

# Capital Visions

## ABRACADABRA

The magician makes his (or her) way to the stage. The audience, enthralled by the grandeur of the performance, waits silently in anticipation. The magician's assistant is already present, standing next to a large object (it doesn't matter what it is; sometimes it is even alive). The two meet at center stage, take a brief welcoming bow and then walk off together. Moments later the pair returns, walking briskly toward the large object. They are dragging a huge white sheet that seems to dance like water on the stage as they flip it up and down while pulling it toward the large object. They reach center stage and take another little bow.

After a brief theatrical pause, one can hear the background music, heretofore barely audible, slowly build. It is as if the audience should stand, but they do not. Now both magician and assistant take a strong hold of the white sheet, raise it above their heads and walk around opposite ends of the large object that has remained motionless (even if alive). Completely covering the object so that its outline is still visible beneath the sheet, the two return to face the audience. Another theatrical pause, this time a bit longer than the last.

The music is now reaching a crescendo as the two on stage slowly turn back, walk to opposite ends of the covered object, take hold of the sheet once more and with dramatic flair, yank the sheet away . . . to reveal . . . nothing! *Abacadabra*, the object has vanished.

We describe this often-played scene because this past quarter the greatest magic "trick" in the history of the world was performed. No, it wasn't Houdini brought back to life. No, it wasn't the Lance Burton show in Las Vegas. It wasn't even David Copperfield making the Statue of Liberty disappear. It took place in Prague, Czech Republic as scientists made the planet Pluto disappear. *Poof!* Gone. Unlike magicians who are sworn to silence, we at MetWest Capital will reveal the secret of this, the world's greatest magic trick. Pluto didn't really disappear. Surprised?

Pluto, the ninth and farthest planet from our sun, was discovered by American astronomer Clyde Tombaugh in 1930 and named for the Roman god of the underworld. But this past August, the International Astronomical Union changed its definition of a planet. That distinction shall henceforth be awarded only to "a celestial body that is in orbit around the sun, has sufficient mass for its self-gravity to overcome rigid body forces so that it assumes a nearly round shape, and has cleared the neighborhood around its orbit." Thus, from this day forward (or until the definition changes again), Mercury, Venus, Earth, Mars, Jupiter, Saturn, Uranus and Neptune shall be planets. Pluto, which is only one-fifth the size of Earth's moon and has an eccentric orbit, will be dubbed a "dwarf planet." *Poof!* Pluto is a dwarf.

Pluto didn't really disappear. Actually, it hasn't changed at all. It is still made mostly of rock and ice. It still has very little atmosphere. It still takes nearly seven days to rotate and 248 years to make its way around the sun. It is only our *perception* of the object that has changed. Just like the magic trick on stage, the hand may be quicker than the eye while perception catches up with reality. So, too, in investing.

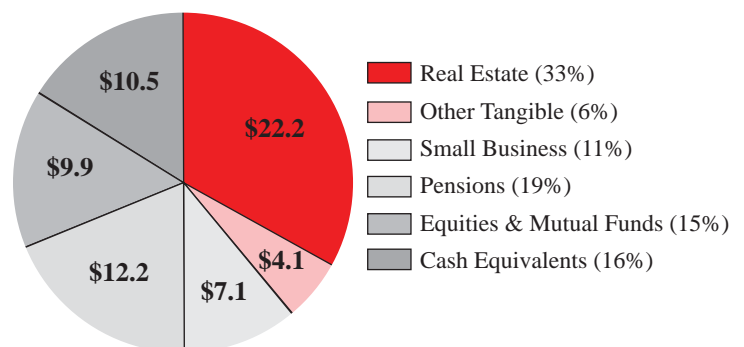
### Perception versus Reality

Is economics an art or a science? While mathematics and statistics are needed to build and study economic models, such models are only as useful as the data inputs that, themselves, are subject to interpretation and opinion. There is no clear answer to the question. It is often perception versus reality. As an example, let's briefly examine the expected impact that the Federal Reserve's (Fed's) two years of interest rate hikes may have on the U.S. economy.

Conventional "wisdom" goes something like this: As rates rise, consumers must spend a greater portion of their incomes on servicing debt. This leaves less for other consumption (cars, vacations, clothes, etc.) Reduced consumption (coupled with recent dramatic price increases) will reduce housing demand and possibly cause a housing crash. Housing weakness (by itself only 5% of GDP) will have a contagious effect by decreasing equity extraction, thereby causing more weakness for all consumer goods. Weakness for the consumer means weakness for business, leading to less hiring, higher unemployment, lower wage growth and yet lower consumption—and a recession ensues. Sounds awful, but plausible.

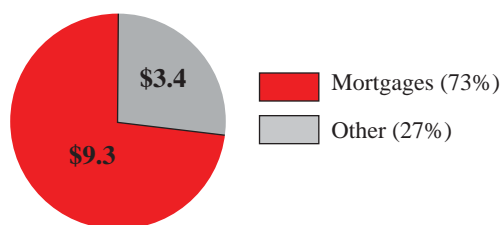
But, *abracadabra*, let's consider reality from another angle by examining the following pie charts.

**U.S. Household Balance Sheet**  
Assets = \$66.0 trillion



## U.S. Household Balance Sheet

### Liabilities = \$12.7 trillion



Source: Bear Stearns, Prudential and the Federal Reserve Board

These pie charts show an estimate of the composition of the assets and liabilities of all U.S. households in aggregate as of June 30, 2006. The first thing to note (depicted by the relative size of the two pies) is the significant net worth of U.S. households. The red portion of the asset pie represents tangible (“real”) assets. The blue portion represents financial (“liquid”) assets. Assets total \$66.0 trillion (T) while, as shown in the second pie, liabilities are \$12.7 T. This leaves a net worth of \$53.3 T, or \$184,000 for each of our country’s 290 million legal inhabitants.

Note that while significant, real estate holdings constitute only about one-third of gross household assets. Note, too, that interest-earning cash equivalents comprise 16% of the \$66.0 T of total assets, or \$10.5 T. This is over one trillion dollars **more** than the total of all mortgage debt. So while the cost of mortgage debt is rising, the interest earned on bank accounts, CDs, money market funds, etc. is rising faster. These numbers are taken in aggregate, meaning it is unlikely the same individuals will have both abundant cash **and** hefty debt. But for our assessment of the financial well-being of the nation, those with assets will generally have more spending power to offset those with the liabilities. So, while the sentiment of flatter (or lower) housing prices may be a negative, interest costs may not be.

Other points from the charts to consider (some potentially positive and others negative) include:

- Real estate’s share of the pie has been very volatile, moving with house prices. But the average since 1952 has been 32%, very close to where we are today. The recent dramatic rise in housing values merely made up for the prior decade when financial asset prices (stocks and bonds) rose while real estate gains were modest.
- Homeowners have become more leveraged to their real estate over time. Back in 1990, for instance, mortgages represented only 31% of the value of homes. Today, homeowners owe nearly 42% on the value of their homes. This higher debt level, however, is offset by the fact that interest rates are lower, meaning the average monthly payment per home has held steady.
- Pension and other retirement assets (including a portion of the Equities + Mutual Fund slice) have grown steadily over many decades to their current portion of 34% combined. This is up from 26% a decade ago. So the oft-reported “savings rate” of our country is likely underestimated.

- The cash-equivalent share of assets has been declining. Cash represented 23% of assets in 1990, but only 16% recently. This decrease may be perceived as both good and bad. On the one hand, less cash means fewer reserves for emergencies or an economic slowdown. Such a downturn, therefore, may be more pronounced. But the cause of less cash is likely the opportunity for higher returns from alternative investments. Holdings of stocks, bonds and real estate as well as small business ownership have grown. These investments may be more productive assets than cash, boding well for future productivity and growth.

Just as magicians don’t really make anything disappear and Pluto still exists (it simply has a different title), so, too, can economics be viewed from different angles. Very plausible, yet sometimes opposite, conclusions may be drawn from identical data. If scientists can’t consistently agree on what Pluto is, how are economists going to predict the future course of the U.S. economy? This is one of the reasons we at MetWest Capital choose not to dwell too much on broad economics, freeing us to focus on individual businesses.

Keeping this in mind, let’s turn our attention to the financial markets, the results of the third quarter of 2006 and what may lie ahead.

## VALUE EQUITIES STRATEGY

U.S. financial markets continued what some have called surprising strength through the third quarter of 2006. The S&P 500 Index including income gained +5.7% for the quarter and is up +8.5% year to date. Large cap, small cap, growth- and value-oriented equities all rose, with only technology stocks lagging materially.

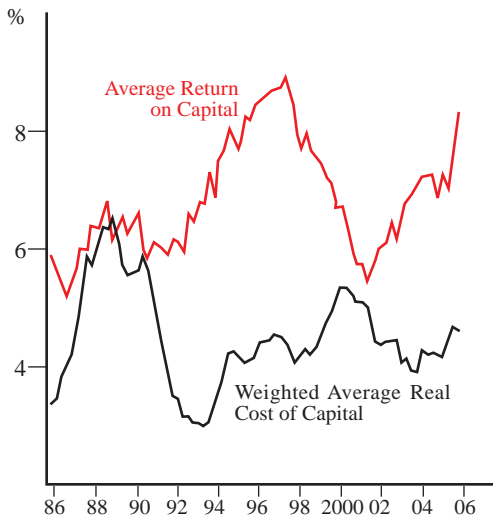
As discussed in the prior section, the U.S. housing market is a focus for many market soothsayers. According to *The Bank Credit Analyst*, “The national home price index has not declined on a calendar year basis since the 1930s, but there is a chance that it could happen in the current cycle.” But again, we point to the difference between perception and reality. As both the prices of homes and the number sold have been at such elevated levels for almost a decade, a decline back to more normal levels is all but inevitable. Furthermore, we believe such a correction may be healthy and, if housing declines modestly (as opposed to stopping cold), the pause could serve to **extend** the current economic expansion, not **shorten** it as conventional wisdom may surmise.

This is because other parts of the economy (business investment, net exports and state and local government spending, for instance) could take up the slack of housing. Meanwhile, monetary conditions would likely not tighten further, and thus other interest-sensitive industries may continue to do well. Eventually, housing will rebound as it always does, but we don’t expect a resumption of outsized real estate price increases for potentially years to come.

One area of potential longer-term concern, however, is corporate profitability. We believe that just as housing prices could not spiral upward (toward Pluto?) forever, there is a limit to how

much money companies can earn. The following chart highlights our point.

### Returns on Capital (Non-Financial Corporate Sector)



Source: The Bank Credit Analyst

Here we see the cost of business capital (solid blue line) versus the returns that capital enjoys (solid red line). Note the historically high level of profits that businesses now earn. This has come *despite* rising input costs (particularly raw materials and energy) and heightened international competition. One of the reasons for this strength is the lagged effect of the deployment of new technologies that began in the 1990s. We believe it is only today that companies are reaping the true benefits of all the new systems, software and communications equipment they started buying last decade. This, coupled with labor's inability to fully share in the benefits of this productivity, has resulted in historically high profits.

We believe that the benefits of a wealthy society must broaden beyond corporate profits—either voluntarily (a good thing) or by edict. This means that at least some portion of the future growth in earnings should be “sacrificed” to pay for higher wages, benefits or other societal needs. While we are very big believers in free enterprise, we are also pragmatists, understanding that those *without* will always demand a share from those *with*. As we live in a society of one person/one vote, if those without grow in number, eventually they will elect those who believe in forced transfers of wealth (i.e., taxes). This is not the most efficient way to democratize society, and we are hopeful that companies will institute policies to avoid such forceful measures.

Our concern is that this “broadening” of benefits means that, while corporations may still earn respectable returns in excess of their costs of capital, the gap between the two may not widen further. Over the coming years, the U.S. population will likely continue to grow about one percent annually. Consumption per capita may expand (as it always does) modestly, and inflation could level out near 3%. Given this scenario, nominal corporate sales may grow about 5%. Even if margins still expand a bit further due to continued productivity gains, corporate profits are unlikely to grow more than 7% annually. Many estimates of future earnings gains are above

this level and thus other investors could be disappointed, driving share prices temporarily lower.

While we believe the above scenario could play out, margin compression could be offset by balance sheet restructuring (including share repurchases) and other corporate actions designed to maintain profitability. In any event, changes are likely to occur gradually (even if by mandate), and thus our individual company focus should help identify those firms that are forward thinking and those that will be “dragged” along. The anticipators could make for better investing. This is but one of many long-term trends we consider in our company analyses.

## INTERNATIONAL STRATEGY

It was not too long ago that when the U.S. “sneezed,” the rest of the world “caught a cold.” That is, the U.S. economy was the engine of growth for just about everyone else. While still true to a certain extent, the overseas influence of U.S. economic activity is diminishing—and this trend is likely to continue.

While a significant share of global exports involve the U.S. on one side or the other, with each passing year more of the world's trade is bypassing the U.S. For example, Brazil is now a major supplier of agricultural commodities to both Europe and Asia, usurping the U.S.'s role as the “bread basket” of the world. Japan, long a big exporter of consumer items (cars, electronics, etc.) to the U.S., is now finding new markets in China, India and Vietnam. While some countries (Canada and Mexico, for instance) are still inextricably intertwined economically with the U.S., most others continue to broaden their economies.

Domestic consumption within foreign economies is also fueling this trend as international per capita GDP closes the gap with the U.S. This allows local Chinese, for example, to buy televisions for their own use and not merely assemble them for American living rooms. We find this trend encouraging.

In the past when it appeared as if the U.S. economy was slowing down (as today), international stock markets corrected markedly. But with the caveat that the U.S. economy currently remains in an uptrend, for the reasons mentioned, thus far this time seems different. Foreign markets, as measured in dollars, rose about +4.0% (as measured by the MSCI Europe Australasian Far East – EAFE – Index) for this past quarter. Year to date, local currency EAFE is up +9.2% while, as measured in a weakening dollar, EAFE is up +14.9%, all figures including income. After its strong showing last year, Japan's stock market is one of the weakest thus far in 2006.

As Japanese Prime Minister Junichiro Koizumi hands the reins over to his successor, 52-year-old Shinzo Abe, Japan continues its economic recovery. The Ministry of Land reported that as of July 1, for the first time since 1990, commercial and residential land prices rose (0.9% year over year) in the three largest metropolitan areas of Tokyo, Osaka and Nagoya. While Japanese stock prices have corrected recently, this may have been expected. Factors implying such a hiatus include:

- > The need for a breather after having risen 45% (in Yen) during 2005.

- The end of the Bank of Japan's zero interest-rate policy as short-term rates were raised to a "whopping" 0.25% on July 14—the first change in six years.
- The mistaken belief that a slowdown in the U.S. economy would significantly impact Japan's nascent recovery.

We remain sanguine about the future of Japan's economy and financial markets and have maintained about one-quarter of our International portfolios invested in companies headquartered in that country. Furthermore, our investments are focused disproportionately in companies that may benefit from a resurgent Japanese consumer. Thus **Toray Industries** (a manufacturer of textiles, chemicals and engineered plastics), **Aeon** (one of Japan's largest retailers) and **Mitsubishi UFJ Financial** (the country's largest bank) could all benefit from the continuing comeback of the world's second-largest economy.

## INVESTMENT ACTIVITY

Past issues of *Capital Visions* included portfolio activity sections in both the Value Equities and the International portions. Beginning this quarter we will combine those two into one "Investment Activity" section. Here we will briefly highlight a few new investments from any or all of MetWest Capital's equity strategies: *Intrinsic* (Large Cap) Value, Small Cap Value, International Core Value and Global *Intrinsic* Value. In addition, we will continue to offer insight into the fixed income portion of our Balanced strategy in the separate "Fixed Income Strategy" section that follows.

The following new investments were selected as representative and do not necessarily reflect our "best" or "highest-conviction" ideas:

- **Aflac Inc.** is best known for its iconic "duck" advertisements in the U.S. Its biggest business, however, is in Japan, where it is one of that country's largest supplemental life and health insurance providers. The company has been a model of consistency over many years, due to its ability to offer unique products tailored to underserved markets and distributed through highly effective alternative channels (such as workplace payroll deductions). Short-term factors have caused the stock price to decline, offering us the ability to invest at a discount in this global, value-additive enterprise.
- **Unilever**, recently purchased in our International portfolios, is one of the world's largest food and household products companies. Dual-headquartered in Rotterdam, Netherlands and London, England, its familiar brands include Lipton tea, Hellmann's and Best Foods mayonnaise, Breyer's and Ben & Jerry's ice cream, Dove soap, Vaseline and many others. Volume trends have been weaker than normal in recent years, and the stock's current valuation reflects this disappointment. But the company remains a marketing and new products powerhouse, both inventing new categories (such as with Axe body sprays) and extending existing brands (such as Dove into hair care). With 38% of its sales generated in developing markets, the company has leading brands in many rapidly growing countries. A 4½% dividend yield affords us the opportunity to give the company the

time it needs to resume its industry-leading ways.

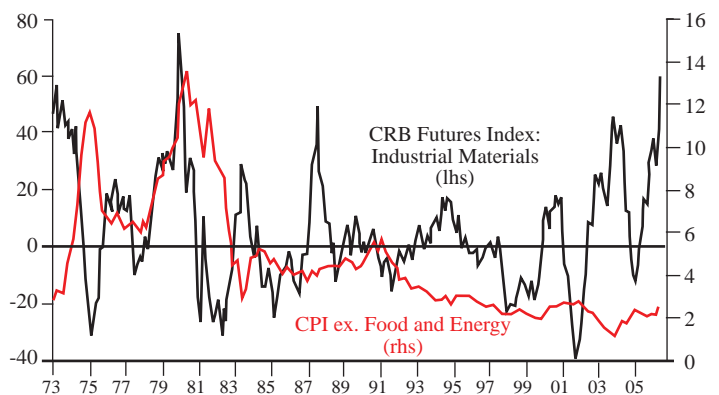
- **ITC Holdings Corp.** is the first and only publicly traded, independent electricity-transmission company in the U.S. Based in Michigan, it is a \$1 billion market cap company that owns and operates a regulated high-voltage system that transmits electricity from generating stations to local distribution facilities. It owns neither generation nor end-client-facing facilities. After years of systemwide underinvestment in electricity transmission infrastructure and the scare of the 2003 blackout in the northeastern U.S., transmission is once again an area of focus for the utilities industry, as well as for federal and state regulators. Given its unique focus, we believe ITC to be a high-quality, pure-play opportunity, with earnings prospects unique among its peers. ITC stock's current valuation does not, by our work, reflect the company's strong underlying fundamentals, predictability and attractive business model.

## FIXED INCOME STRATEGY

"Clearly we are now much closer to the end of the rate hikes than the beginning." Without knowing precisely when the Fed would stop its uninterrupted two-year tightening, we made this comment last quarter, thinking it would be soon. Since then, incoming Fed Chairman Ben Bernanke has gone two consecutive meetings without altering rates. After seventeen consecutive hikes, the Fed is now on hold with short-term rates stuck at 5.25%. Within 50 basis points, we think we could be "stuck" here for some time.

Some investors are worried about the inflationary effects of the recent rise in commodity prices. While we can't summarily dismiss its impact, we believe the price increases for gold, silver, aluminum, copper, magnesium and even gasoline may not find their way broadly through to product and services end prices paid by consumers. The following chart corroborates our thinking.

### Core Inflation (Year/Year % Change)



Source: Bureau of Labor Statistics, Merrill Lynch

This graph, dating back to 1973, depicts the core (excluding food and energy) Consumer Price Index (CPI) as the red line (right-hand scale centered at 5½%) versus the Commodity Research Bureau (CRB) Industrial Materials Price Index as the blue line (left-hand scale centered at 0%). Note that thirty years ago (when Pluto was still our ninth planet), there was a high correlation between

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industrial materials prices and core CPI. But since about 1983, that correlation has dramatically declined.

One point not made obvious by the chart is that commodity prices have gone almost nowhere over the past 40 years, while overall inflation has been positive. As a matter of fact, *The Bank Credit Analyst* has pointed out that “. . . the 2005 level [of real commodity prices] is down 75% over the previous 150 years. This covered periods of exceptional economic growth, including the opening up and development of North America, the industrialization of Europe, and the rebound in activity and world trade after WWII.” Of course there were periods of substantial increases, but the long-term downward trend remains unbroken.

The reason prices are flat over the long run is that the world continues to develop tools to provide its inhabitants with both necessities and luxuries, all with *fewer* natural resources per capita. Thus, the use of new technologies, increased productivity and the continued substitution of new goods for old allow society to progress without depleting our natural ability to do so. Take technology itself as but one example. Early uses of technology (electricity, lighting and even computers) required significant amounts of copper, silver, gold and steel. Today, while these metals are still needed, the biggest resource consumed is silicon to make semiconductor chips. The raw element in silicon is sand. While Pluto may not possess much of this element, the Earth certainly does.

While we remain of the belief that core inflation could tick up for a couple more years (owners' equivalent rent is a large component), we do not share the view of some that our rapidly developing world will grow its way out of natural resources and thus cause inflation to spike. The fixed income portion of MetWest Capital's Balanced portfolios remains conservatively positioned. We will wait for somewhat higher longer-term yields before venturing to lengthen the duration of fixed income portfolios.

As always, we will monitor all the economic indicators, yet act only when prudent and primarily driven by individual investment opportunities.

*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

A husband and wife went out with friends for a game of golf. Anxious to get going, the husband failed to warm up. He thus hacked his first shot right through the window of the biggest house adjacent to the course. He cringed, “*I knew I should have taken a few practice shots! Now we'll have to go up there, find the owner, apologize and see how much my lousy drive is going to cost us.*”

So the couple walked up to the house and knocked on the door. A warm voice said, “*Come on in.*”

When they opened the door, they saw the damage. Glass was all over the place and a broken antique bottle was lying on its side near the pieces of windowpane. A man reclining on the couch asked, “*Are you the people who broke my window?*”

“*Uh . . . yeah, sir. We're sure sorry about that,*” the husband replied.

“*Oh, no apology is necessary. Actually I want to thank you. You see, I'm a genie, and I've been trapped in that bottle for a thousand years. Now that you've released me, I'm allowed to grant three wishes. I'll give you each one wish, but if you don't mind, I'll keep the last one for myself.*”

“*Wow. That's great!*” the husband said. He pondered a moment and blurted out, “*I'd like a million dollars a year for the rest of my life.*”

“*No problem,*” said the genie. “*You've got it, it's the least I can do. And I'll guarantee you a long, healthy life! And now you, young lady, what do you want?*” the genie asked.

“*I'd like to own a gorgeous home complete with servants in every country in the world,*” she said.

“*Consider it done,*” the genie said. “*And your homes will always be safe from fire, burglary and natural disasters!*”

“*Now,*” the couple asked in unison, “*what's your wish, genie?*”

“*Well, since I've been trapped in that bottle, and haven't had a good meal in more than a thousand years, my wish is for you to cook me a feast.*”

The husband looked at his wife and said, “*Gee, honey, you know we now have a fortune and all those houses. But the other couple is waiting for us to get back to the golf course. What do you think?*”

She mulled it over for a few moments and said, “*Considering our good fortune, I think it's the least we can do. I believe our friends will understand.*”

The couple spent the next three hours preparing all types of gourmet dishes. Then they sat the genie down at the table and for two more hours waited on him hand and foot. Appetizers, soups, salads, three main courses, drinks and, to top it off, a chocolate soufflé. The couple was so worn out they couldn't even eat.

When finally satiated, the genie turned around, looked directly at the husband and wife and asked, “*How old are you two?*”

“*Why, we're both thirty-five,*” they responded breathlessly.

“*No kidding,*” he said. “*Thirty-five years old and you still believe in genies?*”

Things are not always what they appear to be!

This quarter we highlighted magicians and the (former) planet Pluto. Abracadabra, even a planet can be made to disappear.

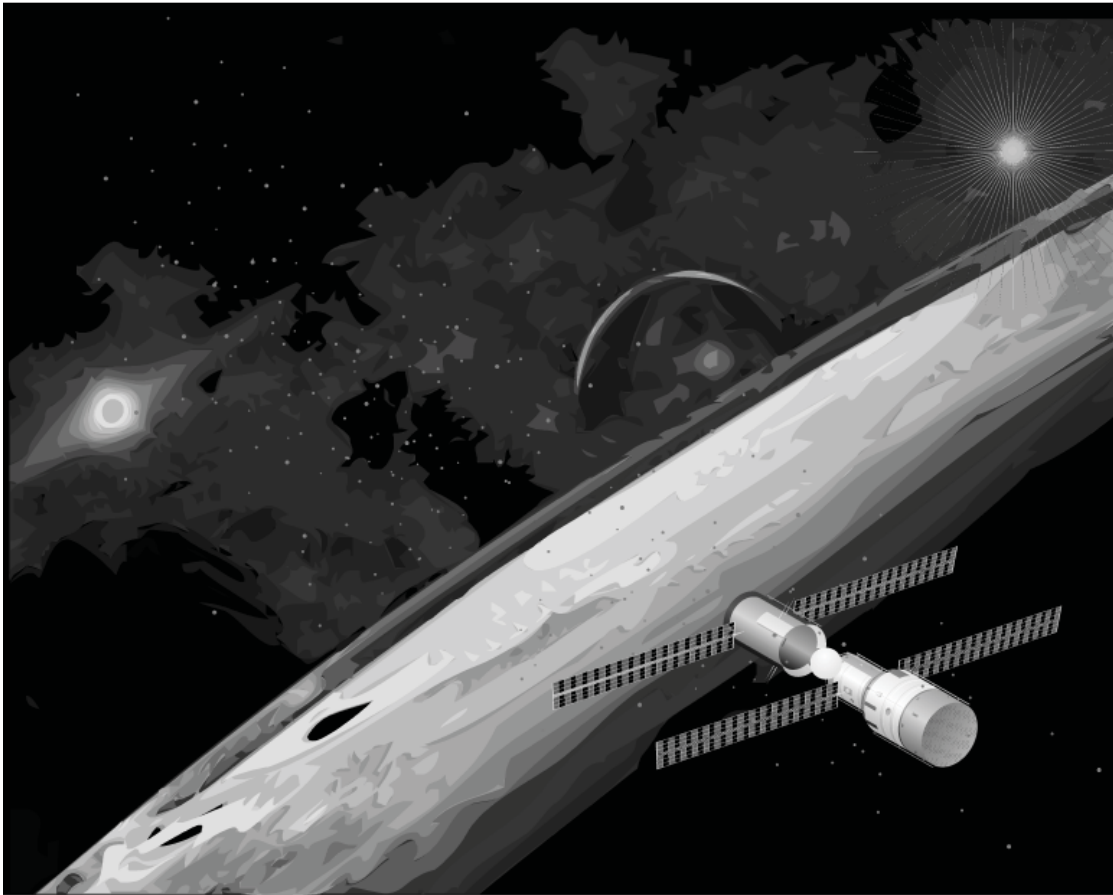
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With a few examples, we showed that these objects do not really cease to exist, but are renamed, or made to look differently when viewed from a different angle. It's often a matter of perception versus reality.

Economics and magic may share similar characteristics. The Fed just finished raising interest rates, a process that lasted for two years. What will be the impact of such policies? Based on conventional wisdom, it may appear that the U.S. economy is headed for trouble. But examining the same issue by focusing on the U.S. household's balance sheet yields the opposite conclusion. This is why, although we do not ignore

economics, it plays only a secondary role in our individual company approach and, even then, we consider it only from a long-term perspective.

We highlighted several recent investments and our concern that the current healthy levels of corporate profitability may go no higher. On the other hand, we are not overly worried about the impact that elevated raw materials prices may have on core consumer inflation. As always, these and other thoughts are just a few of the myriad factors utilized in our long-term, fundamental, company-focused research approach.



*The Sun and Neptune viewed from Pluto*

*We welcome Samir Sikka, who joined us as Senior Vice President to help uncover the truths in smaller company investing.*



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