

# Capital Visions

## Peter and the Wolf

Is it true about the demise of good music? No, we are not comparing recent hit artists such as Kanye West with yesteryear's Journey or Fleetwood Mac. It seems as though every generation thinks only its music is real and besides, it's a matter of personal preference. But one of our investment professionals read with interest a recent article focused on the quality of the sound available on today's most popular music players. With investments in content providers **Walt Disney** and **Warner Music** as well as the iPod developer **Apple**, he felt it necessary to dig into the comments to investigate their validity.

While he doesn't have a large (by modern standards) music collection, it is quite varied, both by genre (classical, rock, show tunes) and by medium (CDs, DVD music, solid state). He even still has a few vinyl albums, those for which he couldn't find digital substitutes. Flipping through the vinyl, he reminisced about such artists as The Mamas & The Papas, Jim Croce and just about everyone from Motown. Going further back in time, he found one of the records beloved by many children – "Peter and the Wolf," a musical children's fable composed by Sergei Prokofiev.

This, he thought, would be the perfect test. He had a vinyl version of the tale as narrated by Sting, with music played by the Chamber Orchestra of Europe, conducted by Claudio Abbado. He was also able to locate an identical digital version and set about comparing the two. Here is where he got sidetracked. For, as he did as a child, he fell in love with the composition and could not help but play it over and over again.

What a novel way to get children (of all ages) to learn about music and the different instruments that work together in a composition. The story of "Peter and the Wolf" is simple enough. A boy, living with his grandfather at the edge of a forest, gets involved in a tussle involving a little bird, a waddling duck, a sneaky cat and a big grey wolf. Bird argues with duck, cat chases bird, wolf eats duck, boy rescues cat and bird, grandfather scolds boy, all live happily ever after (except the duck, we guess, whose fate is left unresolved).

The magical part is that the story is set to music with a different instrument representing each of the characters. So, upon the opening, when the narrator describes the bird chirping happily on a tree branch, a flute plays a little melody. Each time the bird comes into the story, the same melody is played on the flute. This approach is used for all the characters with instruments carefully chosen that best depict them. A clarinet is used for the cat, a deep bassoon for the grandfather, French horns for the wolf and the entire string section represents Peter.

Prokofiev used the orchestra to masterfully show that just as the small animals worked with Peter to defeat the hungry wolf, so, too do the instruments work together to create music. While each of the melodies used for the characters is pleasant alone, together they are most powerful. Thus, at the end of the composition, the narration describes the line of characters walking toward a zoo. The entire orchestra plays during the procession and one can literally feel the ensemble as they march away.

Yes, he got distracted from his music test (you may refer to the Conclusion section of this letter for the results) but found a more important lesson to share with you, our clients and interested readers.



### The Conductor

Each quarter in *Capital Visions*, we share a brief thought or two about the economy, financial markets or our strategies for managing investments. In our July 2005 edition, we described how MetWest Capital is organized into three silos, one each for communications, operations and investments. This structure provides for the independence of the investment team and, particularly during volatile times, its insulation from non-pertinent external influences. We highlighted our attempt to not repeat the "Heisenberg Uncertainty Principle," which holds that the process of measuring something may, itself, cause a change in that being measured.

This quarter we go one step further and use "Peter and the Wolf" as a metaphor for the way we organize our investment team. The children's story shows how an orchestra works together to create a musical masterpiece. While each instrument can convey a tune, only when they are played together do we fully appreciate the richness of the ensemble. The characters in the tale are similarly reliant on each other. It is not until Peter devises a plan involving the cat and the bird that they are able to defeat the wolf. So, individually they play well, but together they create a formidable force. Let's now consider the MetWest Capital investment team.

Here we may compare each instrument with a member of the group:

- **Senior Analysts.** Like the string instruments in an orchestra, MetWest Senior Analysts are front and center, the ones the conductor looks to first. Like a violin or a guitar, they can carry the melody of a composition or add accents to it. The

first (sometimes referred to as “lead”) violin is represented by the Director of Research. Our Analysts function as global sector specialists. At any given time, each focuses on one or two sectors (energy, technology, financials, etc.) as he or she gets to know many of the companies around the world, be they large or small. The conductor does not tell them *how* to play, for each artist has his or her unique style. They look to the conductor for guidance, assuring the orchestra works in concert. There is no incentive for one member to upstage another for like the music of an orchestra, it is the end result of the team for which each “player” is rewarded.

- **Analysts.** Like woodwinds that perform just behind the string section, Analysts work just behind their more senior brethren. Their notes, while every bit as clear as the strings, are a touch crisper, not yet mellowed with age. Analysts function as do the Senior Analysts, but with less experience. We see this as a strength. Just as newer artists are often the ones to develop new and unique techniques for playing instruments, our Analysts may look upon companies from new angles or with novel approaches. Without the baggage that history may sometimes bring, Analysts are unfettered by mistakes of the past. But they also know that living through an orchestral “crash” or two may be a required learning experience.
- **Research Associates.** Like the percussion section provides accent to the melodies, MetWest Research Associates provide support to the Analysts. They allow the Analysts to focus on the companies they must get to know. Timpani and other drums act as the rhythm to the music. By themselves, they may not be melodic, but as an accompaniment to the orchestra, they are required. Our Research Associates help uncover and sort information from corporate filings, databases and other stores of history. They focus on what has occurred, while Analysts try to predict what will be.
- **Lead Strategists.** Like the conductor leads the orchestra, our Lead Strategists provide leadership and direction to the other members of the investment team. In addition, we insist that each of our Strategists functions as an Analyst, specializing in one or two global sectors while acting as a generalist as well. This is analogous to conductors also taking up the piano, playing the underlying melody of each composition. Thus, our Strategists are Analysts as well as coordinators. They set the priorities of the investment team and help to “orchestrate” decisions at times of controversy.
- **Portfolio Managers.** As described in past *Capital Visions*, MetWest Portfolio Managers (PMs) are an important component of the investment team. They participate in the entirety of the investment process and serve to implement the decisions of the Analysts. PMs are also tasked with communicating our strategies to the outside world, similar to Sting’s role as narrator of “Peter and the Wolf.”

So, in summary, the structure of the MetWest Capital investment team may be compared to that of an orchestra. The conductor/pianists (Lead Strategists) lead the group of masterful musicians

(Analysts and Senior Analysts), is supported by percussion (Research Associates) and works closely with the narrators (Portfolio Managers) for the benefit of our valued clients.

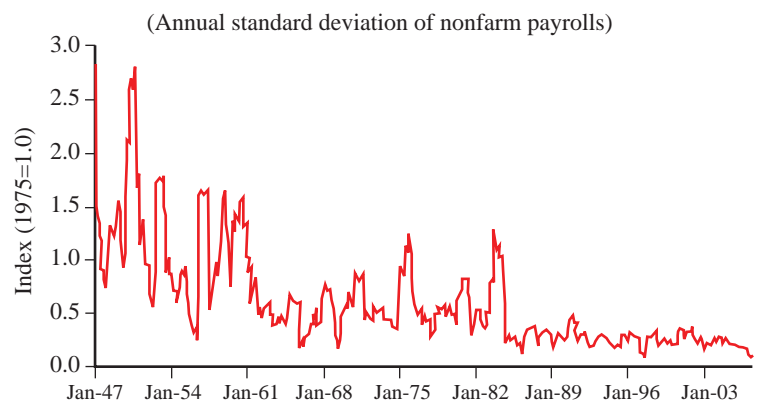
Now let’s turn to the financial markets, the results of the third quarter of 2007 and our thoughts for the future.

## VALUE EQUITIES STRATEGY

Could it be that Alan Greenspan has come to our rescue yet again? How could that be; he retired as Chairman of the Federal Reserve Board (Fed) a year and a half ago? Some have blamed the current U.S. credit problems on his allowing speculation to build up by keeping interest rates too low for too long. Others blame him for raising rates too far. But in his last acts, The “Maestro” (in keeping with our orchestral theme this quarter), as some have nicknamed Mr. Greenspan, raised U.S. short-term interest rates to a level at or slightly above neutrality. Thus, the 5¼% Fed Funds rate he left to successor Ben Bernanke has now given the new Chairman enough flexibility to be able to lower interest rates without undue fear of stoking excessive short-term inflation. This flexibility to send the proper “signals” is one of the most important tools available to any Fed Chairman.

So once again we may find the U.S. in a position to, at best, avoid, or at worst, mitigate, an economic downturn. We have, in past editions of *Capital Visions*, discussed what we see as reduced volatility in the U.S. economy. The following chart, dating back to 1947, highlights this view.

### Volatility of Employment



Sources: Bear, Stearns; Haver

This is a graph showing the volatility of U.S. employment. Note the sharply higher changes in employment experienced prior to the 1980s relative to more recent periods. This reduced employment volatility also feeds through to a decline in the changes of economic activity as measured by Gross Domestic Product (GDP). Contrary to recent media headlines, we see the economy becoming even **more** stable over time.

This reduced volatility is not without risks. In a relatively free capitalist system, while some checks and balances are legislated, most are assumed to occur naturally, as a result of market forces. Thus, investors should be wary not to take on too little risk for fear

of being left out of attractive opportunities. But they should also not take on too much risk, as periodic corrections (be they in the economy, financial markets or real estate) could result in significant damage to one's portfolio. Periodic disruptions are a necessary way of "cleansing" the system and restoring a healthy risk/reward balance. So while we expect the issues of the day to be corrected over time, we do believe that *some* additional pain may be required before the beginning of a new economic cycle.

What we find most interesting about the current difficult credit environment is that neither it nor its causes are anything new. Reading current accounts of today's fixed income market activity may have one thinking that hedge funds and rampant home price increases somehow caused a new sequence of events with which we are unfamiliar. But what has been happening lately is little different from previous savings & loan and banking crises. It's basically the same concept: borrow short-term money at a low rate, create leverage and then lend long. And no matter how hard one tries and how many "exotic" hedges are put in place, the mismatch of assets and liabilities will eventually come home to roost. But the country worked its way out of such past predicaments, and while always mindful of the dire consequences of a credit squeeze, we believe the world's credit markets will work their way out of this one.

## INTERNATIONAL and GLOBAL STRATEGIES

Like the characters and the orchestra in "Peter and the Wolf," and the investment team at MetWest Capital, so, too, do countries around the world now work together, understanding their roles in

the global economy. No longer is it "every country on its own," with only the (often ineffective) World Bank as the orchestrator. This scenario has come about more from necessity than by careful design. Inflation in the developed world was caused by production bottlenecks and an increasingly inflexible (and/or unwilling) workforce. Emerging countries have now come to the "rescue" providing, for the most part, high-quality yet inexpensive labor and goods for the mature consumer economies. The developing world gains by importing capital and "know-how" to build up its infrastructure as it learns to provide for the needs (and wants) of its growing population.

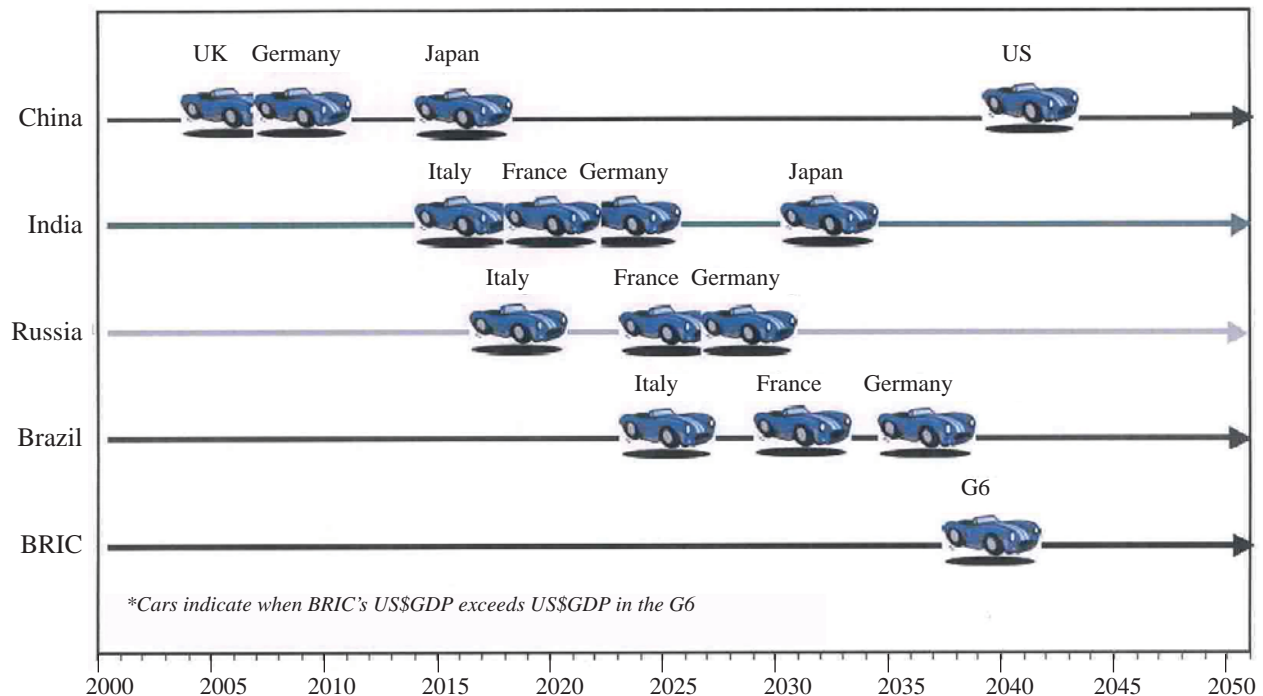
We believe that differences in income levels within countries and between countries is a necessary evil. The communist system ("from all according to their abilities and to all according to their needs") sounds marvelous, yet history says it is not practical. Incentives are required as a motivating tool for most people. Poorer people should have the ability to work hard and succeed in accumulating wealth. Wealthier folks should have impediments imposed to control the power that could result from excess. So we may always desire some economic inequality, as long as it is not excessive.

We are pleased to see that the huge wealth imbalances in the world today are narrowing. Even more optimistically, we see this imbalance being cured **not** by wealthy nations becoming poorer, but by poorer nations growing faster than their richer brethren. The graph below highlights this progress.

This graph plots race cars representing the relative wealth of selected nations. Wealth is measured as GDP in U.S. dollars

### A New Economic Reality

(Overtaking the G6: When BRIC's US\$GDP Would Exceed G6)



Sources: DnB NOR (a Norwegian commercial bank) and Goldman Sachs

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(current dollars at current exchange rates). The race cars denote when one country or region's Gross Domestic Product is expected to overtake another's. The largest and fastest-growing developing countries are listed as one line each on the vertical axis. Together, **B**razil, **R**ussia, **I**ndia and **C**hina are sometimes referred to as the "BRIC" nations. Each car stands for one of the largest developed nations and together, the U.S., U.K., Japan, Italy, France and Germany are grouped as the G6.

Note that as a first step, China has already surpassed the U.K. in economic size. It is expected to surpass Germany this year. In 2006, China's GDP was \$2.6 trillion while the U.K.'s was \$2.4 trillion. The U.S. (whose 2006 GDP was more than \$13.0 trillion), with a population that is growing at 1% annually, will likely remain by far the largest economy on earth until it is overtaken by China. Even that wouldn't occur before 2040 and only if China can maintain its growth rate of twice that of the U.S. throughout the period. But note that in the coming thirty years, one by one, India will surpass Italy, France, Germany, then Japan as Russia will become larger than Germany, etc. Eventually, the BRIC countries as a group are expected to be larger in economic output than the G6 as a group.

One must point out that, as the population of the BRIC countries is far greater than that of the G6 countries, even by 2040, GDP per capita will be far higher in the developed world. At that time, we look forward to updating you about what the world may look like in 2070!

Let us now highlight a few opportunities we are taking advantage of 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: Large Cap Intrinsic Value, Small Cap Intrinsic Value, International Core Value and Global Intrinsic Equity. Fixed Income is covered in the section that follows. The following new investments were selected as representative and do not necessarily reflect our "best" or "highest-conviction" ideas:

- **Hospira**, spun off from Abbott Labs in 2004, is a hospital supply company that focuses on specialty injectable pharmaceuticals and medication delivery systems. We often find value in "spinoffs" and Hospira is a good example. Having become lost within the larger Abbott organization, Hospira management is now better focused on its core businesses and able to allocate R&D and capital for the benefit of its new shareholders. Its recent acquisition of Mayne Pharma Ltd. fills out its sales footprint in Europe while adding new products to its pipeline. This highly accretive acquisition would likely not have occurred under Abbott. With high returns on capital, we find Hospira a compelling investment.
- **Invensys** is a U.K.-based company formed by the 1999 merger of Siebe with BTR, plc. The company's history can be traced to the early nineteenth century when Augustus Siebe commercialized the modern diving helmet. Today, Invensys's products include factory automation equipment & software, rail signaling equipment and appliance &

building controls. While the current stock price (less than 12x next year's earnings) reflects the cyclical nature of some of the company's product end-markets, we believe that many of its long-cycle businesses (including oil & gas, electric utility and petrochemical process controls) will add value for years to come.

- **Papa John's International**, with revenues exceeding \$1.0 billion, is the world's third-largest pizza chain. It franchises more than three-quarters of its U.S. locations and all of its overseas shops. This model allows the company to generate very attractive returns on invested capital and generate FREE cash flow that is consistently used to repurchase its shares. Management is expanding internationally through the franchise model and believes that overseas markets offer tremendous growth opportunities. Temporary weakness in U.S. consumer spending has provided us an opportunity to invest in a business with solid financial characteristics at a very attractive price.

## FIXED INCOME STRATEGY

We believe that, within a very wide range, the cost of a necessity is less important than its availability. This is true of food, energy and our national defense. It is also true of money and credit. Defining the cost of money as interest rates, we took note of how the economy expanded uninterrupted as the Fed raised short-term rates from 1% in mid-2004 up to 5¼% two years later. As long as credit was readily available, money was borrowed. But more recently, even as interest rates have declined, the increasing difficulty of getting credit has threatened the current U.S. economic expansion.

We thus may be proven wrong in our thinking that interest rates will remain within +/- 50 basis points (one-half percent) of where they began 2007. Already, at the Fed's meeting of September 18, it moved short-term rates down by that amount. Longer-term rates have stayed inside that band but between June and September have neared **both** the upper and lower extremes (5.2% in June and 4.3% in September). We had not factored in the near shut down of some U.S. credit markets and, while we remain sanguine in our long-term outlook, we remain concerned about the ramifications of such a credit crunch.

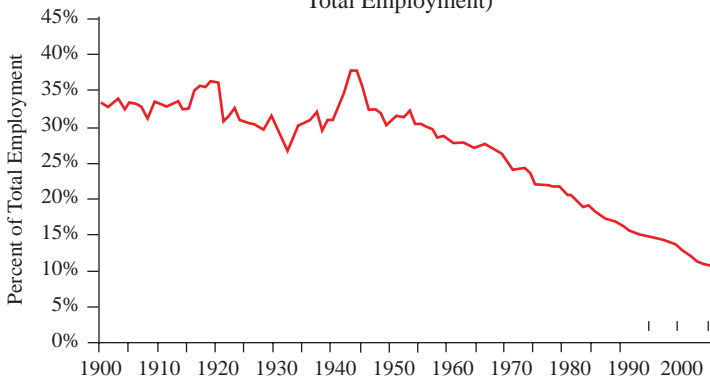
Lower interest rates, in and of themselves, may not remedy the current problems. Remember that interest rates are near **zero** in Japan and yet that economy has remained sluggish, as nobody wants to borrow money at **any** price. Renewed confidence in our financial system and the outlook for the future is required for credit to become desirable again. As modest credit growth acts as a "lubricant" for a healthy economy, its availability is essential.

Many believe that the Fed was caught off guard about the impact that housing and subprime lending would have on the economy. We believe one of the reasons for this lack of clarity is the changing composition of the economy. Over the past several decades, a lot of effort has gone into developing leading indicators. The difficulty is that these "leading" indicators have been developed using "lagging" techniques. The following chart highlights an example.

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## Employment

(Manufacturing Employment as Percent of Total Employment)



Sources: Bear, Stearns; Haver

This chart, dating back to 1900, shows U.S. manufacturing employment as a percent of total employment. It is no secret that this country is now a “service” economy. Thus, insurance, medical care, education, leisure and restaurants employ far more people than do auto, textile and steel factories. Today, only 10% of our workforce produces goods while 90% provide services. We see manufacturing as following a trajectory similar to that of agriculture, whereby productivity is so great that today less than 3% of our population produces far more food than the entire country can eat. We see this as a long-term positive, leading to sustainably higher living standards.

However, we believe that government statistics have likely not kept pace with the economic shift. While we do not wish to single out any particular economist, a recent survey by UBS attempted to gauge inflation views by corporations. Of the 26 industries questioned, only **four** were in the service sector. As but one (blatant) omission, food manufacturers were included but restaurants were not. Since in 2007 nearly half of all food consumed in the U.S. will be eaten away from home, this seems symptomatic of the difficulty we have in properly accounting for this inflation indicator. As services continue to increase in importance in our economy, economists must find more inclusive ways of measuring economic data. If not, we may continue to be caught off guard by suddenly changing credit or other trends. We shall continue to diligently monitor these important trends.

*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

We are often asked to describe the organizational structure of the MetWest Capital investment team. “How are decisions made? Do you use the ‘star’ system, whereby one person makes all decisions? Or do you employ a committee structure with one person, one vote?” The answer is, “neither.” We use an “orchestral” approach, similar to the characters and the accompanying musicians of Sergei Prokofiev’s “Peter and the Wolf.” We further described our internal structure this quarter in our continuing efforts to communicate not only our investment strategies, but also the method by which those strategies are developed and implemented.

This quarter we also discussed the lessening volatility of the U.S. economy. We believe that today’s credit crunch, little different from past episodes, will be resolved over time. We maintain that we are living through a new economic reality whereby, at current expansion rates, the world’s largest developing countries will overtake, in total GDP, the developed countries within thirty years.

But what about our music test? Our Analyst was sidetracked by his love of the score for “Peter and the Wolf.” But he did eventually compare the older media (vinyl and CDs) with the newer digital MP3 format. Maybe this will be the topic of a future edition of *Capital Visions*, but the test reminded us that like so much in life (and the financial markets), there are tradeoffs. The vinyl sounded more “real” and lifelike with warmer musical tones and wonderful fading in and out of tracks. But it also was “scratchy,” sometimes distractingly so. The newest MP3 format was the clearest, lacking any distractions, but the high flute and low bassoon sounded, in a way, compromised and not nearly as extreme as that heard on the vinyl. The best medium may be the CD, a good compromise of quality and reality.

But beneath it all, one must remember that in any medium, it’s the underlying musical composition that elicits the feelings. The same, we believe, is true in an investment organization. Properly constructed, the “whole” should always be greater than the sum of its individual parts.

*We welcome the newest addition to our investment “orchestra.” Jake Gilden joins us from the Haas School of Business at U.C. Berkeley as our newest Analyst. Jake says that, “Like a bagpipe, my analytical work is traditional and resilient.”*



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