

Capital Visions

CATHERINE THE GREAT

Sophie Friederike Auguste was born on May 2, 1729, in what was then Stettin, Kingdom of Prussia – today a part of Poland. From birth she was always elegant and wise beyond her years. Both cautious and aggressive, she knew what she wanted and also how to go about getting it. Sophie was born into the ruling “class,” as her father governed the city in which they lived. Two of her cousins became kings of Sweden: Gustav III and Charles XIII.

As a young woman, Sophie had ambitions that were shared by her mother. According to Wikipedia, “*her mother’s hunger for fame centered on her daughter’s prospects of becoming Empress of Russia.*” So the two moved to Russia, diligently studied the language and ingratiated themselves with the ruling family, including then-Empress Elizabeth. As preparation met with desire, which then met with circumstance, Sophie was wed to Peter of Holstein-Gottorp, nephew of Empress Elizabeth. She converted to the Russian Orthodox Church, which gave her the new name of Catherine. All this she accomplished by the age of 16.

Sixteen more years passed and upon the death of Empress Elizabeth, Catherine’s husband succeeded to the throne as Peter III. Mission accomplished . . . or was it? Catherine and Peter’s marriage had been “arranged” more for political reasons than love or kinship. Closer ties were sought between Russia and Prussia partially to offset the growing influence of Austria. So, it was not too surprising that rumors surfaced that Peter had taken a mistress.

Elisabeth Vorontsova, born in August 1739, was a cunning woman in her own right. Far from lovely by most standards, she was even described by some as a slob. “*She swore like a soldier, squinted her eyes, smelled bad and spat while talking.*” Just the opposite of whom most would pick for a czar, but apparently quite appealing to Peter III. So much so that word got back to Catherine that Peter was planning to banish his wife to a convent so that he could marry Elisabeth.

Ever the proactive woman, Catherine sprang to action. The first time Peter left Saint Petersburg (on a hunting trip barely six months after taking the throne), she led a coup d’état, deposed Peter III and was proclaimed Catherine II, the leader of Russia. Peter did not protest and no blood was spilled over the incident. Days later, Peter was killed by Alexei Orlov. His death was never fully linked to any order that *may* have come from Catherine. She reigned for 34 years until her death in 1796.

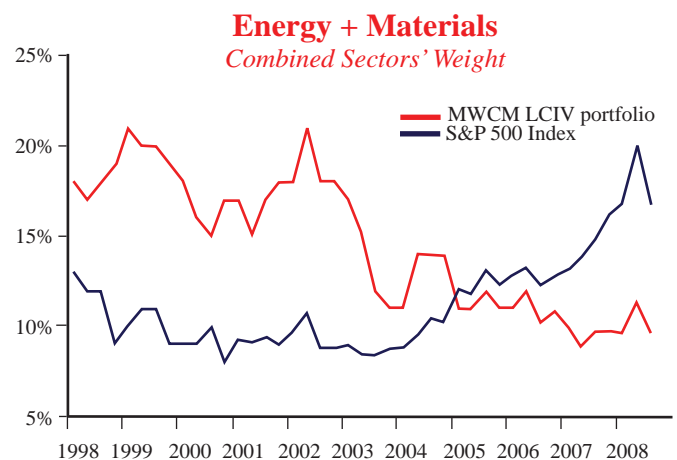
We recount the story of Catherine the Great this quarter as an example of proactive thinking. This is a trait we at MetWest Capital

constantly strive for in our investment process. We believe it has been sorely lacking, however, in most of the financial world.

Proactive

Catherine II of Russia was proactive her entire life. As a child she and her mother knew that to gain great power they would have to move to Russia and blend into that society. She was rewarded by her marriage to the man who later became Czar Peter III. But this could have been taken away from her if the rumors proved true and she was pushed aside to make room for Peter’s mistress, Elisabeth. If Catherine had waited for the banishment to be proclaimed, it would have been too late. She wisely anticipated the czar’s action and moved to thwart it before it was enacted.

We, too, try to *anticipate* future events rather than react to history. To do so, we look for the “big picture” as part of our individual company analyses. Take, by way of example, the following chart.



Sources: Internal, Bloomberg

The red line shows the combined weights of the Energy and Materials sectors in MetWest Capital’s Large Cap *Intrinsic Value* equity portfolio for the past 10 years. The blue line represents the combined weights of the same sectors for the overall market, as measured by the S&P 500 Index. As the S&P 500 Index constituents change only slowly, the dramatic rise in the combined weight from 2003 through early 2008 was largely price driven. The changes in the MetWest Capital weights result from individual companies purchased into or sold out of the portfolio.

At the peak of our exposure in 2002, we had investments in such energy companies as **Chevron, Conoco** (prior to its merger with Phillips Petroleum), **Valero** and **Weatherford International**. We also saw hidden potential in mining, chemical and steel companies including **Cytec, Dow Chemical, Pohang Iron & Steel, IMC Global** and **3M**. All these investments were made prior to the commodity price boom that began in 2003 and ended in mid-2008. While we did not invest for purely cyclical reasons, as prices continued to rise, we found some of the companies' stock prices moving to levels we considered fully valued. So today we continue to hold only about half of the companies in these sectors that we did five years ago. All of our investment decisions are made on an individual company, case-by-case basis.

Compare our proactive approach with that of many others. We know the aggregate of others' approaches, as they must be reflected in the weights of the indices. So, coincident with the rise of material prices, others invested in those related companies. The result was a peak weighting of 20% in 2008, right at the height of what we are now calling the commodity price "bubble." By contrast, at the time of this peak, MetWest Capital's ownership of these sectors was at a nadir. We believe that this important element of our investment methodology has contributed to past successes and may become even more important in the coming years.

Of course it's fun to, after the fact, "pat oneself on the back" for a job well done. Clearly this is not the time for such boasting. For even with the many correct proactive decisions made, the overall market environment has been nearly impossible to overcome. While MetWest Capital's clients' portfolios have performed well over the long run, we were unable to escape the dismal returns posted for 2008.

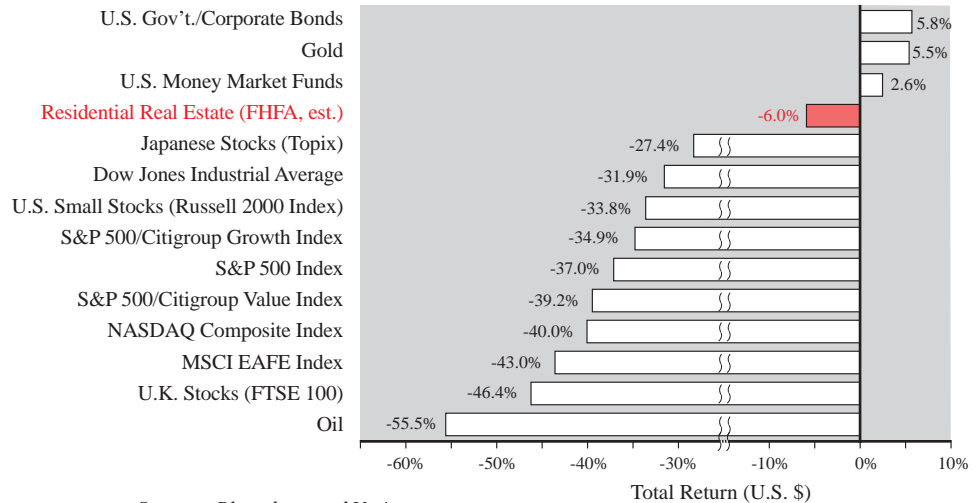
VALUE EQUITIES STRATEGY

In our *Capital Visions* of one year ago entitled "The Dead Sea," we said that we were surprised by the continuing strength of U.S. stocks in the face of an uncertain economic environment. We proposed that "... either U.S. stocks are a disaster just waiting to happen, or something extremely powerful underlies the continued strength." We now know that, while there are still many long-term positives, the "disaster" scenario has unfolded.

As the following chart shows, in 2008 U.S. stocks, as measured by the S&P 500 Index, declined by the most in a single year since 1931. Recall that while the single largest *daily* decline (-20.5%) in recent times occurred during October 1987, for the year, stocks rose more than 2.0% that year. But for 2008, large, small, growth and value companies all experienced historic stock price drops.

As highlighted earlier, while oil and most commodity prices reached all-time highs intra-year, by December 31 they had not

2008 Asset Performance



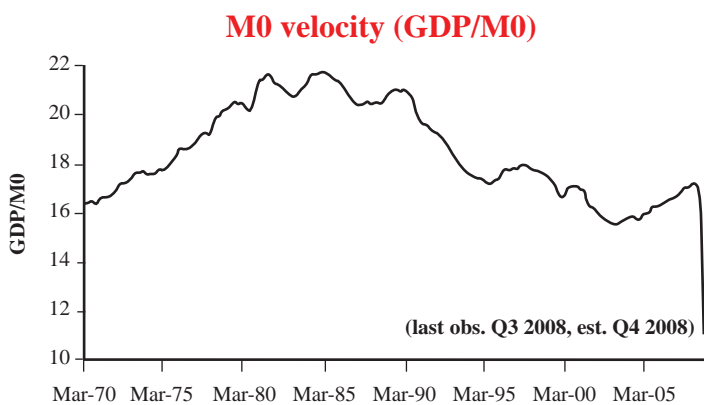
Sources: Bloomberg and Various

only given back recent gains, but retraced most of their upward move of the past few years. Thus, oil and gas fell more than 55%, while corn, wheat and other foodstuffs dropped more than 20% on average. Precious metals mostly fell, too, with the lone exception of gold, which poked its head above \$1,000 / oz. in March but finished the year near where it began.

For the first time in measured history, residential real estate prices dropped in the United States. While just about every year brings about regional declines somewhere, and while "median" house price measures tend to distort reality (putting more weight on foreclosures, for instance, that could be transitory in nature), the Federal Housing Finance Agency (FHFA) we highlight in the chart is the most revealing measure we have found. It aggregates, for every region in the country, existing single family homes OF LIKE KIND and compares actual transaction prices in one year versus the next. On this measure, the 6% decline from 2007 to 2008 is unique.

Many believe that housing is where the troubles began and so housing is where they must end. We do not disagree. But day by day, as further and deeper measures are taken to "jump start" economies around the world, our thoughts return to the lack of a proactive plan and the bubbles caused by similar past actions. Some may call it "flailing around" to find a solution. Yes, we believe that the steps taken thus far to un-seize the global credit markets were essential. Without a functioning financial system where counter-party risks are understood but not infinite, global business cannot move forward. But the absolute fear of recession and the "*do-whatever-it-takes-to-end-it*" attitude may be unwarranted and, potentially, counter productive.

Note from this next graph the unprecedented drop-off in the velocity of money in the past two quarters. Velocity attempts to measure the "bang for your buck" – literally. That is, it reflects how much GDP is generated for all the cash and available credit in circulation. Recent steps taken around the world to simultaneously lower the cost of money (via reduced interest rates) while increasing its availability (via infusions into banks and the banking system) have not resulted



Source: Haver; Encima Global

in increased lending or GDP growth. Rather, the huge increase in money supply is being hoarded. This is occurring with financial and non-financial businesses and individuals alike. The unintended consequences of putting policy after policy in place before being able to gauge the success of previous actions could be enormous.

We shall thus be very cautious in our company analyses, even more so than has historically been the case. For in addition to customary business plans that deal with competition, labor, suppliers, the environment and, of course, customers, companies will for some time have another issue to analyze. That is, how will all the unintended consequences of all these new programs affect their business models? A proactive approach to this new investment issue is, we believe, as warranted as the threat of exile needed to be eliminated by Catherine the Great.

INTERNATIONAL & GLOBAL STRATEGIES

As can be seen from the chart of asset performance in the previous section, most international markets fared even worse than their U.S. counterparts in 2008. Reversing previous gains, developing markets in Asia, Latin America and Eastern Europe performed worst of all. The markets in Brazil, Peru, Austria, Greece, Poland, Russia, Turkey, China, India and South Korea all dropped by more than half, as measured in U.S. dollars including income. The Ho Chi Minh Stock Index of Vietnam fell -64.5% in 2008 after having risen more than sixfold during the prior four years.

For the developed markets of Western Europe and Japan, local currency returns were on par with the U.S. Weak foreign currencies exacerbated the declines, with the notable exception of Japan. The broad-based Topix Index declined -40.7% in local currency, but the uniquely strong Yen reduced the decline to -27.4%, as measured in U.S. dollars.

We believe that MetWest Capital's global approach to analyzing investments may help us navigate in these unprecedented times. We have long asked if the Japanese economy was *behind* or *ahead* of that of the U.S. We thought (hoped) it was the former but now fear it is the latter. The Japanese bubble economy of the 1980s had much in common with the U.S. and European economies of the 2000s. Big increases in the availability of credit coupled

with a steady upward trajectory in economic growth resulted in speculation on everything from real estate to pachinko parlors. The Japanese economy has been mired in sub-optimal growth for much of the past 17 years.

In Japan, then, just as in the U.S. today, government spending program after government spending program was enacted to "jump start" the economy. All worked a little but ultimately failed. Only in recent years with the market-based policies of former Prime Minister Junichiro Koizumi did Japan begin to right itself. While we see many important structural differences between Japan and the rest of the developed world, we are fearful that little has been learned from their sub-optimal experience.

But there are reasons for optimism, some of which we will highlight in future reports. The relatively flexible U.S. economy, a still-growing population, strong productivity and our basic *desire* to succeed and prosper all bode well for the future. We believe that, as in Japan during its troubled period, individual companies can still do well and strongly positive equity returns are achievable. We will maintain our proactive and individual company focus in our efforts to add value for the long term.

INVESTMENT ACTIVITY

We now highlight three 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:

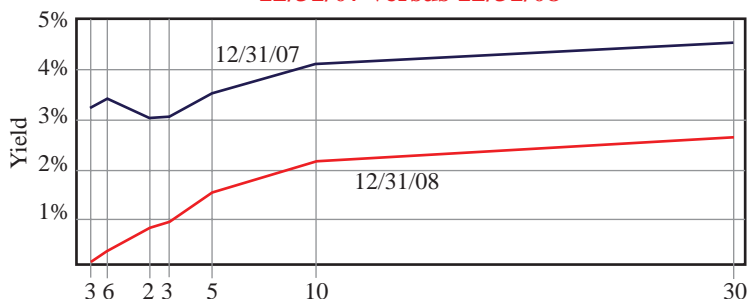
- **FPL Group** is, in our estimate, one of the best-positioned electric utilities in the U.S. While near-term weakness in the Florida housing market could dampen electricity demand, longer-term prospects for population growth make that state's economy appealing. A favorable regulatory environment has resulted in the company's ability to generate consistently high returns on its invested capital while allowing for meaningful growth in earnings and dividends. On top of this stability is **FPL Energy**, one of the nation's largest providers of alternative energy, including wind and nuclear.
- **Covance Inc.** is a contract research organization providing drug development services to the pharmaceutical and biotech industries. As an "outsource provider" of R&D and other services, the company may offer a very quick economic payback for its customers. More than a third of all clinical trials in the world use Covance to help analyze billions of data points needed to render useful conclusions. The company's reputation and scale allow it to capture a price premium, thus generating operating margins significantly above those of its competitors. Its cash flows are used to fund growth initiatives earning a mid-teens return on capital. Recent concern over a slowdown in biotech funding has provided us with an opportunity to invest in this market leader at a depressed valuation.

- **Toshiba**, based in Tokyo, with an \$11 billion market capitalization, is one of the world's largest providers of industrial and consumer electronics equipment. It is both a scientific and market leader in just about all that it does. If Toshiba can't retain pre-eminence (such as with its failed attempt at HD-DVD), it will move to divest or otherwise wind down the operation. Its largest businesses of NAND flash memory and power generation equipment (including its ownership of the Westinghouse nuclear reactor business), among others, hold great long-term promise as they are proactively positioned where we expect demand will be over the coming decade. We estimate the *intrinsic* value of the enterprise in excess of ¥1,000 versus its recent price below ¥400.

FIXED INCOME STRATEGY

As discussed earlier, huge growth in money supply, but with velocity falling off a cliff, has resulted in a “hoarding” of cash that is seeking the ultimate safety of U.S. Treasuries. This has resulted in historically low levels of interest rates across the yield curve spectrum. There have actually been short-term T-bill auctions resulting in a very slight *negative* yield, whereby investors are willing to pay a basis point for the safety of principal.

**U.S. Treasury Yield Curve
12/31/07 versus 12/31/08**



Source: Bloomberg

So, as this chart shows, interest rates declined precipitously during 2008. The yield curve shifted down by 200 basis points (2%) on average. While some have said that the current low level of interest rates is not sustainable, we again point to the example

of Japan. There, short-term rates have remained between 0% and 1% for years. Longer-term rates are not substantially higher.

But it is clear that one's ability to earn a competitive return employing strategies involving U.S. Treasury securities is now quite limited. Our nearly 50% exposure to this sector for the fixed income portion of MetWest Capital's Balanced portfolios has protected the principal. Now it may be time to selectively seek somewhat higher-yielding choices. We will report more on this in future editions of *Capital Visions*.

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

Catherine the Great ruled Russia from 1762 to her death in 1796 from the then-capital city of Saint Petersburg. In the opinion of this author, Saint Petersburg is one of the most beautiful cities on earth. It is one of the newer “old” cities of Europe, founded by the first Czar Peter the Great in 1703. It was not named for him, but rather in honor of Saint Peter. Known as Petrograd from 1914 to 1924 and Leningrad from 1924 to 1991, its original name was restored during *perestroika*.

We recount the story of how Catherine ascended to power to highlight the strength of proactive thinking and the potential benefits of such actions. The MetWest Capital investment process relies upon proactive thinking and seeks out unique companies with leaders who also believe in and practice this approach. Even during turbulent times, this process has protected clients' portfolios as well as may be expected – yet far from perfectly.

We are concerned that government leaders were not proactive in the past and don't seem to be so today. Policies usually seem intended to solve historical issues or, at best, those of the moment. This “flailing around” putting out “fires” can have unintended consequences. By contrast, MetWest Capital is now being *proactive* to guard against and, where possible, take advantage of these actions.

We wish you a truly “GREAT” 2009.



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