates, are performing differently this time around, with Brazilian, Indian, Russian, Vietnamese and other markets gaining more than 20% in U.S. dollars.

Interest rates are on the rise the world over. The U.S. has been raising rates every other month for nearly two years. The European Central Bank (ECB) raised rates this past quarter, the second time during that period. The ECB benchmark rate now stands at 2.5%. Even Japan is signaling an end to its zero interest rate policy. The good news with regard to the rate hikes is its indication of strong global economies. The downside is the potential for higher inflation that overheated economies may bring. Bank of Japan Governor Toshihiko Fukui said that “...while not a binding target, the bank today said it would be desirable to keep consumer price rises within a range of zero to two percent . . .” Fukui further said that “...policy will remain accommodative and interest rates will be kept at very low levels.” This is to ensure that the mistakes of the 1990s (changing policy and raising rates as soon as it looked like the deflation had ended, as opposed to waiting for true sustainable evidence) are not repeated.

Our mosaic approach to investing extends outside of the U.S. border and we remain convinced that global investment opportunities are plentiful. To that end, recent new international investments include:

- **Barclays** is the third-largest bank headquartered in the U.K. Its businesses span the globe, including retail banking in more than 60 countries, corporate banking throughout Europe and Asia and investment management worldwide through Barclays Global Investors (BGI). BGI is best known for its “iShares”-branded electronically traded funds (ETFs) and has grown to dominate this market. With a 4% (and rapidly growing) dividend and a stock selling at 11x earnings, we believe that Barclays is an undiscovered bank whose long-term prospects are not yet reflected in its current valuation.

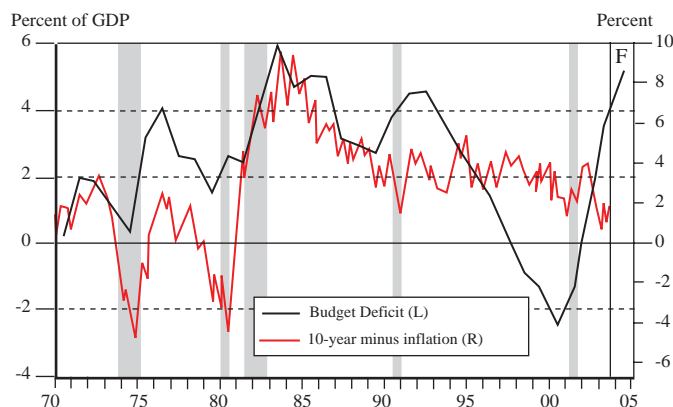
- **Royal Caribbean Cruises Ltd.** truly has the global demographic wind at its back. As the world's second-largest cruise ship operator, its 29 ships (with several more on order) service nearly three million voyagers annually. An aging population, growing disposable income, greater acceptance of the cruise "experience" and the ability to provide more amenities on today's larger ships will all serve to expand the demand for RCL's product. As industry supply grows slowly, this higher demand may translate into rising "yield" (revenues per passenger) and thus profits. While today cruising is mostly an American industry, its appeal is likely to broaden globally and provide another leg up for this concentrated industry.

## FIXED INCOME STRATEGY

The "changing of the guard" went smoothly last quarter and, just as his predecessor did, incoming Federal Reserve Board (FED) Chairman Ben Bernanke raised the Fed Funds rate another quarter of one percent, to 4.75%.

A fixed income-related "mosaic" worth investigating is the U.S. federal budget deficit. While we have long been skeptical of the meaning of trade, current account and personal debt deficits, we do believe that government deficits matter. The following chart is helpful in explaining our views, but their derivation comes from companies such as **Vulcan Materials, IBM, Autodesk and General Motors**. These companies (and others) do a lot of business with municipalities. These companies sell aggregate materials to build roads and bridges, computer outsourcing services, software to help design civil projects, and vehicles like police cars. Since our research of these companies continues to show the increasing multitude of available contracts, we know that state and local budget spending is likely to remain robust. On the funding side, increased home values have property taxes literally going through the roof.

**Deficits Matter**  
Budget Deficit versus Real Interest Rates



Source: Bureau of Economic Analysis, Department of the Treasury and Merrill Lynch

As for the federal deficit, contact with the companies named above plus defense contractors (such as **Boeing** and **L3 Communications**) leads us to conclude that spending growth will continue. But spending is only half of the equation. Since 1960, federal receipts (individual, corporate and social security taxes) have averaged 18% of GDP and are near 17% today. Outlays (spending) have averaged 21% of GDP but are near 25% currently, resulting in an 8% deficit today as depicted by the solid blue line in the previous chart.

The red line is the real 10-year U.S. government bond yield. Note that, while not perfect, there is a high correlation between the budget deficit and real interest rates. So if we expect the budget deficit to remain wide, we may then believe that real interest rates could rise. Should inflation remain at or above today's levels (4.2% change year over year including food and energy), then a 2% to 4% real yield on top of that (as the chart may predict) would result in 10-year yields approaching 8%, far higher than most investors (including us) anticipate. We will carefully monitor these trends while maintaining a conservative posture for the fixed income portion of MetWest Capital's balanced portfolios.

*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

Each quarter we attempt to "enlighten" you, our clients and interested readers, about our investment methodology. This quarter we used "The Mosaic" in order to highlight our individual company approach. We pointed out that individual tiles, painted and placed side by side, can, when viewed from afar, look as extraordinary as a painting. Such is the case for Raphael's *Transfiguration* that hangs in St. Peter's Basilica.

Just as the unique tiles of the mosaic form the picture, so too can information gathered from individual companies create our "big picture" view of the economy and financial markets. We find this method more reliable than traditional macro analysis, but use it only AFTER THE FACT to explain our current portfolio theses. We have found that most macro views have little predictive power and thus we rely more on the accumulation of data from companies, one at a time.

We described two themes thus formed: a positive view of European equities and a less sanguine picture for most U.S. banks. We remain cognizant, however, that not all businesses will follow the trend of the mosaic. We will continue, therefore, to focus on identifying unique companies whose business prospects are bright, regardless of how dull the overall painting may be.

*We deeply value our continued relationship with you and always welcome your feedback, comments, questions and suggestions on the above or any other topics.*



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