

Capital Visions

High Hopes

Many within our firm strive to stay healthy with good diets (within reason) and regular exercise. As part of this regimen, one of our Portfolio Managers visits a nearby health club almost daily. He's been going to the same one for the past few years. His workout routine begins with some stretching exercises, followed by sit-ups, twelve minutes on a stationary bicycle and, finally, thirty or forty minutes of weight training. All in, with a quick clean up and travel time, it's a refreshing seventy-five minute break from his day analyzing investments.

Recently, in the middle of his routine, he noticed a group of fellow exercisers he hadn't seen before. At first, they stood out due to their unique blue polo shirts. Then he saw other differences. Some within the group were exercising no differently than others at the gym. But some required special assistance to adjust the weight machines. A few were lifted out of wheelchairs and placed into some of the curl or leg machines. There was one lady who caught his attention as she spoke loudly while using the StairMaster® machine. Loud (annoying) talking on a cell phone is not unusual these days, but this person did not have one, nor was her conversation directed at anyone in particular.

Assessing the group more carefully, our PM concluded that about half of the people were there to work out and the others were present to facilitate the process. It was then that he noticed the logo on the blue shirts: "High Hopes." What a wonderful organization!

A charitable organization started more than thirty years ago, the **High Hopes Head Injury Program** has a stated mission of rehabilitating and retraining individuals who have suffered traumatic head injuries. The basic premise is that both mental and physical conditioning foster the rehabilitation process. Particularly with cognitive or neurological disorders, physical exercise is one of the most therapeutic, yet oftentimes overlooked, parts of the process. So at least twice per week, High Hopes fills a van with patients and staff to go to the local gym for a workout.

In some cases, the exercising is not overly strenuous, as some of the injuries have resulted in lingering physical debilitations. But patients, either on their own or with help, work up a sweat that, at times, puts to shame others sharing the health club. The exercise has many benefits. First, interaction in a public gym allows part of the "stigma" of injury to moderate. Next, the build-up of adrenaline during exercise aids body movement and

builds muscle adjacent to any injured areas. Finally, and a great benefit of exercise for anyone, it promotes better and longer rest at night that, in itself, fosters deeper relaxation and a calmer, more productive day to follow.

So while head injuries may affect the outward appearance of some individuals, beneath the surface still oftentimes lie wonderful and capable people. The High Hopes organization recognizes the uniqueness of the individual behind the façade. It works to help get behind the "cover" of the individual to unlock each person's strengths. High Hopes "invests" in great people whose qualities others may not sufficiently recognize. This is similar to how MetWest Capital invests in great businesses that others don't sufficiently recognize, either.

Differentiating Factors

With all the press reports of recession and financial market dislocation, we think this is a good time to reiterate the MetWest Capital investment philosophy and how it may differ from others. We describe High Hopes' mission with its clients as analogous to MetWest Capital's investment philosophy. It is often difficult for rehabilitation workers to look beyond the symptoms of head injuries to really connect with the individuals underneath. Similarly, with cursory analyses, investors often overlook great businesses. In this quarter's report to you, while we will briefly discuss our thoughts on the markets and the economy, we wish to emphasize that our process remains focused on individual companies.

With more investment management firms in this country than stocks listed on the New York Stock Exchange, one often wonders how one money manager may differ from others. While each firm strives to add value in its own way, the table on the next page lists factors that we believe differentiate MetWest Capital from many of its peers.

The left-hand side of the table pertains to various characteristics of MetWest Capital. Each corresponding line on the right is what we have found with regard to those characteristics at many other firms. The top boxes of the table describe elements of the investment process, while the bottom boxes show how investment firms' structures may differ. While space will not permit us to expand on each item in the table, we would be happy to have the opportunity to do so in person or via phone or e-mail; please do not hesitate to contact us for such a review.

<p style="text-align: center;">MetWest Capital INVESTMENT PROCESS</p> <ul style="list-style-type: none"> • Invest in businesses • Individual company focus • Do <u>not</u> start or end with valuation • Global process • Long-term focus, resulting in low turnover • Best efforts learning more about what we currently own • Ensure proper diversification by security, sector, industry and economic factors • Study the “how” of corporate profits • “BIG PICTURE” – focus on pertinent business drivers • True investment opportunities are few, but long lasting • Build long-term <i>normalized</i> financial models • Seek to identify structural business change 	<p style="text-align: center;">Many Investment Firms INVESTMENT PROCESS</p> <ul style="list-style-type: none"> • Trade stocks • Industry/“theme” focus • “Screen” on value metrics • U.S. or country-centric process • Turnover $\geq 100\%$ • Always looking for “new ideas” • Value-oriented indices guarantee high interest-rate sensitivity and high exposure to financial services firms • Focus on the “if” of corporate profit growth • “MINUTIAE” – focus on less significant, shorter-term factors • Stock opportunities are “fleeting” • Focus on reported historic metrics • Look to “beat the Street”
<p style="text-align: center;">FIRM’S STRUCTURE</p> <ul style="list-style-type: none"> • All analysts may impact investment decisions • Analysts compensated on success of entire strategy and work with each other • Understand the importance of partners (owners, employees, clients, suppliers, community) 	<p style="text-align: center;">FIRM’S STRUCTURE</p> <ul style="list-style-type: none"> • PMs make decisions • Analysts motivated singularly and compete with each other • Some “hedge” funds generate extraordinary fees for owners that could create objectives inconsistent with those of clients and others in the firm

In summary, our process seeks to invest in HIGH-QUALITY businesses utilizing a GLOBAL approach with a LONG-TERM perspective and FOCUSED investment team. Similar to the way High Hopes invests in people, our style is to INVEST in great companies that are not sufficiently recognized by others.

As with any investment methodology, there are certain characteristics associated with MetWest Capital’s *Intrinsic Value* approach that are important to understand. Some of them are:

- Sometimes buying or selling investments too early. Like J.P. Morgan’s famous quote, “I made all my money by being too early,” we do not try to time absolute bottoms or tops, but rather seek to identify good values that we expect to perform well over the long term. We are in an *optimization* business rather than a *maximization* business.
- Focus on trying to distinguish temporary changes from fundamentally failing business models. While difficult, it is important to discern cyclical or temporary changes (that will be overcome with time) from fundamental, long-term sustainable shifts. When supermarkets began to lose market share to restaurants, some saw it as merely a sign of a healthy economy. Others recognized changing eating habits. Now that grocery stores are gaining share again, we must try to determine the sustainability of that trend.
- Finally, as we take the time to get to know the companies in which we invest, we must always be “on guard” not to get too close, for fear of forming an “allegiance” or feeling beholden to anyone if the time comes to sell. Our continued pursuit of objectivity is a critical part of our process.

These represent some of the characteristics fundamental to our approach. Importantly, we continue to work hard to learn from every investment we make as well as from those that we analyze but choose not to make. Now, we’ll provide a brief review of the financial markets and some thoughts about the future.

VALUE EQUITIES STRATEGY

Murphy’s Law (“*Anything that can go wrong will go wrong*”) struck as predicted. As our investment philosophy is more focused on individual companies than broad market or industry trends, we typically limit the frequency and fervor of our market predictions. Last quarter, however, in our *Capital Visions* entitled “The Dead Sea,” we noted that even with all that was “thrown” against them, the U.S. economy and its stock market just wouldn’t seem to go down. With some trepidation, we concluded our report saying that “*Murphy’s Law would suggest that as soon as we write [about] the never-ending bull market, stocks will decline.*” And so they have thus far in 2008.

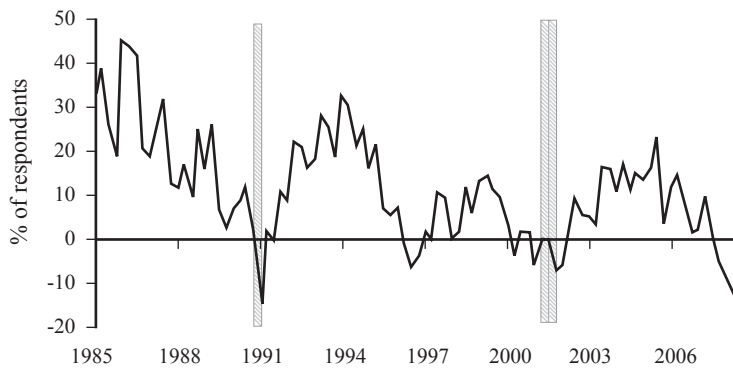
The “good” news is that the reason for the recent uncertainty seems clear. There is an ongoing deleveraging of fixed-income investments. This was precipitated by a slowdown of the U.S. housing market after several years of outsized gains. While at first confined to only housing-related segments of the economy, the malaise seems to be spreading and has now hit the all-important labor market. We say it is “good” to know this as with the issues clear, policymakers can now go about their attempts at solutions.

There is an old adage that states, “Banks will lend only to those

who do not need to borrow.” This may never have been more true than it is today. As is quite typical in an economic cycle, during the “good” times, banks and other lending institutions find it easy to lend, as most businesses are growing, people are well employed and both are capable of repaying borrowed funds. As each cycle progresses and eventually turns downward, the fear of nonpayment of debt (default) has those same lenders reining in. Logically, it *should* be the opposite, but it is not. In an ideal system, during the boom times, lenders would hoard cash and serve to “tap the brakes” on the economy. They would then be able to “floor it” and dramatically loosen up lending when the environment turns sour.

The following graph, however, depicts reality, not ideality.

Increased Willingness to Lend to Consumers



Data source: Federal Reserve Board website

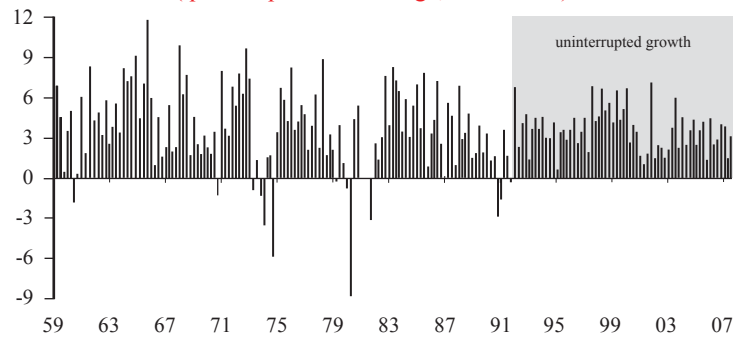
The graph represents a survey of bank lending officers taken from March 1985 to February 2008. The questions behind the survey are meant to gauge a change in lending behavior rather than the absolute level of loan activity. As the graph shows, banks typically reduce their willingness to lend during periods of slowing growth. The points to notice are the steep declines coincident with recessions. The recessions are depicted by the vertical shaded areas in 1991 and again during 2001. While we may be in a recession as of this writing, it has not been officially recorded and therefore is not yet delineated on the graph. But the -15% figure of the last observation is consistent with prior economic downturns. Isn't this like “closing the barn door after the horses have escaped?”

Of course, lenders are not alone in their backward-looking thinking. How many homebuilders have cut production *after* sales began to slide? How many consumer companies have cut back on advertising *after* consumption slowed? How many individuals have failed to save for a “rainy day” only to wish they had when the job market became bleak?

While we recognize that economic recessions always cause hardship for many, we are not unduly concerned about its occurrence today. As slowdowns of magnitude have been few and far between in recent decades, the uncertainty a recession brings is causing policymakers (both on the monetary and the fiscal sides) to “pull out all the stops” in order to limit its depth and duration. The following chart shows that the last time the U.S. consumer

experienced **negative** real spending growth was nearly *sixteen* years ago. It is no wonder that fear of the unknown is taking hold.

Real Consumer Spending (quarter/quarter % change, annualized)



Data source: The Bureau of Economic Analysis website

So, why the lack of worry on our part? With the caveat that the current “chasm” of illiquidity must be crossed, we believe when that occurs, the financial markets will follow the global economy higher. While it may be painful in the short run, it is healthy to experience a recession. There is no doubt that uninterrupted global growth carries with it ever-expanding expectations of returns that cannot realistically be met. This overreaching was to some degree responsible for the tech bubble in 2000, the housing bubble more recently and what may be an ongoing commodity boom (we won't quite use the term “bubble” yet, but we could be getting close) today. A slowdown will bring with it a partial unwinding of excess financial leverage and more realistic expectations for future returns. We expect that we are going through this process today.

INTERNATIONAL/GLOBAL STRATEGIES

International financial markets mostly took their cue from the U.S. this past quarter. There is some early evidence that as the U.S. economy slows, import demand will fall and cause a small ripple effect throughout countries that have relied upon the U.S. for their exports. Thus, German, Japanese, Dutch and even Chinese equities declined during the first quarter of 2008. As we discussed in our *Capital Visions* last quarter entitled “The Dead Sea,” we don't believe that the emerging economies of Brazil, Russia, India, China and others are sufficiently “decoupled” from the U.S. so as not to feel our slowdown.

We at MetWest Capital are looking forward to evaluating the fundamental performance of some of the larger companies within emerging markets during such a slowdown. While we have long agreed that their prospects were bright, we have also seen them as largely untested throughout an economic cycle. Part of the investment process we highlighted this quarter is to invest in “great” companies. One of the characteristics of greatness, we believe, is acceptable results during trying times. Thus, each down cycle changes our views on at least some companies, both in the U.S. and around the world.

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: *Intrinsic* (Large Cap) Value, Small Cap *Intrinsic* Value, International Core Value and Global *Intrinsic* Equity. Fixed income is covered in the next section. The following new investments were selected as representative and do not necessarily reflect our "best" or "highest-conviction" ideas:

- **Three Banks:** As many financial-related "babies" get thrown out with the "bath water," we have recently invested in three banks. **Zions Bancorporation** focuses on business lending in its home state of Utah as well as throughout Texas and the western states (including California). **Synovus Financial**, after its recent spin-off of payment processor Total Systems, is now a "pure" bank operating in the southeastern U.S. Like **Zions**, it allows each of its bank holding companies to operate independently under local community banners. Shared services such as back-office processing allow each bank to tailor its offerings to its unique customer set while still maintaining a highly efficient company. Lastly, **East West Bancorp** (previously owned for both our Large Cap and Small Cap *Intrinsic* Value clients) focuses on the ethnic Chinese community, largely in Southern California, in its consumer banking business while taking a more general approach toward all client types in its business lending.
- **AMN Healthcare Services, Inc.** is the leading temporary healthcare staffing company in the U.S. The company provides traveling nurse and allied staffing, temporary physician staffing and permanent physician placement services. It recruits healthcare professionals both nationally and internationally and places them on variable-length assignments at hospitals, physician practice groups and other healthcare facilities throughout the U.S. Due to short-term factors, we were recently able to invest in this market leader for the second time in the past five years.

FIXED INCOME STRATEGY

The Fed is in a dramatic easing mode, having lowered the Fed funds target rate, injected liquidity into banks and brokerage firms and otherwise exercised its authority to ease credit and facilitate the normal functioning of U.S. credit markets. As a result, interest rates are far lower than the most recent peak that stood for the two years ending September 2007. David Malpass, Chief Economist at Bear Stearns, sums up the current environment well:

"The [previously] low Fed funds rate since 2002 and inattention

We welcome the newest member of the MetWest Capital investment team. Alex Alvarez, CFA joins us to focus on smaller company investments. We have very "high hopes" for his future.

to credit quality encouraged massive leverage, bidding down credit spreads to record lows across many asset classes. Short-term funding of long-term assets became common. [MetWest Capital comment: Another example of quite typical behavior within an economic cycle.] It's a wrenching process for credit markets to reduce the maturity mismatch, shifting to a system with less leverage, wider spreads and a reduced notional value for derivatives . . ." Dr. Malpass goes on to predict a "not too disruptive" impact on U.S. GDP.

As discussed earlier, policymakers, including the Fed, are doing all they can to avoid and/or limit a U.S. economic recession. This they may well do. But the current level of U.S. interest rates is inconsistent with the current trajectory of inflation. Fixed-income securities are supposed to compensate investors for the long-term decline in the purchasing power of currency. Over very long periods of time, interest rates have slightly exceeded inflation, and so their current discount to inflation levels is not sustainable. We therefore believe that over time, either inflation levels will drop or interest rates will rise. To that end, we have been very conservative in our fixed-income investments.

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 decisions 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

This quarter we drew parallels between members of High Hopes and the companies in which we invest. At MetWest Capital, we seek out those companies that we believe will not only recover, but will also go on to new heights. We used the High Hopes analogy this quarter to emphasize the MetWest Capital investment process and how it may differ from that of other investment firms.

We use a GLOBAL approach to seek out HIGH-QUALITY businesses. We invest in a small number of companies with a LONG-TERM time horizon. We try not to be too distracted by the "news of the day" and, instead, attempt to uncover and FOCUS on those few companies that can thrive during different market and industry environments. While we can't consider ourselves the lone firm employing this philosophy, we do see ourselves as increasingly rare, given the ever-shorter time frame we witness others utilizing.

Of course, we cannot guarantee our investment results. But we can say that our team, together for many years, will remain focused on implementing our process for the benefit of our clients.



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