

Capital Visions

Peking Duck

One of our Portfolio Managers was fortunate enough to take a trip to Asia this past spring. He visited several cities within Taiwan, including the current capital of Taipei and its older sibling, Chiayi. He then went on to Hong Kong and stayed a day in Macau before spending a week in Beijing, mainland China's capital. The timing of the trip was fortuitous, as he was able to witness several historic events, including the Taiwanese presidential election and preparation for the upcoming 2008 Summer Olympics.

One of the highlights of any such trip is always the sampling of the local fare. Taiwan is known for its unique smoked chicken (best eaten right out of the smoker while standing on the edge of a highway). Macau featured some wonderful dishes reminiscent of its history as a European colony. Thus, the Portuguese sausage was amazing. But the pièce de résistance was to be found in Beijing.

While in the capital city, it was highly recommended to venture out to the Beijing Da Dong Roast Duck Restaurant. While the phonetics for Chinese changed some time back, the previous spelling for the name of the capital city has, for Americans, been retained in the name of the traditional "Peking" duck dinner. The place was mobbed as the establishment is so popular that reservations are not taken. But not being in a hurry, our PM stood with his party in the large waiting room. He was mesmerized as he gazed into the kitchen through a special window where he could watch the duck being prepared.

First, he witnessed a thorough cleaning of the bird, both inside and out. Next, the trimming of the parts that wouldn't be eaten. He noted that the head remained attached and later saw it is a delicacy for some. Then the duck was given a quick "bath" in an oily solution so secret that the restaurant wouldn't even admit it existed. "Oh, that's just another ritual of cleaning," they claimed. But this was part of the "secret sauce" that resulted in an exceptionally crispy, yet not too greasy, skin.

Initially, our PM thought the kitchen window was a bit of gimmickry designed to keep restless clientele occupied during their long wait for a table. But he was later told that the intent of the window was to highlight the cleanliness of the facility and a rare "A" government rating. Most restaurants would never allow such a window for the horrors that may be revealed. The Peking duck dinner was delicious, but the lessons in transparency learned from the restaurant were even "tastier."

Transparency

Beijing is rapidly transforming. China's second-largest city after Shanghai, its 8.5 million inhabitants are exuberant to be hosting the upcoming Olympic Games. It is also a metropolis, like so many in the developing world, that is home to both great wealth and great poverty. The abundance was in plain sight, such as the long lines to get a table at Da Dong. But the weaknesses, as in much of China, were hidden. Unlike at the restaurant, transparency was seldom to be found.

China undoubtedly holds long-term promise. Its population of 1.3 billion makes it by far the largest country on earth by that measure. While it is not self-sufficient in all that it needs or wants, the country does have vast natural resources including oil, minerals and fertile land. Its culture, dating back thousands of years, honors hard work, education and high ethical standards. The bottom line is that its people and their leaders really want to succeed.

But China is a centrally planned, semi-regulated economy with a Communist political system. Therefore, we believe that China's economic ascension may not result in the path to substantial growth that many of the world's companies seem to be counting on. During an increasing number of meetings conducted by MetWest Capital analysts, companies talk about China and the promise it holds for them. Yes, they discuss other emerging countries as well, but none as much as China. But consider a sampling of issues that highlight a lack of transparency:

- > Chinese citizens can own their own homes and apartments, but only on LEASED land. What happens when the leases come due – not an issue for the current generation, but certainly one for the future – has not been considered at this time.
- > Non-Chinese cannot own land, buildings or even a majority interest in businesses.
- > Part of the great economic rejuvenation in China is that workers may be paid bonuses based upon their individual productivity. They may even own a business – as long as it doesn't compete with any government-run enterprises (which are many). So, it is common for people to hold two jobs: one "official" and then a second. How many of these second jobs are truly in the official employment/tax/revenue figures is anyone's guess.

- Just about every aspect of the Chinese economy is centrally planned and controlled. Even “free market” initiatives are constrained so as not to be too free. But what does “too free” mean and how is this notion applied? Again, these constraints are unknown, even to those within the system.
- Interest rates, currency values and the prices consumers pay for just about everything from housing to rice to electricity to gasoline are all carefully set and controlled. The formulas (should they exist) for setting these important levels are not widely disclosed.
- Economic trade and investment are neither open nor free. Further, accounting rules and regulations are often not based upon recognized international standards.
- According to its published data, China has not experienced an economic contraction in recent times. Most companies are not experienced in navigating one. In addition, property rights are untested during adverse conditions and one does not know if companies (domestic or foreign) will be allowed to claim assets from other companies and/or individuals, should the need arise.

We are not, at this time, stating that one must avoid China and any company doing business there. On the contrary, we still believe that China, together with many emerging economies, will continue to develop and narrow the income gap separating them from their developed brethren. But we must raise some important issues and questions. These and other issues have been, and will continue to be factored into our thinking about the companies in which we choose to invest. Our point this quarter is very simple: In one’s investment analyses, beware of China and its growing importance to the world’s economy and do not rely solely on this one country’s ascension. It is not yet a transparent society and thus poses considerable risks and uncertainties.

Now, let’s provide a brief look at the financial markets and some thoughts about the future.

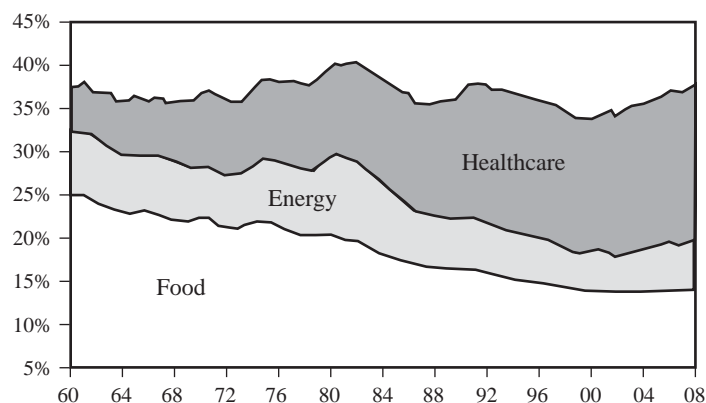
VALUE EQUITIES STRATEGY

U.S. stocks have taken their cue from the U.S. economy and, as measured by the S&P 500 Index, have declined more than 10% thus far in 2008. Most of that damage occurred during the first quarter, but as the economy weakened further, and uncertainties persisted, equities struggled in the second quarter as well.

We believe that U.S. and world monetary and fiscal authorities may be a little *too* worried about the dangers of recession. “Memories” of the Great Depression and, more recently, the decade-long Japanese slump, have policymakers doing all they can to avoid repeating mistakes of the past. While economic slowdowns cause short-term pain that we wish on no one, they are sometimes healthy in the long run and can rejuvenate otherwise unbalanced growth. Free economies require that risk taking be limited beyond what may be sustainable. Unsustainable risk taking was happening and, one way or another, had to be contained.

We also believe that too much focus is on food and energy prices and not enough on some potentially monumental issues facing our society long term. Especially during an election year, we understand the temptation for policymakers to cater to the worries of the day. But **every** year there’s an election (or, at the least, opinion polls) going on somewhere. Thus, some very difficult choices are not adequately addressed. The following chart highlights our concern.

U.S. Consumer Spending



Source: Federal Reserve Board

This chart, dating back to 1960, shows the proportion of U.S. consumer expenditures for food, energy and healthcare. As of 2008 Q1, consumption was about 72% of total GDP (the other 28% being investments, government expenditures and net exports). The chart shows that of the 72%, food and energy represent about 20% (so just over 14% of total GDP) while healthcare, the most rapidly growing component, comprises another 20%. In many ways, the solution to runaway food and energy inflation may be easier than a fix to rapidly rising healthcare expenditures.

While the following may sound outlandish, let’s say that every able-bodied adult in the U.S. voluntarily went one day during the year without consuming any food or using any artificially created energy. Just the slight excess caused by the resultant demand reduction could drive prices of such commodities lower for the entire year. This is NOT our suggested cure, but an illustration that a fix may not be as intractable as some think.

On the other hand, we absolutely cannot do without healthcare, even for one moment, as that instant could be the difference between life and death. We are also mindful that most healthcare is “consumed” as we get older. Food and energy consumption, oppositely, typically declines as people age. Demographic trends clearly point to an explosion in the demand for healthcare – not entirely today or tomorrow, but consistently over the coming years. So, our two-cent political pitch in an election year is *Let’s work together to focus on the most important long-term issues our civilization faces*. That’s not to say we’re to ignore food, energy and all other issues, but putting things in priority order would be a nice first step.

The United States is different from China in many ways. While our country is certainly very far from perfect in many respects, the problems we face **are** largely transparent, well known and often discussed. Yet we fear that if inaction persists long enough, the choices we have for solutions today may turn into extremely difficult mandates in the future.

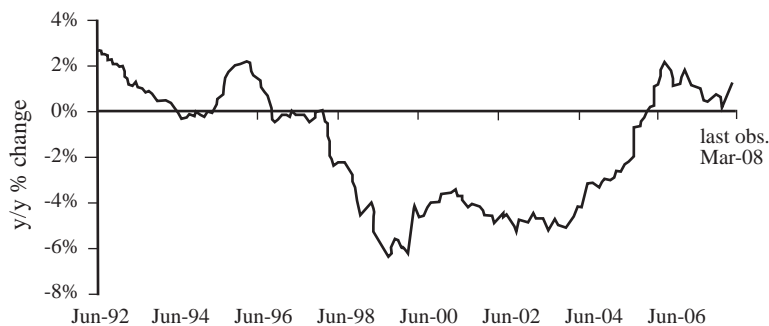
INTERNATIONAL/GLOBAL STRATEGIES

International financial markets have mostly been taking their cue from the U.S. of late. Most European stock markets were down modestly for the quarter but have declined double-digits in local currencies year to date. China's stock market has performed poorly (declining more than 20% in each of the first two quarters of 2008) after a sharp run-up in prior periods. The slowing global economy has been exacerbated by continuing difficulties that Europe has had in coordinating the many disparate interests of its individual constituents. This past June, for instance, Ireland derailed an effort to adopt a new European Union governing treaty. The accord seeks to further strengthen the authority of the central body, but some of its 27 members (all of whom must approve) believe it goes too far. More discussions (and likely discord) are to take place.

On the other hand, the Japanese economy is holding up well. The unemployment rate is at a ten year low of 4.0%, corporate profits are growing in excess of 10% and consumer confidence, after a long lull, is beginning to improve. Most notably, this is an economy that **benefits** from increasing inflation. As the economy has suffered from deflation expectations that curtailed investments and postponed spending, moderately higher prices could act as a significant *catalyst* for future growth.

Also, after more than a decade of fixing their "broken" balance sheets, most Japanese banks remained on the sidelines of the speculative global lending of the past several years. So, not only have they maintained their capital, but most are uniquely positioned to continue to lend, while others around the world are pulling back.

Japanese Bank Lending



Source: Bear, Stearns & Co.

This chart depicts the year-over-year change in lending by Japanese banks from June 1992 through March 2008. Note that after the "bursting" of the Japanese economy in the early 1990s,

bank lending still grew, but at a subdued pace. Eventually, as corporate bankruptcies increased, lending contracted and some of the banks themselves became insolvent.

Recently, for the first time in nearly ten years, Japan's banks are lending again. We see this as broad based, including lending for domestic construction, lending to overseas subsidiaries of Japanese companies (including those doing business in China) and direct lending to firms outside Japan who find Japanese banks' willingness to lend refreshing. We believe this trend is sustainable and thus remain convinced of the continuing growth in Japan's overall economy.

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

- **ConAgra Foods, Inc.** is a food company with many familiar brands including *Healthy Choice*, *Orville Redenbacher* and *Hebrew National*. It also owns Lamb Weston, the leading provider of potatoes and french fries to the fast-food industry. CEO Gary Rodkin joined the company in late 2005 and is dramatically transforming this once-staid food conglomerate into a focused and innovative consumer foods company. Still in the early stages of a long-term process, and with the company's stock yielding 3½%, we find ConAgra to be a compelling investment.
- **EMC Corp.** is the world's largest provider of high-performance data storage products. EMC, IBM and Hitachi dominate this market as other companies try to grow with smaller systems. The company is also an important software developer, particularly for data storage, security and virtualization. Its 85% stake in publicly traded VMWare is, by itself, worth 62% of EMC's \$33 billion market capitalization. This leaves the remainder of the core businesses extremely undervalued, in our view. We believe that management is focused on narrowing this significant price discount to the *intrinsic* value of the company and will succeed in doing so over time.
- **Bio-Rad Laboratories, Inc.**, with \$1.5 billion in revenues, is a multinational manufacturer of life science research, clinical diagnostic and analytical instrument products. The company's systems separate complex chemical and biological materials and identify, analyze and purify their components. A lack of growth in the last few years due to a declining mad cow disease testing business provided us an opportunity to invest in a solid business at a very attractive

valuation. New product introductions, recent acquisition integration and favorable macro trends in the life science research market should lead to margin expansion and act as *catalysts* to increase the valuation of this company towards our estimate of its *intrinsic* value.

FIXED INCOME STRATEGY

The Federal Reserve Board (Fed) continues to do all it can to calm the fixed income markets. It has lowered interest rates seven times, leaving the Fed Funds Rate currently at 2.0%. It has injected liquidity in many ways, including an historic move to lend to securities firms (typically the Fed lends only to banks). Finally, in June of this year, the Fed provided a \$35 billion guarantee of assets to help close J.P. Morgan's purchase of Bear Stearns. Further actions may be taken if conditions don't improve, but we believe that the fixed income market needs to "right" itself. Thus, confidence must return so buyers have comfort that what they purchase today will not disintegrate tomorrow. This will occur when "de-leveraging" has run its course.

We often attempt to discern what is "normal." Are companies **over**- or **underearning** their steady state? Is the global economy, and its components, **overheating** or functioning **below** its potential? With the belief that these factors rarely operate **at** normal (we're usually too "hot" or too "cold"), we believe that the U.S. is currently going through a "normal" economic slowdown. The last slowdown (in 2001) was somewhat of an aberration in both its cause (tech bubble burst and 9/11) and makeup (significant business slowdown while the consumer continued to spend). Today, a weak housing market, less confident consumers and higher unemployment are all normal at this stage in a cycle, in our opinion.

Yes, housing sales and new starts have declined by historically large amounts. But at 600,000 new single family units at an annual rate, this is similar to past cyclical periods. The drop has been exacerbated by the unusually **high** number of starts earlier this decade. So while the boom, and now bust, in housing are causing ramifications beyond that sector, we see current events

as needed and, though painful for many, required to cure some of the excesses that were built.

We are sanguine about the long-term prospects for the resilient (and relatively transparent) U.S. economy. We think that while there is still some risk of further market dislocations, a year from now we could be well on our way to recovery. We thus see very little value in longer-term fixed income instruments as higher interest rates could accompany such a rebound. As always, we will monitor events and take action across all of our investment portfolios as the situation warrants.

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

The trip to Asia was memorable. Not only in the sightseeing (the new Olympic stadium in Beijing was truly a sight to behold), but also in the lessons learned on transparency. It was unusual to find restaurants with windows into the kitchen, as most had far lower than "A" cleanliness ratings. The Da Dong ("Peking") Roast Duck Restaurant was an exception. The same held true for all of China as wealth and progress were well displayed, but much of the "norm" was hidden.

As so many companies around the world herald their increasing exposure to the rapidly growing Chinese economy, we raise a caution flag. Take a good look. Note the lack of transparency in much of China's society and many of its companies. We at MetWest Capital will not avoid Asian investments but will verify that among our investments, those companies who do business there are well prepared for bumps along the road to prosperity. For while bumps may be ridden over, crevices are hard to traverse. We look for great businesses that can thrive without China, adding "gravity" on top should that country thrive without pause.

We wish much success to the athletes and look forward to games well played at the upcoming XXIX Olympiad.



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