

# Capital Visions

## Wake Up!

Newlyweds Mike and Joanne were experiencing some marriage issues. They went nearly an entire day speaking little to each other, mostly leering. As evening fell, this descended into the “silent treatment” with both determined not to be the first to crack. But right before bed, Mike remembered that he would need his wife to wake him up at 5:00 the next morning for a golf outing with some friends. Not wishing to break the silence (tantamount to admitting “guilt”), he wrote on a piece of paper:

*“Please wake me at 5:00 tomorrow morning.”* He did not add a “thank you” or hint at anything loving whatsoever on the paper—only the curt message.

The next day Mike arose to discover it was nearly 9:00. He had surely missed golf. Furious, he was about to confront Joanne to see why she hadn’t woken him, when he noticed a piece of paper by the bed.

*“It’s 5:00 am. Wake up,”* the paper said. The moral of the story is that most men are simply not capable of competing with women in this manner. So, regardless of who is at fault, it is best to admit guilt, fix the problem and live happily ever after. So, too, in investing.

## Bankrupt

Over the years we have shied away from highlighting “news of the day” in our *Capital Visions* reports. There are plenty of sources of such information, most of which is short term in nature. We wish to emphasize our long-term investment process and de-emphasize short-term cyclical factors. But we do not invest while “sleeping” and understand that this past quarter the world’s financial markets came dangerously close to not making their way through the chasm caused by an historical confluence of circumstances.

We began this quarter’s report with the “Wake Up!” story creating an analogy to illustrate that those with the power to “cure” have been “asleep” to the dangers of the environment just as those being affected by such dangers sat helplessly by.

Bankruptcy is often thought of as an excess of liabilities over assets. This is not precisely so. An entity (be it an individual, company or even government) is typically not declared bankrupt unless its cash flows cannot match its short-term obligations. Indeed, at the time of Lehman Brothers’ Chapter 11 filing (the largest in U.S. history) on September 15, it listed assets of \$639 billion and liabilities of

\$613 billion. Yet it was forced out of business as its counterparties abruptly and completely shut down the company’s access to short-term funding. Yes, its assets were sufficient to cover its liabilities, but they could not be liquidated in the immediate term. This liquidity crisis was in the process of being repeated throughout the global financial system. Extraordinary measures are, as of this writing, being discussed by governments and regulators to avoid a calamity. The extent of these actions is unprecedented dating back to at least the 1930s.

While no one factor, in isolation, may have resulted in the recent turmoil, following is a list of some of the issues influencing this past quarter’s events. We could devote an entire report to each one (and stay tuned, perhaps we will), but for now we simply list them herein for brevity.

- > Flawed credit rating system. As one example, rating agencies several years ago did not understand the risks inherent in newly created collateralized fixed income securities. More recently, the same rating agencies changed long-term practices and abandoned traditional credit metrics (such as matching cash flows with liabilities) and used stock price movements as indicators of “sentiment” and of credit worthiness.
- > Housing bubble / burst. On a year-over-year percentage change basis from 2002–2006, housing prices in the U.S. rose at their fastest rate in more than thirty years. Two years hence, in 2008, the Office of Federal Housing Enterprise Oversight’s (OFHEO) estimate of housing prices *fell* year over year for the first time since the end of the Great Depression.
- > “Speculation” of many types and forms and by many financial industry participants.
- > Ease with which one could enter the lending or lender brokering business.
- > Reduced global economic volatility led many to believe that economic contractions could not or would not occur. This led to more risk taking.
- > Mispricing of risk of ALL types.
- > Antiquated or nonexistent regulatory framework. Reactionary, as opposed to proactive, policies that did not keep up with accelerated disaggregation of global banking.
- > Reduced “stigma” of personal bankruptcy.
- > The misguided use of “mark-to-market” accounting rules.
- > Short-selling rules, lack thereof or lack of enforcement thereof.
- > Business models that rely on a certain “shape” of the yield curve (borrowing short to lend long) or are overly dependent on the availability of short-term funding.
- > Rampant untethered growth of semi-regulated or unregulated financial intermediaries, including “hedge” funds.

- Prevalence of “hedge” funds that do not “hedge,” but rather speculate.
- Common practice within many institutions to use their internal treasury departments (including their oversight of pension and retirement funds) as a training ground for newer employees who see their jobs as only stepping stones to higher corporate positions. This can result in less experienced personnel responsible for these critical functions.
- “Cheap” and available credit. Former Federal Reserve (Fed) Chairman Alan Greenspan must share at least part of the blame for this. It became known as “the Greenspan put” whereby any failure of great magnitude or severe economic downturn would be “bailed out” by unlimited liquidity. This led to higher and higher levels of debt and risk taking.

We highlight the last point with the following graph.



Source: Bureau of Economic Analysis

This graph measures the five-year change in the ratio of U.S. total debt (government, corporate and consumer) to GDP. Note the significant and rapid buildup of debt between 1998 and 2006. Note, too, the similarity between the current increase and that which occurred in the late 1980s. That time also culminated in a near financial meltdown and so the current predicament is not too surprising.

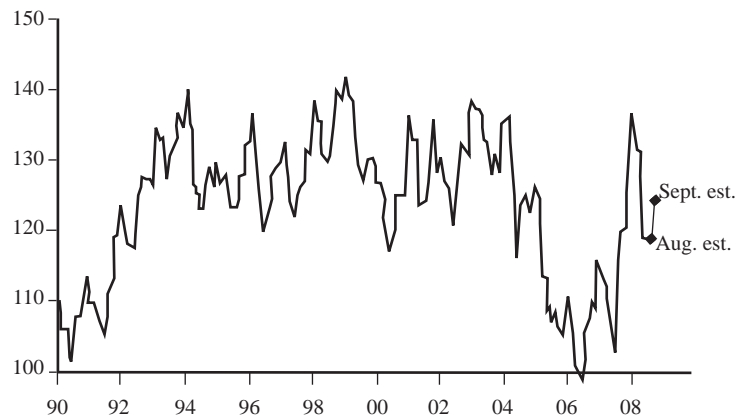
Like our newlyweds, the “silent treatment” was not working. Doing little but reducing short-term government interest rates was allowing all of the above-mentioned factors to fester. More was required. So, as we approach the Presidential election, one hears both candidates talking about what government is going to provide for the people under their leadership. But there are many who believe that the purpose of government should *not* be to *provide* for the people at all. They believe the purpose of government is to foster a system whereby the people can fairly provide for *themselves*. As this was no longer occurring in the financial system, government did as it should by taking the extraordinary measures recently contemplated.

Will they succeed?

## VALUE EQUITIES STRATEGY

There are many long-term positives we see in the U.S. economy even today. The biggest one is the flexibility of our system and its ability to adapt. Other factors such as the existence of insurance safety nets, a still relatively low (though currently rising) unemployment rate and improving global competitiveness all factor into our long-term sanguine view. Population growth also makes the U.S. somewhat unique. As one of the root causes of the current crisis is the bubble, followed by the burst, in housing prices, a 1% population growth rate (including immigration) means that each and every year we need to build three million new bedrooms in this country.

### Housing Affordability Index



Sources: National Association of Realtors, Bloomberg

The chart above shows that, on a national level, housing has become much more affordable today than just two years ago. At an index of 100, a family earning the median U.S. income has the income required to purchase an existing home at the median price using conventional financing. Note that even during the peak of the bubble, the index did not drop below 100. This is because this measure does not take into account housing availability, down payment requirements and, most importantly, wide regional disparities. For instance, housing in upstate New York (where it freezes and snows half the year and one is devastated by heat and humidity the other six months) is almost always affordable. Southern California housing, on the other hand, is rarely affordable to any more than 35% of its inhabitants.

So, if the U.S. housing market stabilizes, one impetus for the current crisis could fall away, allowing for a normalization of mortgage debt and, perhaps, its derivatives as well. We have little doubt that now, with the full attention of world central banks, governments and regulators, financial markets will not descend into an abyss. The “chasm” we mentioned earlier will be traversed and in a matter of quarters, we’ll be on the other side.

Focusing again on the longer term, we have questions about the unintended consequences of the actions needed to stem the current crisis. As of this writing, we do not yet have complete details of those actions and so we will withhold comment to a later date. But if history is any guide, there will be unforeseen reactions, good and bad, for us to closely monitor.

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## INTERNATIONAL & GLOBAL STRATEGIES

*The Bank Credit Analyst* has pointed out that:

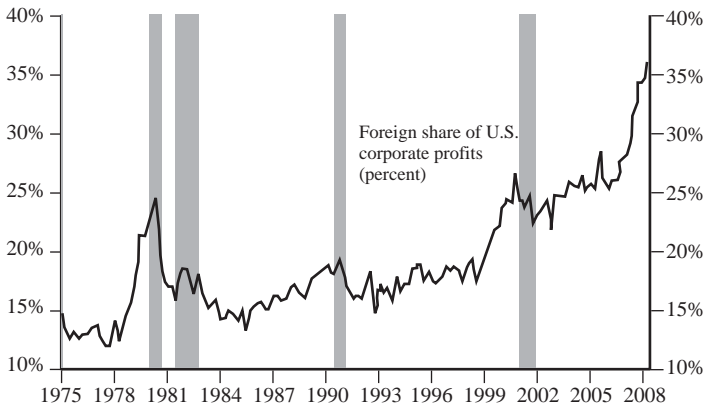
“ . . . even though the U.S. economy and financial system is at the epicenter of current problems, Wall Street has outperformed the global index [thus far] this year. The Fed’s easy stance relative to other central banks may have something to do with this.”

So the lines between nations blur a little more each year. This is particularly true in the financial markets that, performance-wise, seem little differentiated. This is why our International and Global approaches rely on identifying unique individual companies and not on looking to manipulate country or regional exposures.

The following chart shows this as particularly evident with U.S. companies that have taken yet another leg up in their international diversification. The graph depicts the percentage of U.S. company corporate profits that emanate from overseas. Three points are noteworthy:

1. The percentage of profits earned overseas by U.S. companies is now approaching 40%. As global (particularly emerging market) economies continue to grow faster than the U.S., this can only go higher over time.
2. This phenomenon is not unique to the U.S. Most companies around the world are growing faster outside their home countries than within their own borders. This makes globalization ever more important.
3. The shaded areas in the graph depict recessionary periods. Note that international profits have always declined as a percentage of the total during and immediately following U.S. recessions.

### Foreign Earnings



Sources: Haver, Morgan Stanley

We believe that foreign regulatory authorities may have been even more “asleep” than their U.S. counterparts. Not only were they of the belief that U.S. fixed income markets would right themselves, but most European and Asian companies kept repeating that they were not directly impacted by the U.S.’ woes.

In our view, it was only a matter of time before a deep and prolonged slowdown in the U.S. economy impacted major economies worldwide. It is thus heartening to see not only that actions are discussed in the U.S., but also that those policies are

being embraced overseas. We thus see that the “beginning of the end” is in sight globally.

## INVESTMENT ACTIVITY

How has MetWest Capital fared of late? We are never happy to report losses to our clients. Yet down markets are a natural part of investing, one that can never be avoided entirely. We do not employ leverage in our strategies and eschew most companies that employ excessive debt. This is one of the reasons for our typical underweight in financial services firms. Our company, in almost all cases, charges a simple fee based on assets under management for each client and those fees tend to be on the low side of what is normal practice within our industry. So we are proud to report that, as a company, MetWest Capital is secure, prosperous and still growing strongly. Our clients’ assets have been protected better than most of the alternative strategies they could have engaged. Some of our strategies have even *risen* year to date.

We have long said that by the time a problem hits the morning newspapers, there is little that can be done to avoid it. So we are now as focused as ever on three to five years hence and what companies, countries and economies are likely to look like at that time.

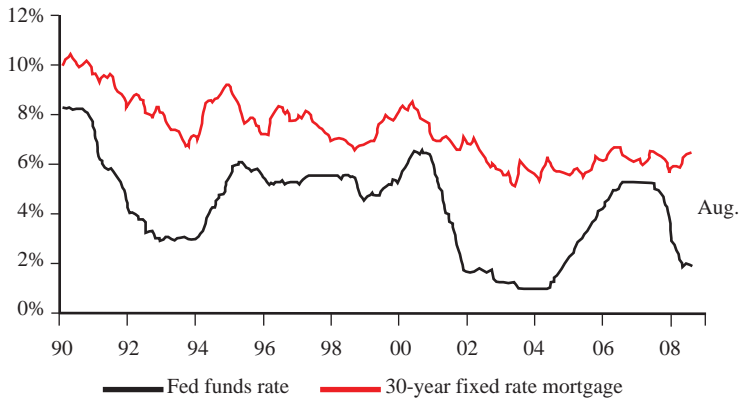
We now highlight two of the newer investments from any or all of MetWest Capital’s equity strategies: Large Cap *Intrinsic Value*, Small Cap *Intrinsic Value*, International Core Value and Global *Intrinsic Equity*. Fixed Income is covered in the next section. The following new investments were selected as representative and do not necessarily reflect our “best” or “highest-conviction” ideas:

- **Vivendi** is, today, little like the massively leveraged conglomerate built up from a French water company by former CEO Jean-Marie Messier. Today the company’s businesses are unrivaled in the categories and geographies where they compete. From video games (Activision Blizzard) to music (UMG) to telecommunications (with leading market shares in France and Morocco) to pay TV (Canal+), each of its businesses is growing and expanding already-healthy profitability. It generates excess cash that is used for share repurchases and accretive acquisitions. With a 5½% dividend yield and selling for little more than 4x EV/EBITDA, Vivendi’s stock is a compelling long-term investment.
- **Varian Semiconductor**, with \$1 billion in revenues, is the leading supplier of ion implantation equipment to the semiconductor manufacturing industry. Ion implant is one of the processes used to construct semiconductors as part of the wafer fabrication equipment market. Varian has continued to increase its overall market share in this industry from 43% in 2006 to more than 60% today. It has done so by focusing on the highest value-added segments of the sub-markets in which it participates. Its superior technology has enabled it to dramatically take share and force the former market leader to exit the segment. Even during the current cyclical downturn, the company has continued to generate gross margins greater than 40% and operating margins and returns on capital greater than 20%.

## FIXED INCOME STRATEGY

The Federal Reserve Board, having found that continuing to lower short-term interest rates was not having the desired effect of calming the fixed income markets, kept rates unchanged at 2.0% for the past quarter. But it began to employ other techniques to unseize the markets, some of which may be working. Part of the problem was that in past cycles, when the Fed lowered interest rates, most rates of all maturities and sectors declined too. This time, thus far that has not happened.

### Mortgage Rates



Sources: Bloomberg, The Federal Reserve

This chart shows the Fed funds target rate in blue versus the 30-year conforming fixed mortgage rate in red. Note that during the slow growth times of the early 1990s and early 2000s, with a slight lag, mortgage rates followed the other rates down. This would then lower monthly home mortgage payments, making it easier for homeowners to remain in their homes or even buy new ones. Often this was a precursor to a rebound in the entire economy.

But note that since the Fed began to lower interest rates in this cycle one year ago, mortgage rates have actually ticked *up* slightly. Part of this is explained by the fact that mortgages have an average duration of seven to ten years and thus follow ten-year bond yields more closely than Fed funds targets. But ten-year treasury yields, too, are down about 100 basis points (1.00%) since the Fed loosening began without the commensurate drop in mortgage rates. This decoupling, partly caused by some of the same factors described earlier, is one of the issues that recent policies are designed to address.

The fixed income portion of MetWest Capital's balanced portfolios has remained very conservatively postured throughout the recent

turmoil. Our exposure to Fannie Mae and Freddie Mac fixed income obligations was long ago reduced due to the limited value-added afforded by these securities. Our exposure to mortgages is primarily via Government National Mortgage Association (Ginnie Mae) government-guaranteed bonds that have performed well. Corporate bonds, used to increase yield in the portfolios, have been limited to investment-grade (BBB- or better) credits and have excluded most securities firms. We remain risk averse and thus our fixed income is performing its task of acting as an "anchor" in turbulent times.

Inflation has increased of late, but fixed income securities (which typically decline in price and increase in yield during such periods) have not responded. It is hard to know with certainty the future trajectory of inflation. Will the past few years' rise in commodity prices work its way permanently into consumer inflationary expectations? Or will the cyclical phenomenon run its course? Let us not forget that until very recently, the engine that most point to as a major cause of the commodity price boom (China) has, itself, been in a deflation. So we will carefully monitor these trends and take the appropriate portfolio actions as needed.

*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 anecdote of Mike and Joanne was sent to us several years ago. We saved it for just this occasion when a multitude of factors went into the creation of the current turmoil in the financial markets and, potentially, the global economy. We listed many of the issues that had a hand in creating this environment. We are heartened that government and regulatory authorities believe, as we do, that we must Wake Up! The problems must be fixed and the bleeding stemmed. We can think about apologies later and certainly must understand the root causes of the issues and how to avoid them in the future.

To that end, we are concerned about the unintended consequences that surely will arise from the "fixes" of today. Once the programs are in place and clearly understood we can embark on our process of uncovering their shortfalls. We will look out at least three to five years to determine how the individual unique companies in which we invest may benefit or be harmed by the policies needed for today.

*We welcome your comments and questions always.*



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