

Capital Visions

PETRA

The guide, Ahmed, handed out cheese and tomato sandwiches on hoagie-style rolls. He explained that the tour would include a very nice lunch, but that wouldn't be for several hours and there would not be concession stands along the way. He said the words "concession stands" with an irritated smirk that, at first, we thought was due to his Jordanian accent. We later learned that concessions would be so out of place where we were going, they would be unthinkable.

Being good little tourists with cameras and backpacks dangling from our shoulders and baseball caps adorning our heads, we began the journey while munching on the sandwiches. We walked on a slightly downward-sloping paved path that led us into a narrowing gorge. The solid rock formations flanking us got taller with each step we took.

Darkness began to creep in, but it was not yet noontime. As the gorge narrowed further, it twisted left, then right. The ever-rising cliffs on our sides blocked the sun at every turn.

On either side, down toward our feet, carved into the rocks was an ingenious system of water conduits. Societies from the beginning of time thrived (or died) with the adequacy of their water systems. Most of Southern California would not exist today were it not for the California Aqueduct bringing water from the Sierra Nevada mountains. Similarly, Petra, the ancient city of 25,000 inhabitants (considered huge by standards at the time), thrived because of the intricacy of the dams, hidden cisterns and conduits like the ones we saw.

Continuing down the path, now paved with large cobblestones reminding us of those found in Rome, we encountered various stopping points. These were not meant for the modern tourists, but for the shepherds, silk merchants and other travelers who used the road as part of a trade route nearly two thousand years ago. The city of Petra was connected by these roads to Gaza to the west, Amman and then Damascus to the north, Aqaba and the Red Sea to the south, and east across the desert to the Persian Gulf.

Yes, we marveled at what we had seen thus far but were just beginning to wonder if we had traveled halfway across Jordan just for this, when ... the gorge was at its narrowest point and took a sharp right turn, leading us out into a large open square with the most amazing structure we'd ever seen. Carved into a



sandstone cliff could be the most elaborate ruin on earth—the *Al Khazneh* (which, we were told, meant "the Treasury"). Named so because it did, indeed, serve as a "bank" two thousand years ago, its facade was a mixture of several architectures. During various ages Petra "belonged" to different owners including, earliest, the Nabataeans (responsible for building most of the water system), the Syrians, the Greeks and, of course, who in that time of world history didn't at one time pay homage to the Romans.

It is this last ruling empire of the land that takes us to the subject of this quarter's report. Most everything we saw at Petra had a purpose designed for everyday life. Everything, that is, *except* the next masterpiece we saw. A few hundred yards

beyond the Treasury, carved into the hillside of *en-Nejr*, was an amphitheater. Many have said that the decadence of the latter stages of the Roman Empire contributed to its fall. We do not have the credentials to comment on this but do point out that in all of Petra, only the Roman amphitheater seemed to be purely "discretionary"—nonessential.

Some may say that entertainment *is* a necessary part of life in that it reduces stress and therefore enhances, and even prolongs, life. It is part of what we today call "discretionary"—that which is not vital. What are the investment implications of the concept of nonessential spending?

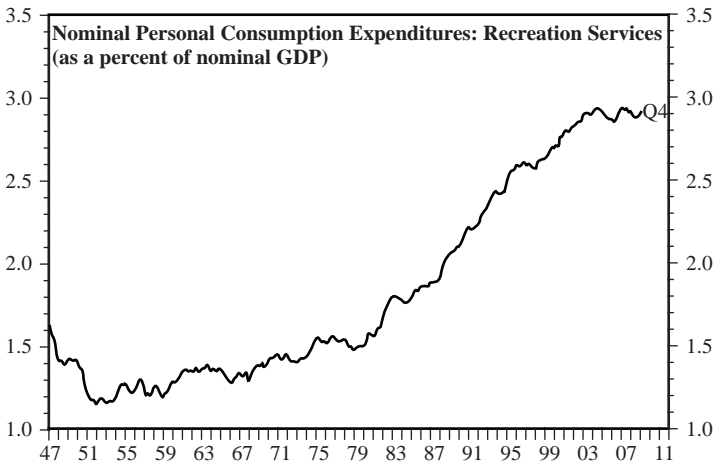
Discretionary Spending

We describe the path to Petra and the Treasury building as examples of all the necessities of this ancient city. The cisterns, water conduits, stopping points and, of course, the Treasury itself were all *required* elements of society of that day. The amphitheater was not. It was built to entertain the people with shows, speeches, sporting events and whatever else they did for fun two thousand years ago.

It is timely to discuss this topic as there has been much said about American "consumerism"—how it has gone too far and must be contained to assure a stable and growing economy. While we would urge more study on this topic, and while anecdotal

evidence of “excess” spending abounds, some statistics do not support this premise. The following chart is one example:

Recreation Services as % of GDP



Sources: *Economic Report of the President* and Yardeni Research, Inc.

This graph depicts recreation service expenditures as a percent of (nominal) GDP. This includes movies, concerts and other events typically held at “amphitheater”-type venues—spending on experiences one does not need to survive. Note that since the end of WWII, while this spending has increased, it is still currently less than 3% of the total. This compares with health care, a necessary item, that was equal to recreation back in 1947 and has grown to more than 13% of nominal GDP today. Partly this result is due to inflation factors, but the trend is clear.

“Discretion” is sometimes difficult to define. Is a meal at *Burger King* a “luxury” as one could cook it at home? Or is it a necessity as it is food and would probably cost more to prepare at home than purchase it out? So, with the caveat of definition, if one adds all purely discretionary expenditures (movies, as described above, but also including, for instance, all cars, furniture, etc.), we find about 18% of GDP is spent on these discretionary items and services. This is far less than even we thought at the outset of the analysis.

The same goes for federal government expenditures. Here the big caveat is how one views defense spending. We won’t get into a political or philosophical discussion but just call it a necessity (at 22% of federal spending). So, other than defense, Medicare, Social Security and interest on the national debt, the *Economic Report of the President* lists \$355 billion (out of total 2008 federal spending of \$3 trillion) as “other.” Let’s just call **all** of this discretionary, yet it’s only 12% of expenditures. (This is why it is always very difficult to get the federal budget in order.)

What may we conclude from our trip to Petra and the notion of discretionary spending?

1. Two thousand years ago, very little excess consumption was evident. Yes, the Romans did have their pleasures. But in all

of the vastness of Petra, we found just one amphitheater as evidence that only a small part of that society’s wealth went into what we today would call consumerism.

2. It may be nearly impossible for the U.S. federal budget deficit to meet the lower targets anticipated by the current administration. We’ve built too many “entitlements” into the system; these are not considered discretionary and thus will take an overwhelming mandate to reverse.
3. The U.S. consumer is **not** “out of the game indefinitely.” We have long held the view that consumers will spend until they are *forced* to curtail spending. That they are at the moment, but this moment will pass.

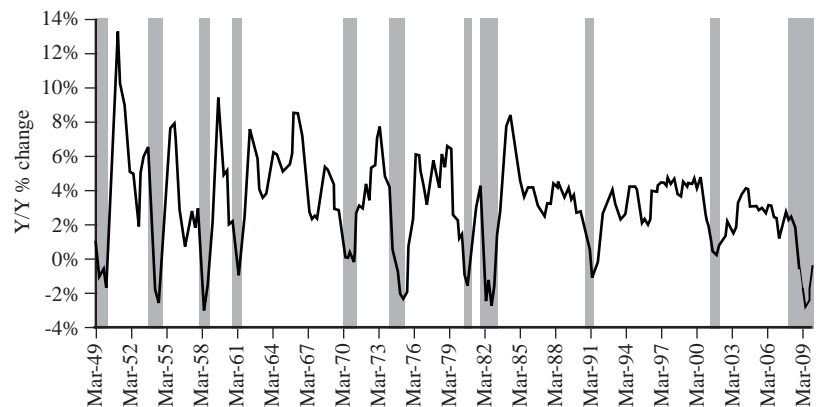
In summary, we conclude that one may expect, over our investment time horizon of three to five years, an expanding economy, but with growth likely below that experienced on average over the past 20 years. Now let’s turn to a few thoughts about the near-term trajectory of the economy.

VALUE EQUITIES STRATEGY

While we never relish others’ misfortune, we firmly believe that periodic economic recessions are a necessary way for capitalist economies to “cleanse” themselves from the inevitable built-up excesses of expansion cycles. Slowdowns are “good” and should be embraced, but they also should be prepared for. Unfortunately, few are. The trajectory of the current U.S. recession is typical, although its magnitude is greater than most. Will it ever end? When? What will be the trajectory of the recovery?

The following chart depicts the shape of real (inflation-adjusted) GDP growth in the U.S. from March 1949 through a projection for December 2009.

Real GDP Change Year Over Year




Source: Haver; Encima Global

The solid line is the year-over-year percentage change in GDP. The shaded bars represent recessionary periods. Note the similar pattern going into and coming out of each recession. That is, a

fairly pronounced drop off in economic activity followed by a sharp rebound.

Many investors have been wading in “alphabet soup.” Will we experience a “V”-shaped recovery, as is typical? Or perhaps a “W” (bouncing along the bottom) or an “L” (sharp drop followed by a period of extremely low or negative growth)? Looking at the previous chart, we see no evidence of anything other than a “V” in recent times.

But we were recently introduced to the concept of the recession taking a “square-root” shape and believe this could well come to fruition.

 The “square root” we suggest may have an unorthodox shape. It would begin with a long down leg as we’ve already experienced. This would be followed by a brief up leg that may look like the beginning of a “V.” We hope this will begin by the end of 2009. But the up leg would be truncated and followed by a flat line—“flat” meaning low but steady year-over-year GDP growth. This shape is very similar to patterns observed in Japan as each round of government stimulus resulted in a brief economic “jolt” followed by renewed malaise.

Equity markets could do well in the environment we envision. Slow, steady growth accompanied by relatively low and non-volatile interest rates could be positive for corporate earnings. We also believe that stock returns should handily beat most fixed income alternatives. The “Bank Credit Analyst” points out that:

“With the Fed [Federal Reserve] not likely to raise interest rates until late 2010 [at the earliest], staying with a large cash position could become painful. ... Investors will feel growing pressure to commit more funds to the [stock] market. ...”

We will continue to carefully monitor business trends with an eye toward the long term. We also must reiterate that while trips to places such as Petra leave us pondering “macro” events, our investment philosophy is based on individual company analysis. We seek out investments, around the world, in businesses that may prosper regardless of the economic environment.

INTERNATIONAL & GLOBAL STRATEGIES

One of the reasons we employ a global approach to investing is that economic patterns tend to repeat over time and across geographies. From the elaborate architecture found in Petra, Jordan to the economic malaise experienced in Japan, there’s almost *too* much to study and to learn. It’s one of the things that makes the investment business interesting and rewarding.

Within a global approach, however, one must also understand that no two situations ever repeat identically. Differences between Japan and the U.S. may be subtle or substantial, but those changes could result in significantly altered outcomes. Sweden experienced a financial crisis in the early 1990s quite similar to that of the U.S. today. In that case, a real estate-led financial

bubble led to a near collapse of the economy and a “run” on the currency. This does not, in our view, portend a collapse for the U.S. dollar. A weakening, perhaps, but a precipitous decline for the world’s reserve currency is highly unlikely.

It used to be said that when the “developed” markets (U.S., Europe and Japan) catch a cold, the “developing” markets (Asia, Latin America and Eastern Europe) catch the flu. Thus far in the current cycle, this does not appear to be the case. The Chinese economy, while weakened, continues to grow. Russia and Eastern Europe do indeed have “flu-like symptoms,” as does Mexico. But most of Latin America remains strong, and massive defaults (routine in past downturns) seem unlikely today.

The U.S. remains one of the most flexible economies, able to go through downturns but emerge stronger for it. International policies have not been as flexible, but there are encouraging signs for the future. Even “old Europe” (France, Germany, Spain and Italy) is showing signs of renewed vigor in its policies. While these are masked by the cyclical downturn, we expect progress could be made in future years. We also expect this progress may outpace that of the U.S., which is adding regulatory burdens to its system. More on this topic will be discussed in future editions of *Capital Visions*.

INVESTMENT ACTIVITY

As a temporary change from past practice, this quarter we shall highlight several investments that were recently *sold*. These companies had been held in one or more of MetWest Capital’s equity strategies: Large Cap *Intrinsic Value*, Small Cap *Intrinsic Value*, International Core Value and Global *Intrinsic Equity*. As always, the following investments were selected as representative and do not necessarily reflect our “best” or “worst” ideas:

- **Time Warner** is a large, diversified media company. Our original investment in 2006 was predicated on the thesis that the multitude of valuable assets owned by the company were not living up to their full potential. Since then, each division (with one notable exception) has made good by executing the *catalysts* we had envisioned. Magazines (*Time*, *People* and others), while the industry is in a secular downtrend, have held up better than most by catering to their unique audiences. Films (via *Warner Brothers* and *New Line*) were refocused away from smaller specialty titles to the mega “tent pole” hits (“*Harry Potter*,” “*The Lord of the Rings*” trilogy and others) that carry the bulk of the box office receipts. **Time Warner Cable** was recently spun out to shareholders. Cable properties (**HBO**, **Cinemax**, **TBS** and **TNT**, among others) continued to gain audience and advertising share. Only **America Online** failed to materially improve its competitive position—even though it did increase its cash flows. Our sale of the company, therefore, was not due to a fundamental deterioration, but, rather, success. We believe that this success is now widely recognized and fairly reflected in the current stock price. We hold the company’s new CEO, Jeff Bewkes, in

extremely high regard and shall continue to monitor this company's progress.

• **UniFirst Corp.**, with \$1.0 billion in revenues, is a provider of rental workplace uniforms and facilities services products in North America. The company has a leadership position in the northeastern U.S. and Texas. Our initial investment in the company dates back to 2003, and we added to the position in 2006 by participating in a secondary stock offering. The fundamental *catalysts* that we had identified were the operational improvements and diversification in industries served other than manufacturing. As we did with **Time Warner**, we recently sold **UniFirst** as these *catalysts* were realized and became fully reflected in the company's valuation. Over our six-year holding period, the company grew its revenues by 65% and approximately doubled its earnings per share. The company could always be acquired as it participates in a fragmented industry, but we do not invest in businesses based solely on the speculation of an acquisition. We thus chose to exit this investment and deploy the proceeds into other companies where numerous fundamental *catalysts* could lead to stock price appreciation.

FIXED INCOME STRATEGY

The yield curve remains historically steep. While long-term U.S. Treasury bond yields are not high, short-term rates with less than one year to maturity are all below 1.0%. From a quality standpoint, interest rate spreads between low- and high-quality corporate bonds are hovering at 30-year highs, even after a significant narrowing of spreads in the quarter just ended.

With three caveats, we believe the most likely trajectory for U.S. fixed income markets over the coming several years will be a path parallel to that of the Japanese experience post their bubble burst of the 1990s. The three caveats are:

1. The absolute level of rates is likely to be higher because even during their bubble period, the Japanese were better savers than Americans are.
2. The Japanese currency has remained strong, while we believe the value of the U.S. dollar could weaken somewhat over time.
3. Similar to the Japanese experience, we expect inflation to remain manageable. This is a wild card, however, as one could make an equally compelling argument for much higher inflation in the coming years or a mild deflation.

So, historically low interest rates (but higher than today) with a relatively flat yield curve (flatter than today, yet still positively sloping) is what we may expect. With this expectation and, as always, using fixed income as an "anchor" for MetWest Capital's balanced portfolios, we remain conservatively positioned. We are utilizing select U.S. Treasury securities for liquidity and conservatism, GNMA government-guaranteed mortgage-backed bonds for modest yield enhancement, and select investment-grade corporate bonds for further yield enhancement and total return potential.

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

Petra, constructed around 100 B.C., is a World Heritage Site and was recently named one of the New Seven Wonders of the World. Were it located in Asia or Europe, it might receive millions of visitors a year. As it is in Jordan, it gets one-tenth that number. But our guide, Ahmed, and the Jordanian Ministry of Tourism & Antiquities are certain the visitor count will grow. The area was unknown to the Western world until Swiss explorer Johann Ludwig Burckhardt discovered it in the early part of the 19th century. We are told (but we're not completely convinced) that as recently as 100 years ago, nomads from the area still dwelled in the caves—between the tombs—carved into the rocks.

We recount our trip to Petra this quarter to introduce the concept of discretionary spending. In ancient times it was clear that construction of, and attendance at, an amphitheater was nonessential. But of all we saw of the ancient city, the amphitheater at *en-Nejr* was the only example of a discretionary relic. Fast forward to modern times and *consumerism* can be found everywhere—notably in the U.S., but increasingly in all countries. So will modern society go the way of the Romans? We think not. Even the wasteful U.S. federal government spends only 12% of its budget on nonessential/nonmandatory items. Even with a liberal interpretation of what constitutes discretionary spending, Americans spend only 18% of GDP on non-essentials. Yes, consumers will spend until they are forced to do otherwise (as is currently the case). We believe spending will recover from its nadir quickly but then settle out at a lower than historical, yet still positive, pace. As always, we will keep watchful eyes.

May your summer shine as brilliantly as the rock-carved, rose-red city of Petra!



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