A Great Park

The spectacle was about to begin. Fifteen thousand people lined the few streets in existence in the largely rural area. They waited, anticipated and looked skyward. It was a typical sunny day with just a hint of a breeze coming off the ocean three miles westward. The man with the binoculars gasped, then yelled, "Here they come!" Far off in the distance and 8,000 feet above the ground, one could see four tiny little "specks." The specks got larger as they swiftly approached. Now one could hear the faintest whirl of engines as the shape of the airplanes formed on the horizon. Then, suddenly, the show began, as four Grumman F8F-1 Bearcat Fighters flew past the crowd in their now famous "diamond" formation. The Blue Angels had begun their inaugural annual Air Show at the Marine Corps Air Station (MCAS) at El Toro, California. The year was 1950.

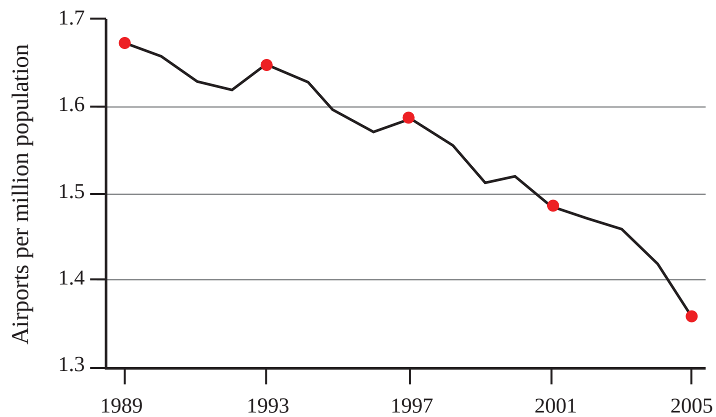
To nonmilitary personnel, The Blue Angels were the best-known part of this secretive air base. As chronicled by the U.S. Department of the Navy, the history of MCAS El Toro began with a series of Spanish land grants in the early 19th century. In 1860, a merchant named James Irvine acquired a 107,000-acre parcel of grazing land from its Spanish owners and successfully transformed the land into farms and orchards, experimenting with everything from strawberries to lima beans. Oh, yes, and oranges! This was the beginning of the city of Irvine in the county of Orange, south of Los Angeles, California.

In 1942, at the height of WWII, the Marines paid heirs of Mr. Irvine $100,000 for the 4,000 acres that became the air base. The base remained active through WWII, the Korean and Vietnam Wars and Desert Storm in 1990. Then, in 1993, it was announced that the Marine base, along with many others throughout the country, would close. The Blue Angels hosted more than two million visitors during their final show in 1997, and the base ceased operations two years later. Then the real "battle" began.

Throughout the latter half of the 20th century, as the base matured, so did Orange County around it. Today it is California's second most populous county and, at nearly 4,000 persons for each of its 789 square miles, the state's most densely populated. Yet the county is without a major metropolitan airport. Prior to 1990, the John Wayne Airport (for those not familiar with the area, YES, that is its real name), was little more than a pair of trailers parked alongside two of the <u>shortest</u> runways in the entire country. Since then, a modern terminal structure was built, yet it houses only fourteen gates. So a proposal was made to turn the closing military base (with one of the country's <u>longest</u> operating runways) into an airport. But after nine years and multiple ballot initiatives, the county's residents narrowly decided to opt for a park instead. Thus, "The Great Park" was born.

The population living near the El Toro base was not unusual in its rejection of an airport. Airports are typically noisy, ugly, congested, sometimes unsafe and better to have somewhere ELSE. The following graph illustrates this point.

Airports Per Capita



Source: FAA

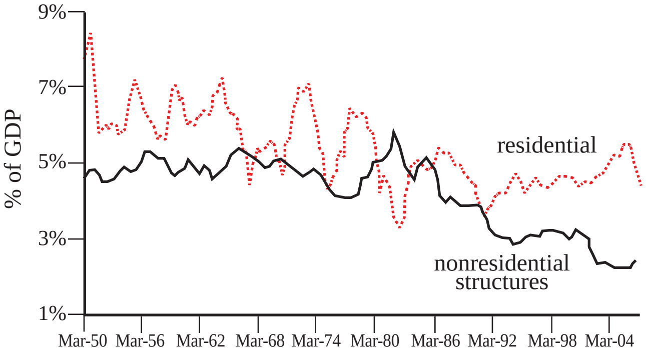
This chart shows the number of large airports per million people in the U.S. since 1989. Note the significant and steady decline from 1.7 airports per million people in 1989 to 1.3 per million today. Partly this may be explained by more gates and runways per airport and more efficient scheduling of enplanements. But considering the increasing frequency of air travel, we conclude that the country (and certainly Orange County, California) may have too few airports. Why is this important?

Capital Investment

Last quarter in our *Capital Visions* entitled "More Than Meets The Eye," we highlighted the high levels of cash accumulated by U.S. companies over the past ten years. This fact may be partly explained by a lack of capital investment. Many company managements are proud to report that their capital expenditures are less than the annual depreciation of their capital assets. This results in the generation of excess cash that may be returned to shareholders in the form of dividends or share repurchases. We, too, value management teams that act as effective shepherds of corporate cash. But taken to an extreme, underinvestment could lead to a permanent depletion of the value of corporate assets.

The chart on the following page highlights our concern.

Investment as a % of GDP



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

This graph depicts, as a percent of U.S. Gross Domestic Product (GDP), investments in long-lived structures. The red dashed line is residential structures (housing), while the solid blue line is nonresidential. Note the significant decline in the percent of U.S. spending going toward investments, particularly since the 1980s. This includes the airports mentioned earlier, but also other public infrastructure-related investments such as roads, bridges and mass transit. It also includes privately funded plants including power and utility, gasoline refining, chemical, mining and technology such as semiconductor fabrication. Even housing, while certainly on the downslope of a bubble in many regions today, appears to be an area of **underinvestment** relative to earlier periods.

We fear that many companies' increasingly short-term focus on profits and excess cash-generation may be robbing future generations of the basic "plumbing" (both literally and figuratively) they will need to maintain and improve upon the lifestyle we hope to enjoy. Some of the decline in the portion of GDP going to structures reflects improvements in productivity and faster growth in services such as healthcare. But the rapid decline of the past ten years may indicate an unhealthy willingness to forego capital projects that must be made up for in the future.

Individuals' reluctance for large infrastructure near their homes also feeds this problem. It always seems easier to put off such projects well past the point of necessity. Witness the lack of electric utility infrastructure in the late 1990s, the lack of oil refineries today and what we predict could be a lack of airports into the future.

Now we don't mean to imply that every closed military base needs to be converted to an airport or factory. Surely The Great Park will be a wonderful place to enjoy, while future airports could be built in alternative locations. But we used The Great Park this quarter to highlight the lack of capital spending in the U.S. and the danger of either crumbling or inadequate infrastructure that may result.

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

VALUE EQUITIES STRATEGY

With every "problem" we uncover comes the potential for investment opportunities. If, as we believe, too little investment has gone into infrastructure, and we are convinced this deficit must soon be corrected (we're not yet sure about this part), then identifying companies that benefit from capital spending could yield favorable investment results. Already in our portfolios are companies such as **Deere & Company** and **Archer Daniels Midland** that benefit from agricultural investments; **Boeing** and **Northrop Grumman** that may participate in commercial and military aerospace expenditures; and utilities such as **Dominion Resources** that could benefit from investments in the nation's power grid.

But these, and all of our investments, must stand on their own and not be beholden to a broad capital spending surge. For we must be wary that just because we believe this country *needs* to invest more in its infrastructure does not necessarily mean it *will* invest, or that those expenditures will go toward the projects we envision or in a time frame we expect. Of course, it takes many companies to build Great Parks too, at least one of which will be built nearby MetWest Capital's offices.

As for the financial markets, overall, with only a few brief corrections of little more than 5%, the U.S. equity market has remained on an uptrend for the past four years. This past quarter, the last major broad index to recover its all-time high did so, as the S&P 500 Index closed at 1539.18 on June 4. We are always asked about the worries *du jour.* Several years ago it was, *"How can the markets go higher in the face of continued terrorist threats?"* Then it was, *"How can stocks go up when technology is imploding?"* Next came, *"Isn't the Fed signaling a serious recession by pushing interest rates so low?"* to be almost immediately followed by, *"Now that the Fed has begun **raising** rates, isn't that typically a bad sign for equities?"* More recently, we've been asked about housing, consumer spending, and most recently, the sub-prime loan and high-yield markets.

We are anxious to field these and many other questions and concerns about the economy and financial markets. It means investors are worried. If investors are worried, they tend to act with caution. Caution is a GOOD trait, especially in the world of investing. But while we are happy to offer opinions on the news of the day, we pay little attention to it during our investment process. For ours remains focused on the long term and emphasizes individual security analysis. To this end, we are sanguine about the long-term prospects for U.S. equity markets. So while we are concerned about the dearth of infrastructure spending of late, free capital markets will adjust as needed over time. And if we're wrong, and no more airports or gasoline refineries are ***ever*** built, well then, at least we can ***walk*** to our Great Park and study investment reports under a nice tree.

INTERNATIONAL and GLOBAL STRATEGIES

European countries have long been known for their beautiful and lush Great Parks. Now they are also getting some press for their improving business environments. Opposite to the slowing U.S. economy, in many places economic activity is so robust that central bankers are raising interest rates to choke off speculative activity. The Bank of England raised its benchmark rate last quarter to 5.50%, its fourth rate hike in as many quarters. While the European Central Bank's rate is much lower at 3.75%, the ECB is signaling another hike is all but inevitable.

Even the political environment internationally is changing to allow for greater corporate flexibility. In May, French voters elected Nicolas Sarkozy to succeed Jacques Chirac as President of the French Republic. Mr. Sarkozy, the first of a new generation never to have served in politics under Charles de Gaulle, ran on a reformist platform. His plans, if enacted, will allow companies to employ their workers in overtime, ease the way employees may change job functions and impose other measures deemed to simplify corporate France's ability to compete globally. Many of the policies being considered are commonplace in the U.K. and America.

The French election follows the earlier transition in Germany to a government now led by Chancellor Angela Merkel. While some of Ms. Merkel's stated policies are to the left of Mr. Sarkozy's, under her administration Germany has seen a decline in the unemployment rate, lower per-unit labor costs and a new willingness to allow for cross-border corporate combinations – even if the "surviving" entity is not German. These and other policies have contributed to the resurgence of European corporate competitiveness even in the face of an historically high value for the euro.

These and other changes are occurring at a time when rhetoric out of Washington, D.C. is turning somewhat anti-corporation. The U.S. economy is held out as being the most flexible in the world, and we would not wish to see that change. We are concerned, however, as has been pointed out in prior editions of *Capital Visions*, that some of this country's prosperity is not being equally shared. The best of all possible worlds would be a voluntary shift in corporate policies allowing for not only the greater capital spending we spoke of earlier, but also an incentive-driven broadening of the "sharing" of our ever more profitable corporate "pie." Should this not occur naturally, we believe that governmental policies are forming in an attempt to force the issue. As we have seen in years past in Europe, such systems can be rigid, and almost always carry with them unforeseen consequences, hurting all constituencies – with the greatest negatives often felt by those who the regulations were designed to benefit most.

The changing political landscape (for the better overseas as compared to the U.S.) is one of the reasons we continue to find many compelling investment opportunities in foreign countries. It is also why, for our Global portfolios, we have a slight bias (currently about 60%/40%) in favor of those international investments relative to those opportunities we find domestically.

Let us now highlight a few opportunities around the globe.

INVESTMENT ACTIVITY

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

- **The Home Depot, Inc.** is the world's largest do-it-yourself (DIY) retailer with 1,800 stores selling nearly $100 billion of merchandise annually throughout North America. The industry has consolidated and, in recent years, has been transformed into a mature, yet highly profitable, structure. Home Depot and Lowe's combined sell nearly one out of every two power saws, screwdrivers, light bulbs and vanity mirrors in the U.S. New CEO Frank Blake has decided to sell the ancillary building supply business so he may better focus on improving his stores' customer "experience." With the proceeds of the sale, the company will repurchase about 28% of its outstanding shares. Other forthcoming value-enhancing initiatives are not, by our estimate, reflected in the stock's current valuation of only 13x expected earnings.
- **Toto Limited** is a Japanese company focused on housing-related items, particularly differentiated bathroom plumbing fixtures. Its balance sheet is conservative, free cash flow is strong and the stock's valuation is low at less than 7x EV/EBITDA. *Catalysts* we see include new products (you really must try their new washlet) tailored to an older and/or luxury-oriented population, new product categories taking advantage of Toto's quality reputation and expansion of overseas sales (particularly in China and the U.S.)
- **Group 1 Automotive, Inc.** (GPI), with annual revenues exceeding $6.0 billion, owns 140 automobile dealerships, primarily in the U.S. While selling new cars is a cutthroat and low margin business, the sale of ancillary products (parts) and services (repair) is highly profitable. Furthermore, pre-owned and imported vehicles typically carry higher margins than do new domestic models and so GPI's management is aggressively focusing on these products. Recent weakness in automotive sales and consumer spending in general has provided us an opportunity to invest in a business with solid financial characteristics at the very attractive price of 9x expected earnings.

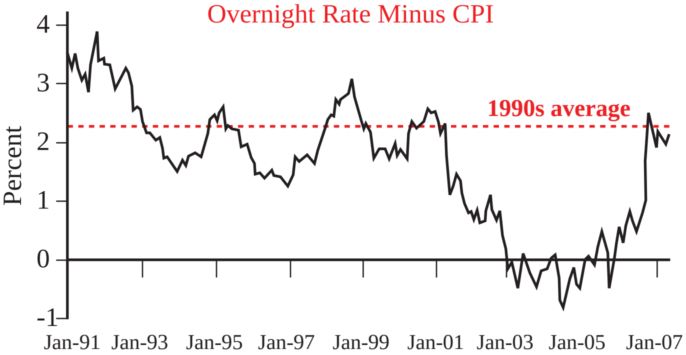
FIXED INCOME STRATEGY

During the second quarter of 2007, long-term U.S. Treasury yields rose to their highest level in two years. After falling back near quarter-end, ten-year Treasuries ended the quarter yielding 5.03%, up 32 basis points from where they began the year. As the Fed has kept short-term rates unchanged, also for the first time since late 2005, the yield curve normalized whereby long term bond yields are now higher than short-term yields again.

With the caveat that interim volatility may be caused by short-term factors, we expect that interest rates across the yield curve could remain within +/- one-half percent from where they are now for the foreseeable future. A wild card that could alter our thinking is the value of the U.S. dollar. Should, as indicated in prior sections, international yields continue to rise due to strengthened foreign economies relative to our own, the U.S. Fed may have to increase rates in order to forestall a further weakening of the dollar. We shall persist in monitoring these trends.

One of the reasons for our "no change" thinking is shown in the following chart:

Global Real Interest Rates
Overnight Rate Minus CPI



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

This graph of real (nominal less CPI inflation) rates is a GDP-weighted combination of U.S., European, Japanese and U.K. data beginning from January 1991. Note that for most of the 1990s, real global rates averaged 2.25%. Then, in the aftermath of 2001 recessions, interest rates the world over dropped dramatically. Rates have remained low for the better part of four years. This long period of monetary stimulus partly explains the "good" economic times we have today. It also almost certainly has exacerbated the commodity price boom of the past two years. As pointed out by *The Bank Credit Analyst* (BCA),

> *"All great bull markets are built on a foundation of buoyant liquidity, and the current cycle is no exception. Initially, the impetus came from the* [U.S.] *Federal Reserve's aggressive easing that followed the bursting of the technology bubble. As the Fed gradually returned its monetary stance to neutral, global factors became more dominant: the combination of still-easy policies in many regions, and a large and growing pool of excess savings in the emerging world."*

While the chart shows that liquidity (as measured by global real interest rates) is now close to neutral, we agree with the BCA, which states that *"the central banks could shut this down if they wished by pushing interest rates to punitive levels. But they have no reason to do so, given relatively* [benign] *inflation rates . . . "* We thus see global monetary policy as near neutral and expect the U.S. Fed to remain "on hold" – possibly for longer than most might expect.

Given our views, we have remained very conservative with the fixed income portion of MetWest Capital's balanced portfolios. We have favored short- to intermediate-term maturities and invest only in securities that are investment grade at the time of our purchase. We do not employ leverage in our approach, nor do we invest in vehicles employing leverage. As downside protection takes precedence over maximizing upside returns, all of MetWest Capital's strategies seek an *optimal* balance between the two. This way, one may enjoy the many Great Parks of the world with peace of mind.

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

The Great Park envisioned for the now shuttered MCAS El Toro could be truly spectacular. Covering 1,347 acres, it will be larger than New York City's Central Park and London's Hyde Park **combined**. Lennar Corp. purchased the rights to build homes and shopping areas to surround the park. The homebuilder has designed several neighborhoods, including what they call a "lifelong learning district" with educational facilities throughout the area. In addition, Lennar intends to build a major transportation hub to encourage the use of mass transit, thereby reducing congestion on California freeways. The park will have lakes, gardens, a performing arts venue, a "Great Lawn" and, to honor the land's history, an aircraft museum featuring The Blue Angels. Doesn't this all sound like a better use of the area than another airport?

Surely this country requires a balance between productive and recreational spaces. Many have pointed out the vast overbuilding of this country following WWII. It seemed like every pristine parcel was turned into another shopping mall or suburban housing development. But in recent years, the pendulum has swung, possibly too far, the other way. This quarter we used the example of The Great Park to highlight our belief that infrastructure spending in this country has been too low and could rise as a percent of GDP.

While a Great Park, and not an airport, will be built in Orange County, California, there are many noteworthy infrastructure projects underway. New York City, for instance, just approved the Second Avenue Subway, its first major new line in decades. We at MetWest Capital are monitoring these trends as we evaluate our existing holdings and new investment opportunities. As always, we will invest according to what *is* happening and not necessarily what we *want* to happen.

We Wish You A Relaxing Summer Filled With Many Pleasant Walks Through Many Great Parks!

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