

Capital Visions

More Than Meets The Eye

“Welcome To The Alcon Manufacturing and R&D Campus,” read the sign. We were led past the entryway, through a set of double doors and down a long hallway. On either side, we walked past a mixture of offices and small laboratories (pronounced with an accent on the “b-o-r” by the English tour guide). The offices, while spacious, were somewhat cluttered – not unusual for those occupied by Ph.D.s and M.D.s. The labs were much neater, with begoggled technicians mixing fluids in test tubes. Others in the labs were sifting through reams of computer printouts, working on cures for the world’s most pressing ophthalmic diseases. At the far end of the hall, we reached our destination and opened another set of double doors, these leading into the factory.

We were visiting Alcon, a Fort Worth, Texas-based investment of ours. The company – partially spun off from Swiss-based Nestlé in 2002 – focuses on pharmaceutical, surgical and consumer products related to the eye. Its products are used in cataract surgeries, to treat eye-related ailments and to clean contact lenses, among other uses. Its profit margins were high *and rising*, and we wished to gain a better understanding of the sustainability of this trend. At the time of our initial investment, net after-tax profit margins were 16%, and we thought they could reach 22% on a normalized basis. But by the time of the visit, margins were approaching 25%, with some parts of the business higher still. Would our factory tour shed any light on the subject?

At first glance, all appeared typical for a facility of this type. We began at the end-product segment of the production lines and worked our way back to the raw inputs. It was a flexible system capable of manufacturing many of Alcon’s products. Indeed, this was one of the reasons why margins were high. On the day of our inspection, Travatan was in production. The end product looks like eye drops, packaged in 10 milliliter plastic bottles, then boxed up individually, ready for shipping. Nothing too unusual here. We continued walking up the line, watching as the labels were applied after the fluid was injected into the bottles. Next we were shown giant vats in which the ingredients were mixed. Finally, now close to the beginning of the process, we were told to look overhead. Giant copper pipes connected on one end to the mixing vats were seen coming into the building at a point marked “Fort Worth Municipal Water District.” “NO!,” we remarked, “The basis for the prescription medication (that typically costs more than \$100 per bottle) is tap water?” If correct, we’ve uncovered at least one of the reasons for the high profit margins of Alcon’s products.

Yes, it was true. Glaucoma, an eye disease, is a leading cause of blindness in the world today, affecting more than 65 million people. Travatan is one of a new class of drugs called prostaglandins that can help reduce and control intraocular pressure, thereby reducing the harmful effects of this debilitating disease. What would one

pay for a product that forestalls blindness? To be sure, municipal water is not the only ingredient in Travatan. Most of its value is derived from the years it took to develop, test and bring it to market. Recall the offices and labs we passed in the hallway, all staffed with seasoned M.D.s and Ph.D.s. In addition, Alcon, as all pharmaceutical firms, must be sufficiently profitable to fund the development of many products simultaneously, knowing that perhaps two out of three will never reach the marketplace. So the product, and its developer, are certainly “more than meets the eye.” So, too, is our goal in investing.

Generations

We highlight Travatan this quarter, and Alcon as its developer, as an example of a company that sells its products for reasons other than price alone. We use this extreme example to show that anyone could take Fort Worth municipal water and sell it for far less than \$100 per tiny bottle. But only Alcon (and very few of its competitors) can take tap water, add some *very* special ingredients, and help to alleviate a leading cause of blindness. Such companies possess a theme common amongst many of MetWest Capital’s investments.

Each quarter in *Capital Visions* we highlight a small piece of our investment philosophy. Often the stories we tell lead to examples of investments we make. As our approach is not formulaic, but instead dependent on company analysis, only a compilation of many examples over time can convey the mosaic of our investment style.

This quarter we emphasize our approach to seek out companies with products or value-added services that are sold for reasons other than price alone. This, we believe, leads to *sustainable* business models, high and/or growing market shares, high returns on invested capital and the ability to perpetuate a cycle to create GREAT companies. If done properly (like Alcon and others), this strategy may lead to a virtuous cycle that can last for *generations*.

Let’s look at a few more examples (chosen to illustrate, not to “brag” nor “predict”):

> **Gillette** is an example we have used previously. Now part of Procter & Gamble, Gillette literally invented the term “razor and blade” business. It means that you “give away” (or sell at low margins) razors so that customers are locked into buying high-margin blades. If you produce the best razors and blades, your profits will be high. You will then be able to reinvest your profits back into developing even better razors and blades (right now they’re up to *five* blades) to stay ahead of competitors. Companies that always stay one step ahead of others have the ability to charge prices reflective of this superiority. This leads to that virtuous cycle.

➤ **(Charles) Schwab** is in businesses in which it cannot charge higher prices than its competitors. Providing trading and investment services is perceived as a commodity business, so Schwab cannot charge a premium price as do Gillette and Alcon. As a matter of fact, the company got its start by charging *lower* prices than its “full-service” broker peers. So, was it doomed? On the contrary, it has grown and continues to flourish, gaining additional market share almost every year. In this case, the company has distinguished itself via consistency and systems. Back office operations are a big expense of many of Schwab’s independent advisor clients. By providing them with error-free record keeping, they can claim that their services help their customers save money. This benefit cannot be matched by others (even at the same *or higher* prices), and so the company continues to expand its market, investing further into more sophisticated technology. This perpetuates their cycle.

➤ **SYSCO Corp.** is a recent new investment. We include it **not** because it generates high margins like Alcon, Gillette or Schwab. Actually, in its best years, this food distributor earns no more than six cents for each dollar’s worth of goods it delivers. But the company’s returns on capital employed (the equity needed to build and run the business) are in excess of 20%, while most of its peers struggle to earn any profits. For SYSCO, its value added is unsurpassed reliability via an expertise in logistics. Let’s suppose you are the owner of a restaurant and you need lettuce to prepare your dinner salads for the evening. Maybe there’s a drought in California, causing lettuce to be in short supply. You could have the peace of mind and rest assured that, as a SYSCO customer, while you may have to pay a few extra pennies per head, your diners will be assured of having their choice of romaine, iceberg or butterhead tonight.

These are but a few examples of companies whose products or services are “more than meets the eye.” While there are many other factors that go into our investment selection process, identifying truly great companies with defensible competitive advantages forms the foundation of our approach.

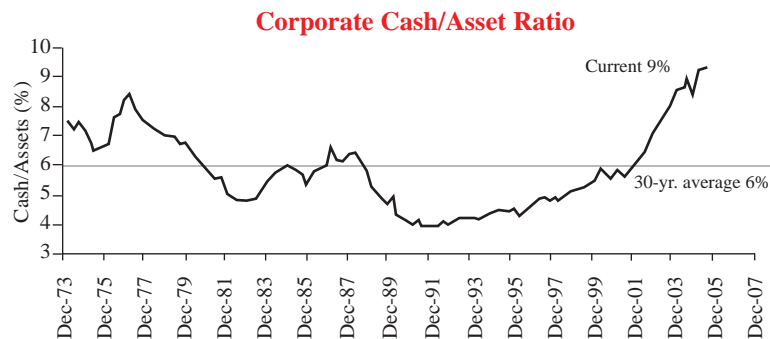
Now let’s turn to the financial markets, the results of the first quarter of 2007 and our thoughts for the future.

VALUE EQUITIES STRATEGY

After a mid-quarter correction, equity markets continued the almost uninterrupted upward path they have followed since early 2003. In the U.S., equity market returns were modest, but mostly positive. The S&P 500 Index gained 0.6% including income. Growth, value, large and small companies, as groups, all performed similarly. Most market indices are not far from all-time highs. With the U.S. economy well balanced, we remain sanguine on our intermediate- and long-term views for the financial markets. Given recent headlines surrounding the U.S. housing market, we point out that weakness in some sectors is actually “good” in that it keeps the overall economy from growing beyond its sustainable limit. We also emphasize that our process typically encompasses thoughts about the next three to five years, by which time housing is likely to return to its longer-term trends.

Part of our optimism stems from the cash that corporate America has accumulated. The following chart shows cash as a percent of assets for S&P 500 companies (excluding financial companies,

whose structure would distort the picture). Note that at 9% as of December 2006, cash is at its highest level in more than thirty years. For cash levels to drop to the 6% long-term average level, \$200 billion would have to be spent or dissipated. That’s a lot of “dry powder” for dividend increases or capital investments, all of which



Source: Compustat and Goldman Sachs

could further increase the attractiveness of U.S. company stocks.

The excess corporate liquidity reminds us again of the 1960s. That decade began with the cash that had built following WWII and the Korean War. It was deployed slowly at first but then more rapidly as the decade progressed. The federal government had vast ambitions, simultaneously funding both the Cold War (including Vietnam) and “Great Society” initiatives. Meanwhile, corporate America was busy building factories around the world as our consumer-driven society was taking shape.

Today’s parallels are many. The Cold War has been replaced by the War on Terror and spending on highways by spending on healthcare. Companies, meanwhile, are relocating factories to lower-cost sites around the globe and still have cash left over. If there’s one thing that is consistent about the U.S., it is that cash rarely lies about idly for long. We therefore expect that in the coming years, the cash/asset ratio could decline. While some of this decline may be due to a “leveraging up” to satisfy short-term investors (read hedge funds and private equity), some will also be used for more productive purposes. Prudent new investments in research & development and capital projects may set the stage for another leg up in corporate productivity. This would be beneficial and may result in higher corporate profitability, leading in turn to higher valuations and rising stock prices.

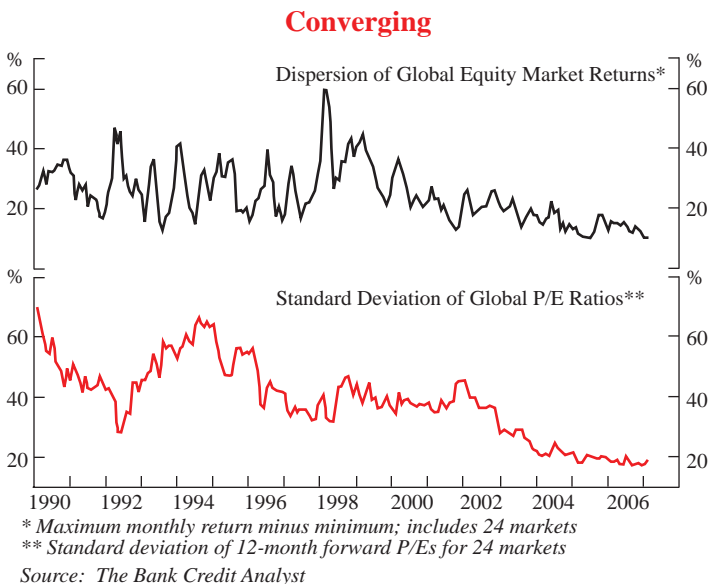
As always, we will monitor these and other trends carefully.

INT’L. & GLOBAL STRATEGIES

Many overseas companies are experiencing the same cash build as that of their U.S. brethren. This is not the only trend we find in common amongst companies across the globe. When the Chinese stock market dropped 9.2% on February 27, almost every major financial market around the world reacted – violently and almost instantaneously. No matter that China’s market had risen almost threefold in the past two years. No matter the history of volatility in that large but still developing market. And when Chinese stocks recovered to make new all-time highs within three weeks, the rest of the world followed suit.

While we typically do not comment on short-term price movements (there was plenty of commentary at the time, most of which has proven false), we do note the significance of increasingly

converged global economies, stock prices and valuations. The following charts illustrate our point.



The top half of the chart depicts the dispersion of stock market returns since 1990. The downslope is partly a result of reduced volatility for all markets over the past sixteen years. But it also highlights the increasing rarity of large movements in some markets relative to others. The bottom portion of the graph shows the convergence of market valuations (as measured by price-to-earnings ratios) around the globe. A third graph (not shown) would highlight narrowing GDP growth differentials, even between emerging and industrial countries. This particular trend may develop further as, over the coming decade, it is expected that the U.S. and most Asian economies may slow from their recent rapid pace of growth. At the same time, reduced structural impediments may foster higher than historical growth in Japan and Western Europe. Globalization is partly responsible for these trends, and we expect this may continue.

Given these trends, some may question the need for international investing. If the world's markets are becoming highly correlated, then one does not benefit from diversification. Yes, this is true, and thus the traditional way of investing globally may eventually become obsolete. That is, analyzing countries or currencies and making investment decisions based upon such "top-down" research may not yield incremental results to simply sticking with U.S.-based companies.

However, at the same time, and for these very reasons, individual stock selection becomes ever more important. This is because as markets around the world converge, one takes little more risk investing in the U.K., France, Japan or Germany than one might take with U.S. equities. By looking more broadly at one big global market (as opposed to individual country markets), the availability of investment options increases. **Alcon** was such an example. While based in Fort Worth, the company is actually still officially headquartered in Switzerland (due to its tie to Nestlé). This turned out to be an extraordinary opportunity for our clients, one that may not have been identified without a global approach.

This is why for ALL of our domestic U.S., international and global portfolios, there's an entire world of companies that offer "more than meets the eye."

INVESTMENT ACTIVITY

In this section, we highlight several of the newer investments from any or all of MetWest Capital's equity strategies: Large Cap *Intrinsic Value*, Small Cap *Intrinsic Value*, International Core Value and Global *Intrinsic Equity*. The following new investments were selected as representative and do not necessarily reflect our "best" nor "highest-conviction" ideas:

- **Dominion Resources** is a holding company for Virginia Electric (a regulated electric utility), Consolidated Natural Gas (a pipeline), non-regulated energy generation assets and a natural gas exploration and production (E&P) company. By most estimates, this last business (E&P) is worth in excess of \$15 billion, almost half the company's market capitalization. As it doesn't really fit with the other assets, management made a recent decision to divest it and began accepting bids in mid-February. This was the *catalyst* leading to our recent purchase. After the divestiture, management will be able to better focus on its core energy and utility businesses and will likely use the cash proceeds of the sale to buy back a significant portion of the outstanding shares of stock.
- **Teva Pharmaceutical** is a Tel Aviv-based specialty pharmaceutical company. By number of prescriptions dispensed, it is the largest in the world, as 90% of its sales come from generic (off-patent) drugs. As global healthcare comes under increasing cost pressures, generic drugs will play an ever-increasing role in providing affordable solutions. Teva may also participate in the generic "biologics" business (biotech-based medications) as well as a select number of proprietary products. Selling at 13.5x our expectations for 2008 earnings, we believe this company presents a compelling valuation for its "more than meets the eye" prospects.
- **CACI International Inc.**, while \$1.4 billion in market cap, is one of the largest providers of information technology products and services to the U.S. Department of Defense and other federal agencies (including Homeland Security). Companies like CACI have seen workflow deferred as the defense budget has shifted to fund the wars in Iraq and Afghanistan. But projects cannot be put off too long, or important systems will begin to break down. We therefore see pent-up demand for CACI, whose future sales and earnings will reflect these critical projects. The company's strengths lie in its long-standing relationships with federal agencies, proven technical expertise and highly skilled personnel with security clearances. We believe that over time, the company's value will grow to reflect these sustainable advantages.

FIXED INCOME STRATEGY

Twice last quarter the Federal Reserve Board (Fed) met and did nothing. Similar to the low turnover approach we employ at MetWest Capital, "no change" does not necessarily mean "no-work." We believe it takes the Fed a bit of courage to pore over an endless stream of data, with some individual points indicating economic strength and others weakness, and conclude that a steady state is best. We believe that Mr. Bernanke and his team could make

these “no-action” decisions for an extended period of time.

But we do have concerns. We ALWAYS have concerns. The following chart, coupled with the cash/asset ratio discussed earlier, indicates there may be too much money in the system looking to find a home. This graph shows the yield spread between high-yield bonds and U.S. Treasuries. High-yield (also called “junk” or non-investment grade) fixed income securities are typically issued by those entities that rating agencies believe to have less than stellar credit. They may possess too much debt, not generate sufficient profits to amply cover their interest liabilities or, for some reason, have greater-than-average risk of some day not being able to make interest and/or principal payments.



Source: Bear, Stearns & Co. Inc.

Note that as of February 2007, high-yield bonds were trading at barely more than 200 basis points (2%) higher than U.S. Treasuries (which are backed by the full faith and credit of our government). This is an historic low. Thus, bond investors deem systemic risk of default to be extremely low. Partly this may be due to the excess corporate cash described earlier, but it may also be a function of too much of that cash chasing higher-yielding assets.

Our concern is that as credit is readily available and relatively “cheap,” more of it will be issued. Companies and individuals may add to their debt burdens while we know the federal government remains on a “tear” in this regard. Without knowing how, why or *when* it may end, leverage-up cycles typically end with too much debt deployed, followed by several high-profile defaults, followed by significantly tighter lending standards and a reduced supply of credit.

Recent media coverage of a small slice of the debt markets notwithstanding, the leverage-up cycle appears to be continuing. As summarized by David Malpass, Chief Economist at Bear Stearns,

“... liquidity has swung from the scarcity of the 1990s to the plentiful environment of [today]. Markets are humming along, investing and allocating the bounty. It’s hard to evaluate possible excesses from plentiful liquidity - high rates of bond issuance related to tight credit spreads, the boom in

commodity-producing investments counting on high commodity prices, China’s buildup in fixed-asset investments and the [now plateaued] surge in global housing starts.”

While we must emphasize that we are not yet witnessing the downside of a credit cycle, we shall remain wary of the build-up of excesses and careful to monitor how the current cycle progresses. Meanwhile, fixed income securities at MetWest Capital are currently managed in a very conservative manner. Our exposure to high-yield bonds is minimal as secure U.S. Treasuries are emphasized.

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

Upon concluding our tour of the Alcon manufacturing facility, we sat down with the then head of R&D, Gerald Cagle, Ph.D. We shared our astonishment with the “raw” materials that were used in Travatan. Dr. Cagle assured us that while, indeed, they were one of the largest consumers of Fort Worth municipal water, they also spent tens of millions of dollars on filters, softeners and other additives, carefully and scientifically selected, that resulted in what is termed “ultra-clean” water. Too clean, he said, to drink, as it didn’t have the minerals required by humans that are typically found in our potable water. We discussed the company’s development strategies and plans for their future products.

We highlighted Alcon this quarter (the stock was subsequently sold when it reached our *Intrinsic* value target) as an example of a company (and its products) that is much “more than meets the eye.” That is, upon superficial examination, they take tap water, put it in small bottles and sell them for \$100 apiece. But it’s really all about what they do to this tap water, and the pharmaceutical chemicals they add, that create the real value. It is the expertise to develop such ophthalmic medicines by all those M.D.s and Ph.D.s in the labs we passed that allows the company to charge the prices it does.

More importantly, from an investor’s view, it is the sustainability of the process that discovered the drug as well as the company’s ability to replicate that process for future developmental breakthroughs. The same with investment management companies. We frequently say “not every quarter, nor every year” when it comes to excess portfolio returns. But the process that produced those returns by uncovering such companies as Alcon, Gillette and others is unwavering. We continue to work to keep it that way.

We welcome your comments and feedback.



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