

Capital Visions

GROWING A TREE

*“This man I know ... has an apple tree he’s hoping will grow.
Day after day he waits, but what does he see?
Not one apple on the tree.*

*This man I know ... works all winter, but the tree will not grow.
Till late in Spring with still no fruit to be found,
he goes out to chop it down ...*

*Lo and behold, like a miracle swept in from the sea ...
Lo and behold, there’s a fog so thick the man can’t see to cut the tree.*

Next morning he ... all excited ... he comes running to me.

*Right there for all to see ... way up on a bough,
small and weak, but hanging on somehow ...
is a baby apple NOW ...”*

“**T**he Tree” (a song whose simple melody fits perfectly to tell the moving tale) is a poem set to music in the 1970 Broadway show “*The Me Nobody Knows*.” With music by Gary William Friedman and lyrics adapted by Will Holt, the entire show, chronicling inner-city New York school children, is based on a book of essays – “*The Me Nobody Knows: Children’s Voices from the Ghetto*” – written by the kids.

Listening to this song recently reminded us of the painstaking care it requires to grow a tree. It then reminded us of the increasing number of large forest fires experienced in the world (particularly the state of California) in recent years. So why bother? If it’s so difficult to grow a tree and the tree’s so susceptible to fire once grown, why undertake the process altogether?

Because, like many things in life, hard work and careful planning are worth the effort. To begin with, life on our planet may not be possible (or, at the least, not as plentiful) without trees. All plants remove carbon dioxide from, and release oxygen to, our atmosphere. Trees also provide shade, may be harvested for wood, paper and pulp and some, as in the example above, also provide fruits, nuts or leaves for nutrition. Finally, they are beautiful to behold and add to our enjoyment of life.

So, while trees are difficult to grow yet easy to burn down, nothing better has ever been invented to supplant their many uses. Thus the subject in the poem, man – and society following him – will continue to plant trees.

The Best of the Rest

There are several parallels we wish to draw from “The Tree” this quarter: political systems, economic systems and investment styles. During times of turbulence, such as the current period, many question some of the basic tenets under which we live. Is there a better way? Must we reexamine what we have long held as “truth?” Is Karl Marx laughing from his grave at the dawning of the death of capitalism? While we at MetWest Capital do not hold ourselves out as experts in these matters, we feel the significance of these questions warrants a few words at this critical time in history.

Political Systems

“Democracy is the worst form of government except for all those others that have been tried.”

This famous Winston Churchill quote is still true 70 years after first said. While political change is often the result of economic despair, no major country in the world today is at risk of a change in its system. Certainly one faction may gain (the Democratic party in the U.S. for example), but even his staunchest critics would call our current U.S. President a democratically elected leader and be happy for that process. True panics such as famine, massive unemployment and hyperinflation have been requisites for past changes in systems. We summarily dismiss nothing but do not expect such a change in the industrialized world.

Economic Systems

Economic systems are sometimes confused with political systems as they often go hand-in-hand. Thus, communism may be considered *both*. Many communist countries (China being the largest) are introducing elements of capitalism in an effort to get the best of both worlds. Oppositely, for the first time since 1850, there is a significant and growing group of Americans who believe that capitalism should be reexamined or, at the least, be more tightly controlled, and that a move towards socialism may be warranted. We disagree.

Under socialism, the state redistributes the wealth of society in a more “equitable” way according to the judgement of the legislators. Socialism is a system of expropriation of private property (regardless of how this was earned) in order to redistribute it to various groups considered (by the legislators) to warrant it. The beneficiaries of this largess are usually the unemployed, ill, very young and very old and, oftentimes, those with political pull. Even staunch socialists allow some free market enterprise, as they must admit that the free market is the best way to **produce** wealth.

Each system has its pluses and minuses. Advantages of capitalism are accentuated during economic expansions when the entire “pie” is growing; most everyone shares to some extent. One of the disadvantages of capitalism was highlighted in our *Capital Visions* entitled “*The Middle Seat*” that spoke of the Gini Coefficient and the growing inequality of wealth in the United States. It was pointed out, however, that while the “rich” were getting wealthier far faster than everyone else, living standards were, indeed, improving throughout the society. A more equitable socialized system could be successful in keeping a lid on individual wealth but ultimately would do little to bring up the bottom “rungs.” We think this concept was widely accepted ... until recently.

Indeed, we feel compelled to broach this subject as the disadvantages of capitalism and free enterprise are highlighted during economic downturns. “Untethered greed” is a watchword for today as the sole cause of our dire circumstances. We hear that capitalism breeds materialism and a culture of “more” and “now.” Risk takers are rewarded disproportionately as they play a “heads I win, tails you lose” game. Home speculators played this game. When prices rose, they made money. When they leveraged too far and prices fell, they were deemed to have been bailed out with little more harm than a temporarily impaired credit rating. Some term this a “moral hazard.”

All taken into consideration, there is no perfect economic system. Capitalism has many flaws. But just as Winston Churchill said of democracy, we believe that capitalism is the worst form of an economic system, *except* for all those others that have been tried. Just as it takes courage, determination and, yes, an occasional “*miracle swept in from the sea*” to nurture and grow a tree, so too does a capitalist economic system require just the proper care and tending ... and an occasional dose of manure.

So we are confident that even if the global economic and financial crisis worsens, major political system change is unlikely. We also

believe in capitalism and while a “blame game” may result in more stringent regulation, ultimately the rewards of a free market will bear fruit. So now to the third parallel to the tree: investing.

Investment Styles

You may be surprised to read here that we believe an *Intrinsic Value* style is the *worst* way to invest ... except for all those others that have been tried. How can one look out three to five years when we don’t know what tomorrow will bring? How can one analyze from a global perspective when protectionist measures could develop at a moment’s notice? Why focus portfolios on fewer investments than others when risk reduction is the catch phrase of the day? Finally, doesn’t the definition of “quality” change with each new program enacted by Congress?

We do not deny that *Intrinsic Value* investing is an extremely difficult process to master. But that tree planted was also very stubborn to bear fruit. Democracy can result in unpopular leaders. Capitalism results in periods of time of great cyclicality. They are all the “worst” ... except for all those others that have been tried.

We strongly believe that one has to look out at least several years into the future as an investment time horizon. Shorter term strategies are nothing more than gambling crap shoots (without the fun of the Vegas casinos). Many studies have shown that the only investment managers that survive multiple cycles are ones with long-term strategies. Others can get it “right” for brief periods but not be able to succeed in differing environments.

A global perspective, in our view, allows for a wider investment universe and also provides one a better ability to evaluate competitive threats. Should the world’s largest countries enact protectionist measures, all economies will suffer. We therefore believe that such short-sighted policies are unlikely to be enacted and that globalization will continue. Will there be bumps along that path? Most certainly. But it is clear to us, and hopefully to those who make policy, that a global economy will lead to a higher living standard for all the world’s people.

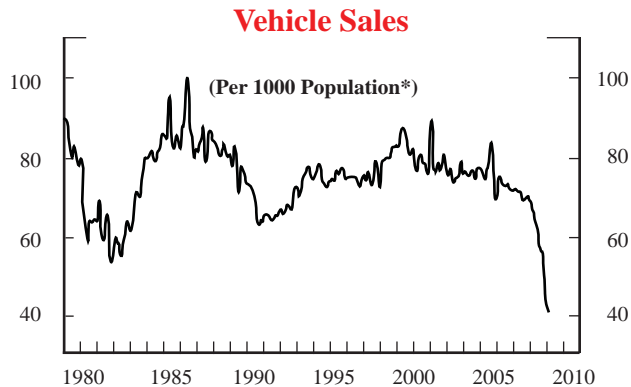
Finally, a style focused on a small number of quality companies has been proven to weather the storms as they come along. The *Intrinsic Value* investment style has shown, and we believe will continue to show, its merits during “bull” markets, “bear” markets (though absolute returns will be negative during these heretofore short periods), “growth” markets, “value” markets, rising interest rate environments, falling interest rate environments and other types of cycles we have yet to encounter.

We do not (and would never) claim to always avoid every market dip. Nor are we infallible. We would be glad to share our thoughts on what we have learned from past mistakes over the years, including investments in **Tyco**, **Xerox**, **Lucent** and, more recently, several financial services firms. Our investment style does not attempt to produce superior returns every quarter or every year. It is designed to generate optimal results over

time. Yes, the *Intrinsic Value* investment style is the worst way to invest ... except for all those others that have been tried.

VALUE EQUITIES STRATEGY

As for our economic and market outlook, the following chart shows how swiftly and steeply the U.S. economy has contracted. Stocks have declined in tandem.



*Population of 16 years old and over, includes cars and light trucks
Sources: Federal Reserve Bank of Philadelphia and The Bank Credit Analyst

Note that U.S. passenger vehicle sales (including light trucks) have fallen nearly in half, from 80 per 1000 of the driving-age population (13.0 million units per year) down to 40 (6.5 million vehicles at an annual rate for February 2009). This is the lowest level in nearly 40 years and one that we believe is not sustainable. One of the reasons we think that auto sales must rebound is that at the current sales rate, this country is scrapping more vehicles than it is building. A LOT MORE. While it's true that people are keeping their cars longer, there's only so far that even a Honda Accord can go before completely falling apart. Thus the roughly 12 million vehicles sent to the junk yard each year means that Americans need to purchase at least that number or public transportation usage will have to rise (not a bad thing, but difficult to entice).

This is but one example of the sharp and unsustainable drop in consumer expenditures. So whether it's later this year or next, car sales will pick up. We also believe home sales will recover, as will many items that go along with housing. While we are not factoring in a return to the free spending ways of earlier this decade, we do believe that a *normal* rate of consumption is somewhere between then and now. Recent investments in auto-dimming mirror producer **Gentex**, tyre (European spelling) producer **Michelin**, and home improvement retailer **Home Depot** could benefit from this trend.

George Will, a highly regarded journalist, has said that "*economics is a science of single instances because every circumstance is unique by time, events, cause and global and other factors.*" We agree with Mr. Will's assertion, which is why each economic cycle is different from all prior ones. The current global downturn

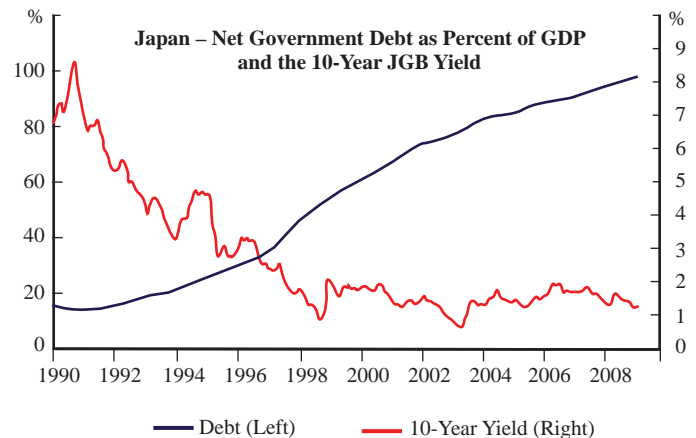
is no different in this regard as its many causes (refer to our prior edition of *Capital Visions* entitled "*Wake Up!*") cannot possibly all come together again in the future. We applaud global leaders for their understanding that the problems we face do require some government intervention. But we are also wary that *too much* interference with the natural progression of necessary cycles *could* cause the path of the economy to take unintended turns. Some of the proposals we read, if enacted, could indeed have resulted in what would have been a steep, but finite, downturn, turning into one much longer and disruptive than what otherwise might have been. We are not, at the time of this writing, forecasting this as inevitable. But we have a watchful eye.

INTERNATIONAL & GLOBAL STRATEGIES

International financial markets continue to take their short-term cues from those in the U.S. This past quarter the negative trends were exacerbated by the weakness of foreign exchange as the U.S. dollar gained ground relative to all major currencies. We see this as more of a "flight to quality" in times of uncertainty rather than a statement about the long-term prospects of international economies or markets. While we expect this trend to reverse somewhat over the coming quarters (with the U.S. dollar weakening relative to our major trading partners), we are not of the belief that the dollar will collapse.

We have witnessed a rapid escalation in U.S. government debt, first to help fund the wars in the Middle East and now to provide stimulus and stability to the economy and financial markets. Some believe that this must ultimately come home to roost, resulting in higher inflation, higher interest rates and a flight from the dollar. As the following graph shows, however, history is not on the side of this argument.

Japan — Net Government Debt



Sources: Citigroup Global Markets and the IMF

The blue line above depicts Japanese net government debt as a percent of Japan's GDP from 1990 to the present. The Japanese economy has been stalled throughout this period even as its government has enacted spending program after spending

program in its efforts to “jump start” economic activity. Sound familiar? While the intent was for the private sector to eventually take over from government stimulus in stoking growth (and thus for tax receipts to bring down the deficit), this never happened in a sustained fashion. Thus, debt has continued to rise.

The red line in the graph is the 10-year Japanese Government Bond (JGB) yield. Note the steady level of 1% to 2% in recent years. This is despite government debt surpassing 100% of GDP. By comparison, total U.S. government debt is currently 65% of GDP; heading higher for certain, but nowhere near the Japanese level yet.

There are differences between the U.S. and Japan, most notably the latter’s significant trade **surplus** in contrast to the U.S. trade deficit. Still, we see an increasing U.S. budget deficit, within the boundaries experienced in Japan, as no guarantee of “out-of-control” interest rates or inflation. Finally, and to our point, the value of the Japanese yen, while volatile over the past 19 years, has remained within a band. So, rapidly escalating federal debt does not, in and of itself, guarantee a rapidly depreciating currency.

INVESTMENT ACTIVITY

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:

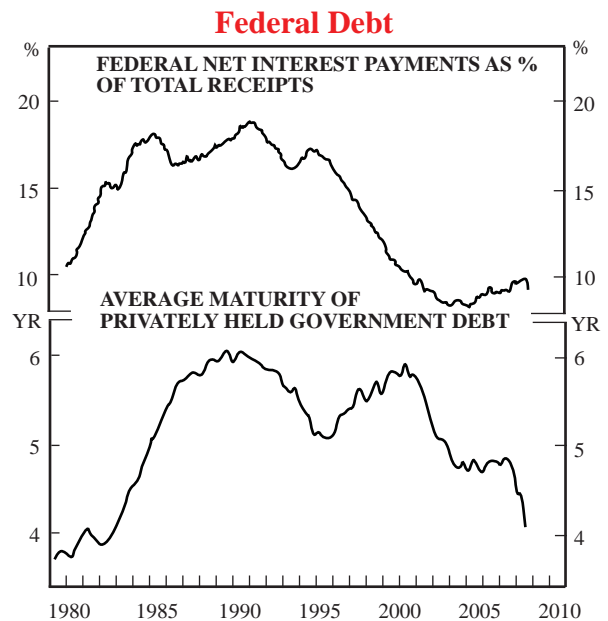
- **Adobe Systems** is known for its creative software products including *Acrobat*, *Photoshop* and *Illustrator*, its business productivity tools such as *InDesign* and its video web tools such as *Flash*. Each of its products enjoys a leading share within its respective market, yet most of the markets are either young or underpenetrated. Streaming video over the Internet using *Flash* is one example. Only in recent times has the company been offering product suites to encourage broader adoption of its software while allowing for higher margins to Adobe. With all its past successes and future promise, the company’s stock sells at only 12x earnings or 4x cash on its balance sheet. We find this a compelling long-term investment.
- **Flowers Foods**, with \$2.4 billion in sales, is an excellent example of a company that executes its business nearly flawlessly within an otherwise very competitive market. It is one of the largest wholesale bakeries in the U.S., producing breads, buns, rolls and other baked goods under the *Nature’s Own*, *Cobblestone* and other brands. Most competitors fight to stay alive (and some, such as the former maker of *Wonder Bread*, fail to do so) let alone earn double-digit operating margins, as does Flowers. Scale, efficient factories and the smart use of capital for selective strategic acquisitions have allowed the company to achieve such differentiation. We believe this strategy is

sustainable as Flowers, while formidable in the geographies in which it competes, is still small compared to the overall market and may thus continue to garner additional share for years to come.

FIXED INCOME STRATEGY

The U.S. Federal Reserve (Fed) is not yet out of “ammunition” to fight the economic slump. NOWHERE NEAR. Yes, short-term interest rate policy seems to be played out, with the fed funds rate now targeted at 0 to ¼ percent. But, as shown this past quarter, there are many new levers that may be pulled. In rapid succession Fed Chairman Ben S. Bernanke announced new programs aimed at unclogging credit. From the purchase of agency mortgage-backed securities to the purchase of longer-dated Treasuries to the offer of guarantees on credit receivables, the Fed is working diligently and rapidly to restore confidence and unseize the financial markets. We believe that between actions of the Fed, Congress and the President, and through global coordination, success will eventually be had.

Our worry is the “price” we may have to pay for – and the unintended consequences of – all of these programs. The economy won’t definitively turn around for months, quarters or even a year or two after the best of these actions is in place. In the interim, more programs may be enacted, not knowing if what’s been done thus far is sufficient. One such consequence is represented by the following graphs.



Source: Bank Credit Analyst

Here we see, in the upper chart, interest payments as a percent of income for the U.S. federal government. Note that due to historically low interest rates and the lingering effects of what, until recently, was a strong economy, only 10% of government receipts are paid out as interest on the federal debt. But that could change.

The bottom chart shows the average maturity of government-issued debt. At only four years, it is historically low. The average maturity may fall further in the coming two years due to the enormous need for borrowing to fund recently proposed initiatives. Worthy or not (and not the subject of this *Capital Visions*), projects to be undertaken, together with the natural growth of existing programs, will require receipts far in excess of what taxation may bring in.

It will most assuredly be a self-fulfilling prophecy that total interest payments will rise markedly. For, as in Japan, spending may not stop until economic growth resumes. But once growth appears, interest rates could rise. This is unless we repeat the “Japan” experience of stagnation as heretofore discussed, that which we hope will not occur. So, as the government deficit is being funded largely with short-term borrowing, as the recovery takes hold, rates will likely rise, causing the cost of servicing the increasing debt to skyrocket. This is but one consequence of the current policies. We at MetWest Capital are studying this closely and positioning investments accordingly.

Thus, in the fixed income portion of balanced portfolios we recently:

- Increased exposure to corporate bonds and municipals where appropriate
- Decreased exposure to U.S. Treasuries
- Maintained high exposure to GNMA mortgage-backed bonds
- Selectively considered (for the first time in more than three years) the purchase of high-quality bonds of securities firms including **General Electric** and **HSBC Holdings**

As always, for our clients, we consider fixed income to be an “anchor to windward” and will maintain caution and conservatism in our process.

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 author has long thought that the “ideal” political structure is a benevolent dictatorship – especially so if this author is the one appointed to be that dictator. As this change in leadership is unlikely to take place any time soon, we pointed out this quarter that a democracy, while difficult at times, is the best form of government that has ever been tried.

We used the concept of the growing of a tree (and its susceptibility to fire) to show that what may be painstakingly difficult is, nevertheless, worth the effort. We drew parallels between the tree and politics (democracy) and economics (capitalism).

We then likened the tree to MetWest Capital’s *Intrinsic Value* investment philosophy. Now applied to large capitalization and small capitalization equities both in the U.S. and abroad, we find the process quite difficult to execute. Yes, it’s the *worst* we can imagine – except for all those others that have been tried.

***We hope to plant many trees in 2009
and watch them grow skyward for many years to come!!***



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