

# Capital Visions

## Little Boxes



Little boxes on the hillside,  
Little boxes made of ticky tacky,  
Little boxes on the hillside,  
Little boxes all the same.  
There's a green one and a pink one  
And a blue one and a yellow one,  
And they're all made out of ticky tacky  
And they all look just the same.

And the people in the houses  
All went to the university,  
Where they were put in boxes  
And they came out all the same,  
And there's doctors and lawyers,  
And business executives [even money managers!],  
And they're all made out of ticky tacky  
And they all look just the same.

And they all play on the golf course  
And drink their martinis dry,  
And they all have pretty children  
And the children go to school,  
And the children go to summer camp  
And then to the university,  
Where they are put in boxes  
And they come out all the same.

And the boys go into business  
And marry and raise a family  
In boxes made of ticky tacky  
And they all look the same.  
There's a green one and a pink one  
And a blue one and a yellow one,  
And they're all made out of ticky tacky  
And they all look just the same.

While most songs require catchy tunes to be interesting, this one, written by the late Malvina Reynolds and copyrighted by Schroder Music in 1962, has lyrics one can analyze for hours and still not tire from the exercise. Born in 1900 and raised in San Francisco, Malvina in many ways epitomized the “hippie” generation with her activist songs and poems. Of course, she received her education at UC Berkeley and consistently opposed every world conflict since World War I. “Little Boxes” was conceived on a car ride from Berkeley down through the San Francisco peninsula. As recounted by fellow singer-songwriter Pete Seeger, “While traveling with her husband, as they drove through Daly City, she said, ‘Bud, take the wheel. I feel a song coming on.’”

The lyrics were a commentary on American society and the sameness it produced. While somewhat dated – not only boys go

into business – the underlying message is still clear. The song was composed during the time of the “suburbanization” of America; families in droves moved out of cities into “box-like” houses twenty miles away. The term “ticky tacky” was created by Malvina and is now part of the Oxford dictionary. It was meant as a put down to describe the little square houses differentiated only by their colors.

“Little Boxes” was rediscovered in late 2005, as the Showtime series “Weeds” uses it as its intro song. Lions Gate Entertainment produces the series in which actress Mary Louise Parker plays a recently widowed suburban mom who manages her cash flow problems by selling marijuana to members of her community. It is a refreshing program, not so much for its (illegal) subject matter, but for its characters who are often sarcastic and cynical, somewhat like “real” people. Our interpretation of the use of “Little Boxes” for such a series is that it exemplifies precisely the OPPOSITE of Malvina’s message. While on the **outside** the ticky tacky houses look all the same, on the **inside** each is inhabited by unique and differentiated human beings. Yes, they all live in suburbia and yes, most are well educated and have successful careers. But the families in the pink, blue, green and yellow houses are hardly the same, nor, in real life, do they pretend to be.

So, too, in investing. As investors in individual businesses, we at MetWest Capital are often faced with companies that appear similar upon superficial inspection, but are quite different when thoroughly analyzed.

## Individuals

Many businesses appear similar on the outside as they sell similar products or target the same customers. But few companies have identical counterparts. By way of example, let’s compare two companies in the same business: **NCR** and **Diebold**. We began purchasing NCR for our clients in 2001 and sold the investment in mid-2005 shortly after CEO Mark Hurd departed for the same position at Hewlett-Packard. Both companies, as their largest business, sell automated teller machines (ATMs, or “little boxes” to Malvina Reynolds) to banks and other financial institutions. Diebold is largest in the U.S., while NCR leads overall around the world. They both have other businesses, but at the time of our purchase, ATMs dominated sales and profits. So at first blush, they appear similar.

We were early in our analysis and NCR’s stock price declined after our initial investment, bottoming in early 2003. At that time, Jonathan Berr of Bloomberg News, commenting on recent earnings, wrote “[NCR’s] stock trades at about 48 times estimated per-share earnings this year. Rival Diebold trades at a P/E ratio of 15.” The reporter was implying that these two “little box” companies should have similar valuations. To him, Diebold was a buy and NCR a sell. We thought differently.

Mr. Berr's calculations were correct. But NCR's earnings that year were artificially (and temporarily) depressed due to one-time items, pension expenses and an underutilized ATM maintenance business. Diebold, on the other hand, reported earnings with few extraordinary items. Using the more reliable cash flow metric, the two companies' stocks were each valued at about 10x. But there was more to the investment story, as NCR's smaller businesses (specifically its Teradata data warehouse segment) were on an upward trajectory, while Diebold's nascent electronic voting machine business, although promising, had many hurdles to overcome. So while on the surface these two companies appeared similar, a more thorough evaluation revealed many differences. NCR's stock price nearly trebled since the reporter's commentary, while Diebold's gained 33%, underperforming most major market indices.

Of course this is but one example, and our work will not always lead to such investment outcomes. But it does highlight the imperative of looking beyond the shape and color of the "little box" and truly analyzing the inherent characteristics of what and who is inside. In today's domestic Large Cap *Intrinsic Value* portfolios we hold **Weyerhaeuser**, but not other paper companies, **Apple Computer**, but not Dell or Gateway, **Kellogg** as our only packaged food investment and **AstraZeneca** as our singular pharmaceutical holding. All may not turn out as we expect, but all are held for company-specific reasons, typically not fully appreciated by casual observation.

Now let's turn to the financial markets, the results of 2006 and our thoughts for the future.

## VALUE EQUITIES STRATEGY

As the following table shows, financial markets finished another good year in 2006, their fourth in a row. Leading assets higher were international equities, which gained 16.9% in appreciating foreign currencies and 26.9% when measured in U.S. dollars (as measured by the MSCI Europe Australasian Far East – EAFE – Index). In the U.S., the S&P 500 Index gained 15.8% including income. For the first time since the market last bottomed in 2002, the Dow Jones Industrial Average rose more than broader indices, setting a new all-time high near the end of the fourth quarter. The S&P 500

is only slightly below its record-high close in 2000, while Value indices are well into uncharted territory. Smaller company equities are now in their seventh year of domination over larger companies with small value-oriented stocks faring better still.

With significant volatility, most energy prices finished the year almost exactly where they began, including oil at \$61 per barrel. But other commodity prices rose, some quite dramatically. Gold gained 23% and copper (even after a year-end drop) rose 32%. The Federal Reserve Board (Fed) raised short-term interest rates during the year. The Fed Funds target rate began the year at 4.25% and was raised four times through June to then remain steady at 5.25%. But longer-term fixed income securities (which typically would decline in such an environment) added value, with the Lehman Brothers Government/Credit Bond Index gaining 3.80%. A lot has been reported about residential real estate, so we won't add more than a few words here. At publication time, fourth quarter figures were not yet available, but we estimate that for the country as a whole, housing prices **rose** about 3% from December to December. Some of the previously "frothy" markets, such as Florida, Nevada and Southern California softened significantly, but most of the Northwest and parts of the Southeast (ex-Florida) continue to see housing price appreciation.

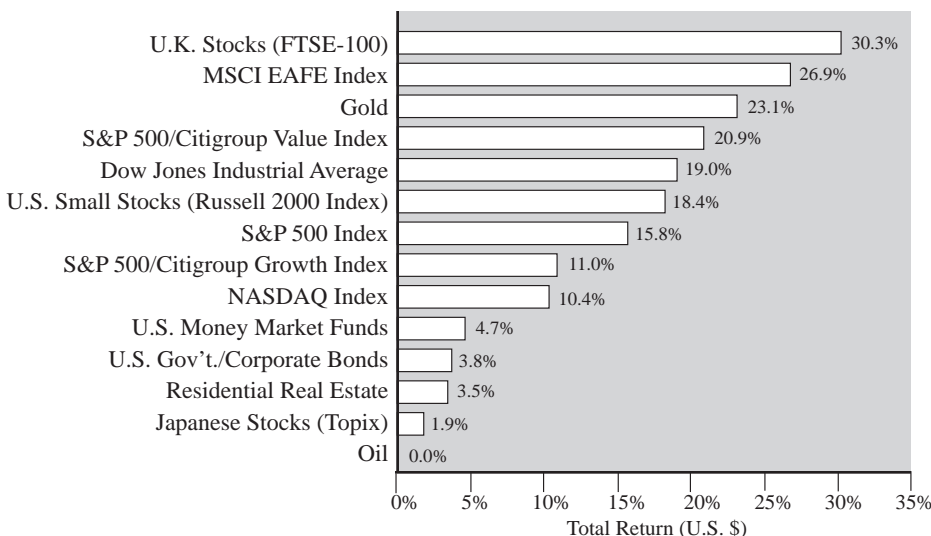
As for our outlook, while a housing-led U.S. economic slowdown appears under way, we view this as a short-term cyclical trend and maintain our longer-term sanguine view for the economy and global equity markets. Last quarter in our *Capital Visions* entitled "Abracadabra," we highlighted a concern that could, if not addressed, challenge our positive stance. We said that while increasing corporate profits were encouraging, the continued increasing margins may not fully reflect all the constituents that companies are obliged to benefit. The following chart highlights this important issue once again.

The chart on the next page compares that portion of a company's income that is paid out to labor (the blue line) – wages and benefits – versus that which goes into capital (the red line) – equity stakeholders. Notwithstanding the headline-making bonuses going to the very top end of "labor," the chart shows that, at 68%, labor's share of the corporate "pie" is the lowest in at least 60 years. At the same time, capital's share, at 31%, is back to a level not seen since the 1950s. Malvina Reynolds would certainly disapprove, and we believe this situation may not be sustainable long term.

The issue is **how** the imbalance will be cured. We do not believe it to be in the best interests of corporations simply to raise wages or hire more people to get the same job done. They are currently not doing so. But we also don't see the societal fairness of further increasing earnings without at least trying to invest more back into business. Of course, the rate of return on the additional investment must be at least as high as that offered by alternatives (such as stock buybacks and other forms of capital distribution).

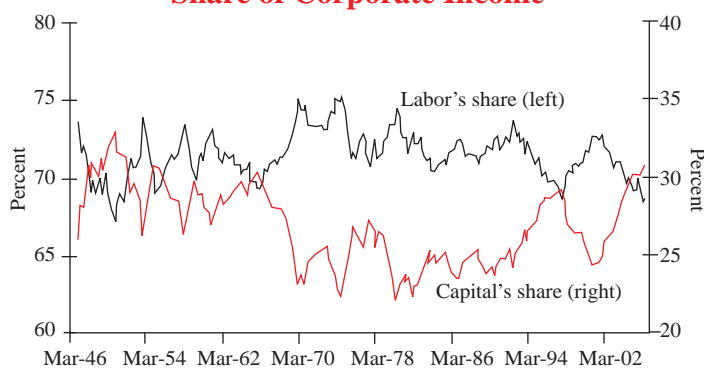
Our biggest concern is that labor (with the unemployment rate at 4½%) will be able to "demand" a greater share of profits **without** offering anything additional in return. This could depress

### 2006 Asset Performance



Source: Bloomberg and Various

## Share of Corporate Income



Source: Haver; Bear, Stearns & Co. Inc.

profit margins and potentially discourage hiring. The unintended consequence would be an increase in the unemployment rate and lowered consumer confidence, and a recession could ensue. We are not, at this time, predicting such a scenario. We merely point out the importance of our diligent monitoring of its potential.

## INTERNATIONAL STRATEGY

In some ways, Japan faces corporate issues opposite those of the United States. While U.S. corporate profit margins may be unsustainably high, Japan's are too low. This is one of the reasons that Japan's stock market has lagged others, as happened again in 2006. A long period of putting society (via lifetime guaranteed employment and other policies) ahead of shareholders has resulted in insufficient capital to foster innovation and drive entrepreneurship. One could have pointed out to Malvina that when the pendulum swings too far in favor of labor, that, too, is not ideal.

But there is now evidence that Japanese companies are beginning to see the benefits of a more balanced approach. Thus, we believe Japan is at the very early stages of significant corporate restructuring that could lead to higher profits and stock prices over time. So even though Japanese stocks lagged others in 2006 (after outperforming in 2005), we remain committed to a significant exposure to that market in our International and Global portfolios.

As for the rest of the world, global GDP\* grew nearly 5% in 2006 led by China and other emerging countries, but also aided by resurgent industrial countries (France, Germany, Sweden, Denmark, etc.) while U.S. growth moderated. Regardless of its leaders' rhetoric, we believe China is unlikely to implement meaningful policies to slow its growth prior to the 2008 Olympics in Beijing. Further global GDP growth appears likely for the foreseeable future, as other emerging economies are firmly in uptrends, Europe and Japan have only just begun to grow, and the U.S. (while moderating from the past few years) appears poised to expand.

\* Estimated by *The Economist* based on 52 countries representing 90% of world nominal GDP.

## INVESTMENT ACTIVITY

Last quarter we created a new "Investment Activity" section in which we will 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. Fixed Income shall continue to be covered in the next section.

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

- **Time Warner** is a media conglomerate owning some of the country's largest cable TV, cable network (HBO, CNN, TNT and others), film (Warner Bros. and New Line), publishing (*Time*, *People*, *Sports Illustrated* and others) and internet (AOL) companies. While the 2001 merger of the "old" Time Warner and AOL never resulted in the synergies envisioned, each of the company's pieces has continued to perform well. With the recent decision to offer broadband internet access for free, AOL has transitioned to an advertising model, much like its peers. Cable continues to roll out new digital and high-definition (HD) services, and the networks are highly cash generative. The company is in the midst of repurchasing nearly 25% of its outstanding stock, proof of how undervalued management believes it is. We concur.
- **L'Oréal** is one of the world's largest and most profitable cosmetics and personal products companies. Beyond its corporate name, familiar brands include Maybelline, Garnier, Matrix and Lancôme Paris. In addition, about one-quarter of its value is in its minority stake in pharmaceutical company Sanofi-Aventis. The stock had always reflected the unique prospects and stability of the company's businesses. Recent transitory factors, however, caused the stock to decline and we used this as an opportunity to invest for our Large Cap *Intrinsic* Value and International-ADR portfolios.
- **Pike Electric** is a \$500 million company that provides services to electric utilities. These services include maintenance, repair, upgrade and extension of distribution and transmission infrastructure, as well as storm restoration services. The company benefits from two major industry trends: increasing infrastructure spending by utilities following years of systemwide underinvestment and a growing use of outsourcing. Pike serves customers in 19 states in the Southeast U.S., with some of its client relationships dating back 60 years. With the stock's decline to now sell at 16x our estimate of normalized earnings, we took advantage of recent weakness to establish a position in this high-quality operator with powerful long-term business drivers.

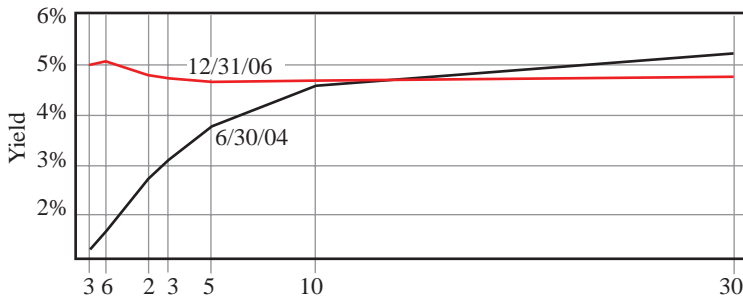
## FIXED INCOME STRATEGY

On June 30, 2004, the Fed began to raise short-term interest rates from their historically low 1.00%. At every subsequent meeting, the Fed Funds target rate was increased by one-quarter percent. Two years later, on June 29, 2006, the rate stood at 5.25% and has been held steady since. Typically, when short-term rates go up, so, too, do longer-term rates – maybe of a different magnitude, but usually in the same direction. Thus far, this time has been different.

The following chart shows the U.S. Treasury yield curve at June 30, 2004 (blue line) and at year-end 2006 (red line). Note that while short-

term rates rose dramatically over the period, the yield of the 10-year Treasury held nearly steady at 4.6% and the longest of Treasury yields has actually *declined*. We offer the following possible explanations for this conundrum.

### U.S. Treasury Yield Curve 06/30/04 versus 12/31/06



Source: Bloomberg

First, we point out that while short-term rates are dictated by the Fed, long-term rates are set by the market. Former Fed Chairman Alan Greenspan expressed concern during the 2001-2004 period of **falling** short-term rates that longer-term yields failed to decline much and so couldn't provide the stimulus to the economy the Fed was seeking. From the beginning of 2001 through June 2004, as the Fed Funds rate declined from 6.50% to 1.00%, 10-year Treasury yields declined by less than 50 basis points (one-half percent). Even at their lowest level in mid-2003, the yield curve was far steeper than the Fed governors had wanted. So it should not be much of a surprise that as short rates have gone up, longer rates, yet again, have not responded.

The second plausible explanation is one we've rarely seen presented elsewhere. Could it simply be that the world's central bankers have finally learned how to do their jobs? Historically, the world's monetary authorities were not very good at anticipating inflation. So, in the past, when the U.S. Fed started raising rates, most investors assumed (rightly so) that the Fed was too late and inflation was going to be a problem. Similarly, when rates were lowered, we often were already in recession. But if the long and capable tenure of the past few Federal Reserve Chairmen (starting with Paul Volcker in 1979) has convinced investors that central banks can and will be successfully proactive, then today inflation is deemed staved off by the rise in short-term rates and thus long-term rates have remained appropriately low.

Part of this new confidence could be a matter of more open communication. Alan Greenspan, while often talking in circles, at least went out of his way to speak publicly about the economy and the Fed's influence on it. Prior Fed Chairmen rarely telegraphed what they were going to do, preferring to surprise investors. Therefore, we believe it possible that the yield curve, while not remaining perpetually inverted, could stay flat for a prolonged period. If inflation can be effectively controlled by the world's central bankers, then the need for an inflation risk premium in longer-dated securities may not be required.

Given this, the fixed income portion of MetWest Capital's balanced

portfolios remains in short- to intermediate-term securities. We are currently positioned with an approximately 3-year duration (sensitivity to interest rates). Emphasis is on Treasuries (for liquidity) and mortgages (for additional yield). Corporates are underweighted as the current small spread to Treasuries does not, in our view, compensate investors for the possibility of default risk.

As always, we will monitor all the economic indicators, yet act only when prudent and primarily driven by individual long-term 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

Malvina Reynolds' song "Little Boxes" was written as a commentary on the sameness of American society. Well, not to worry, Malvina. Since 1962, waves of immigration, changes in societal habits and what some have called a general "maturing" of a nation have made the United States today one of the world's most diverse countries. While many of us **do** live in boxy tract houses, drive boxy SUVs and take many of the same subjects in college, outward appearances mask the uniqueness of us as individuals.

So, too, in investing. We at MetWest Capital employ an *intrinsic* value approach toward investing in a relatively small number of companies. This concentrated approach allows us time to look beneath the surface of each enterprise and uncover what is truly inside. Our aim is to distinguish the good from the bad by not succumbing to generalizations based upon appearance. Sometimes our work is fruitful (such as **NCR** versus **Diebold**), but not always. We have not unearthed any secret formulas nor can we claim responsibility for changing the investment world.

We see our work as painstaking, slow, sometimes a bit boring, but with the goal of exhilarating results. The returns have been good in recent years, including 2006. But our style may, at any time, fall temporarily out of favor as we focus on sustaining long-term performance, not quarter by quarter or year by year.

Trends in the financial markets may persist as global economies expand while the "expert" central bankers keep inflation contained. The U.S. yield curve could remain flat and the U.S. dollar weak. Domestic corporate profit margins are likely as high as they can be, but as sales continue to grow and innovation creates new markets, so, too, can earnings move higher and stock prices rise. As always, we remain diligent in our efforts and look forward to many more years in our own "little box" here in Newport Beach.

*We welcome your comments and feedback.*



610 Newport Center Drive, Suite 1000  
Newport Beach, CA 92660  
949-718-9701  
949-718-9122 fax