

# Capital Visions

## THE “DOG NAZI”

*W*e waited patiently outside the wooden gate that read “Do Not Knock or Enter Prior to 10 a.m.!”

I was the third in line with two more behind me. It was 9:55 a.m. and I had waited ten minutes. The first in line, a thirty-something woman with a cute little poodle in hand, was getting agitated.

“It’s almost ten already,” she muttered. “Open the door.” She then took hold of the handle of the gate that would lead past the side of the house to its backyard. The gate shook but would not open. Almost immediately the gate was swung open quickly, but just enough for the head of a middle-aged brunette-dyed woman to peer through and grunt, “Who knocked on the gate?”

Less agitated and more timid now, the woman with the poodle said, “I did. It’s 10 o’clock and I have to get to work after dropping off Tiffany here.”

“NO! No drop off for you! Can’t you read the sign?”

The gate slammed shut and two puppies yelped behind me. “She truly is a ‘Dog Nazi,’” said the man behind me. “A what?” I asked.

“Haven’t you seen the episode of ‘Seinfeld’ where Elaine is barred from buying soup from a New York soup stand? The soup is so good that the owner of the shop has customers lined up out the door and down the block. You have to wait for an hour sometimes—out in the cold—for his soup. But it’s so worth it that they put up with his abuse. Maggie here, owner of Maggie’s Hotel for Dogs, acts just like Seinfeld’s Soup Nazi, so we call her the ‘Dog Nazi!’”

Somewhat in disbelief, I waited until the stroke of ten when the gate was opened, slowly this time, and not by Maggie, but by her assistant Jennifer. Six of us now were in line waiting to part with our treasured dogs for up to two weeks while we vacationed or were otherwise unable to care for our pets. Maggie’s was in Costa Mesa, California in a residential neighborhood where this one cul-de-sac was zoned for pet boarding. As with the soup shop in “Seinfeld,” Maggie’s seemed to be the only home with a line of pets out front.

Jennifer would not allow Tiffany and her owner through, being instructed by Maggie to, indeed, turn her away. The pleading did not help, and Jennifer escorted the next in line to the little shed in the rear of the yard that was being used as an office. I followed, being asked to wait outside the shed for my turn.

A few moments later, I heard from inside: “NO! No boarding for you! I found fleas. Can’t you read the sign?”

“What fleas?” the man with the collie asked. “I bathed him yesterday in preparation for bringing him to you.”

“Here, fleas!” Maggie showed the man the comb she had just run through his collie and, yes, there was a flea. “Flea bath for dog. Extra charge for you. Pay now! Then leave!!” barked Maggie. The man quickly complied.

Now it was my turn and I was worried. I looked around for more signs. Bath, opening hours, payment required, emergency contacts, etc. Yes, I thought I was prepared. I looked at Maggie and said, “Good morning!” No reply. She looked at my dog, combed for fleas (whew, found none!), patted him gently, slowly removed his leash and collar and led him away. For a stranger to lead him off, my dog Hans had to be quite comfortable, and I was surprised at how obedient he was with Maggie. “No goodbye for me?” I yelled after Hans and Maggie. Jennifer then stepped up, gave me some instructions on how and when to return for my dog and asked me to exit quickly and quietly. “Do not look for your dog or acknowledge him if he barks. Those are Maggie’s orders,” Jennifer instructed. I complied.

Maggie’s was not the least expensive option I had for leaving my pet. It was also not the most convenient, either, especially due to the limited opening hours (that I now knew were strictly enforced). But it was the most highly recommended of all those I had researched. I had tried other boarding kennels before, but it was often MY dog that came back with the fleas (and a bad temperament).

Since that first time, and over the years, I have entrusted Hans to Maggie’s Hotel for Dogs on many occasions. I became a loyal customer, recommending the establishment to others. It turned out that Maggie is actually quite a lovely person. Her gruff exterior and strict business rules came about as necessities. Animals are typically most calm (and obedient) and happiest when held to a strict schedule without distractions. Thus, the rationale for short opening hours and the instructions to exit the yard quickly were sound business practices. While she would prefer to be “nice” to her clients, she found that some would mistake her good demeanor for a sign of lax rules. When she was awoken one morning at 3 a.m. (she lives in the home that is attached to the kennel) by a customer wanting to retrieve her pet, she decided to adopt the strictness. Thus was born the “Dog Nazi.”

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## Control of Their Destiny

What may we conclude from our tale of Maggie, the “Dog Nazi?” Two years ago in our *Capital Visions* entitled “More Than Meets the Eye,” we highlighted our past investment in **Alcon**, an eye care pharmaceutical company that sold its products for reasons other than price. We discussed part of our investment process in looking for such businesses, then investing when *catalysts* are identified and other factors are met. This quarter, we highlight Maggie’s Hotel for Dogs and its proprietor, the “Dog Nazi,” as an example of a business that’s in control of its own destiny. Maggie sets the rules, strictly enforces them, treats her customers (the animals) like kings and queens and has built a truly successful business. The author of *Capital Visions*, for one, sought out Maggie, waited in line at an inconvenient time and paid a higher price for a service that could have been purchased for less elsewhere.

The most important component of the investment process at MetWest Capital is to identify these types of great businesses—large and small, domestic, international and global. These are ones that sell a product or service for reasons typically other than pure price. These businesses also command loyalty and set practices consistent with the true long-term objectives of their clients. Do Maggie’s customers really need to pick up their pets at 3 a.m., thus disturbing the tranquility of the kennel? Maybe one or two really do. But like Maggie made the decision to forego these few clients so as to properly serve all the others, so too do great businesses focus on what’s best for the vast majority of their customers, even if that means forsaking sales to a few.

➤ **Gentex** does one thing—manufacture electro-optic mirror technology. Most of its sales are to the auto industry in the form of auto-dimming rearview mirrors. Backup-camera displays are now available as part of the mirrors and have created an entirely new business for Gentex, but using the same technology in which it has a near global monopoly. Over the 30 years since the company was founded, it has been presented with many opportunities to expand its business beyond mirrors. “*Sales will increase and you will expand your relationship with your customers.*” Gentex was told. But management could not identify how it could differentiate these new products and so has stuck to its core business. Recent years have been brutal to auto parts suppliers, with many going out of business. But Gentex continues to plug along, earning a nice profit with each unique mirror it sells.

➤ **Diageo** sells distilled spirits, wine and beer under brands including *Guinness*, *Smirnoff*, *Seagram* and *Baileys*. While not the priciest, its beverages are not the cheapest, either. The company has, over decades, developed distribution unmatched in its industry. The company’s higher-than-average margins and returns on capital are reinvested back into existing brands, the development of new or related brands and the acquisition of attractive yet under-managed brands. This creates the “virtuous cycle” we seek in companies whose businesses are self sustaining over very long periods of time.

➤ **Safeway** is an example where differentiation has not yet proven successful. Choosing to remodel its supermarkets to target

“upscale” shoppers just as the country’s economy was heading into recession may not seem too brilliant. But remember Maggie. She, too, was willing to give up some clients so as to provide the very best in kennel service to the rest. Safeway, while giving up some of its most price-conscious shoppers, should be rewarded in a more “normal” economic environment. There are plenty of low-cost / low-service food retailers—Wal-Mart being chief amongst them. Safeway knew it couldn’t hope to create its “virtuous cycle” by competing on price alone. It had to offer more. A better shopping environment, a more unique assortment of food items and a better motivated, more knowledgeable staff of store employees (“Food Nazis” need not apply!). This, we believe, will ultimately result in an outstanding company (and thus an attractive investment) that few others recognize the potential for today.

These are but a few examples, and only one component, of how we implement the investment methodology at MetWest Capital. Other parts, such as our *Intrinsic Value* calculations, identification of *catalysts* and risk optimization will again be covered in future editions of *Capital Visions*. Now let’s turn to a few thoughts about the economy, the markets and our strategies.

## VALUE EQUITIES STRATEGY

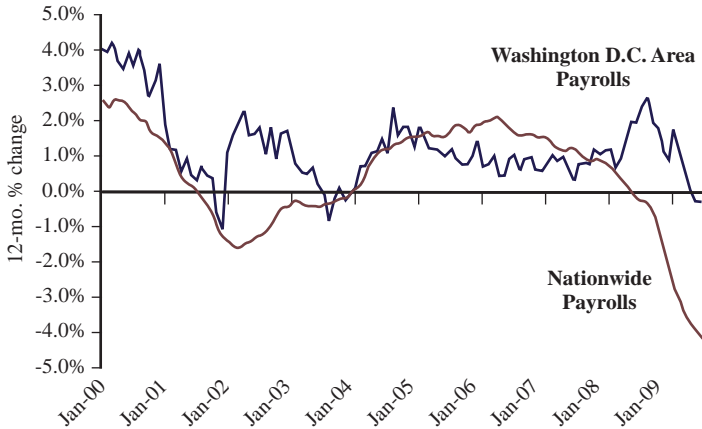
✓ U.S. financial markets continue to rally in anticipation of a rebound in the economy. Last quarter, we introduced the concept of a “square root”-like economic growth trajectory. The downward path is currently near bottom with a resumption of moderate growth likely toward year end. But after some pent-up demand is used up and the economy “snaps back” a bit, we may expect the next several years’ growth, while positive, to be muted. Similar to the shape shown here.

So our view is that the recent market strength is more of a recognition that the “falling off a cliff into the abyss” scenario, which seemed possible in prior quarters, is much less likely now. The past quarter’s market gains, we believe, may now fully reflect our views.

As always, we focus not several *quarters*, but several *years* out in our analyses. So we are now trying to understand the potential for unintended consequences of the myriad of policies that were recently put into place (in the U.S. and around the world) that has resulted in the economic stability. The following chart is something that concerns us.

The red line in this chart is the annual change in U.S. employment from the beginning of the year 2000 until June 2009. Note the recent very sharp drop. The blue line represents the employment change in the Washington, D.C. area over the same time period. Note that while historically the two lines were highly correlated, recently they diverged. Thus while the nation as a whole was experiencing one of the sharpest declines in employment since the 1930s, jobs in D.C. were still available. As employment in the nation’s capital is dependent on the federal government (either directly or indirectly), we are now witnessing a big disconnect between federal government and private job growth.

## Change in Payrolls



Sources: Bureau of Labor Statistics, Haver, Encima Global

Do we really want such disparity between the two and are we comfortable with such growth in federal payrolls? What is the starting point for such a measurement? In other words, had the government become too *small* and unable to perform its tasks? Did under-regulation result in the recent recession and could it have been avoided or mitigated? Will these new government workers be more productive for the country than if they had been employed privately? Could it be merely a timing discrepancy, with private payroll job growth to follow next year?

It is too early to definitively answer the questions we pose. But we shall diligently explore these issues while seeking to uncover additional points of potential unintended consequences as well.

## INTERNATIONAL & GLOBAL STRATEGIES

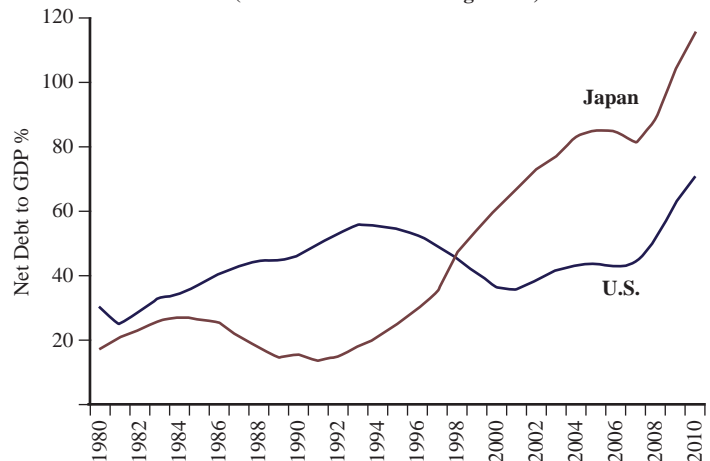
Japan has a new prime minister. Yukio Hatoyama, 62 years old, is the first politician from the Democratic Party of Japan to unseat the long-ruling Liberal Democrats. As we've seen in many parts of the world, the change in power had more to do with disenchantment with the current regime than a mandate for specific actions. The Japanese economy has been largely stalled since its "bubble" burst in the late 1980s. Strongly popular Prime Minister Junichiro Koizumi left office in September 2006 with an economy that finally seemed poised to sustain growth. But the last three years, through three different prime ministers, have witnessed a reversion to the "fits and starts" of the prior 13 years.

The following chart shows part of the difficulty Hatoyama-san has inherited.

The blue line represents net government debt as a percent of U.S. GDP from 1980 through the present. Even with the recent increase and projections for next year, the level is not much higher than prior peaks. The red line is the equivalent ratio for Japan. Program after government program since 1990 has failed to materially reinvigorate the Japanese economy, yet has resulted in unprecedented levels of debt, far higher than that in the U.S. as a percent of their respective economies. The popular mandate, as

## Net Government Debt to GDP Ratio

(last obs. estimated through 2010)



Sources: IMF, Encima Global

we understand it, is not so much to reduce the level of Japanese government spending, but to invest the funds more wisely. The "better bang for your ¥en" theory.

No more "bridges to nowhere" or investments in failing enterprises. More investments in people and planning. Japan does seem to be one place in the world where **more** consumer spending may be warranted. Thus a better balance between "work" and "private" lives may spur spending, reduce a very high personal savings rate, move the economy forward and improve the life of the average Japanese citizen. Journalist William Pesek, in commenting on Japan's new Cabinet, said:

*"Even Americans are questioning U.S.-style capitalism these days. Finding a point of equilibrium between free markets and something kinder has long been a challenge for Japan. ... This is an exciting time ... and change is in the air. There's not a moment to waste or take for granted. ..."*

We do not yet know if the policies of the new prime minister will be effective. But a changing attitude is a good first step. The Japanese economy has great untapped potential. We will continue to seek out those businesses, Japanese and otherwise, that may benefit from the changes as they occur.

## INVESTMENT ACTIVITY

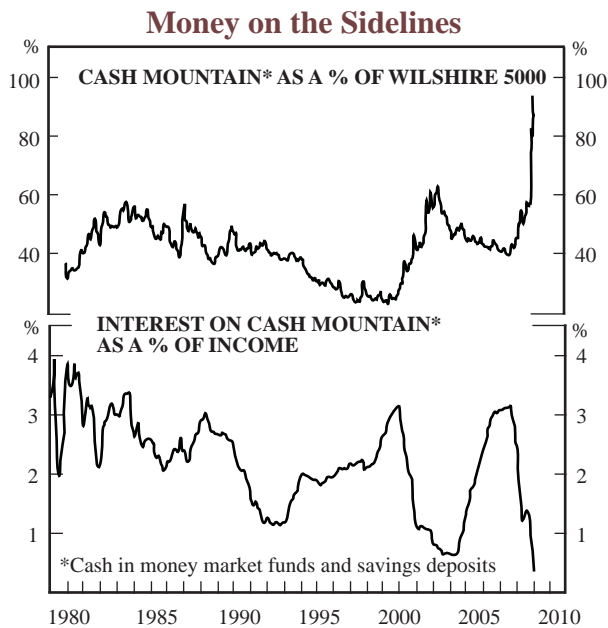
This quarter we shall highlight an investment that was recently added to our domestic *Intrinsic Value* portfolios while still held in our International Core Value and Global *Intrinsic Equity* portfolios. As always, the following investment was selected as representative and does not necessarily reflect our "best" or "worst" idea:

- **Unilever**, headquartered in Europe, is one of the world's largest food and household products companies. Its Knorr and Lipton brands of soups and bouillon, lesser known in the U.S., are consumed by hundreds of millions of people worldwide. Other major brands include Axe, Dove,

Pond's and Vaseline personal products; Cif, Sunlight and Surf household products; and, our personal favorite, ice cream—including Breyers and Ben & Jerry's. The main *catalyst* we see is new CEO Paul Polman's resolve to simultaneously improve the company's competitive positioning as well as profit margins. We believe the great businesses and brands have been under-managed and so the company's future potential is immense.

## FIXED INCOME STRATEGY

Short-term interest rates are now near zero. The interest rate on the largest money market funds in the U.S. is around 0.25% while the rate on municipal tax-free money funds is pegged at 0.01% in many states. Money market fund companies are having to rebate fees so that rates do not decline below zero. The historically low rates are largely a result of simple supply and demand.



Source: Bank Credit Analyst

This chart shows the amount of investments “parked” in cash equivalents (the cash “mountain” as depicted in the chart) and the interest earned on that pile of cash. The top line shows that there is nearly as much invested in cash equivalents as there is in the entire U.S. stock market (as measured by the market capitalization of the 5,000 stocks in the Wilshire 5000 Index). This is twice as much as has been the case on average for the past 30 years.

Note that the bottom chart looks like the inverse of the top chart. This is consistent with supply and demand theory. For instance,

as the stock market rose to new heights in the late 1990s, cash as a percent of the stock market's capitalization plunged to barely more than 20% and interest on that cash rose to 3½%. Today, there is such a great demand for the safety of cash equivalents that investors are willing to accept a near-zero interest rate in return for the protection of their principal.

The fixed income portion of MetWest Capital's balanced portfolios remains conservatively invested. We have selectively sought modestly higher yields by including GNMA government-guaranteed mortgage-backed bonds and investment-grade corporate bonds in client portfolios. While portfolio yields are historically low, we take comfort in the safety of such investments and will continue to favor principal protection over income for the foreseeable future.

*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

Just as Maggie, the “Dog Nazi,” is real and still in business in a Southern Californian suburb, so too was the “Seinfeld” character known as the “Soup Nazi” based on a genuine person. He was an Iranian by the name of Al Yeganeh. His soups were renowned for their excellent quality, but his interaction with customers was brash and bordered on abusive. Both Maggie and Al demand that all their customers meticulously follow strict queuing, ordering, and payment policies. Failure to adhere to their demands brings the admonishment, “No soup for you!” or “No dog boarding for you!” whereupon the customer is refunded his or her money and denied service.

One may question the wisdom of operating a business in this fashion. One may also wonder why we at MetWest Capital seek out these types of companies in which to invest. It is because these are quality businesses with loyal customers who value the product or service provided beyond a low price. These businesses may control their own destiny. If managed properly (we gave three such examples), these companies should create a “virtuous cycle” of profits being reinvested to create even higher profits.

We will continue to seek out investments in quality companies around the world that offer products or services so compelling that their customers seek them out. The result is typically a loyal clientele and a business worthy of consideration. We at MetWest Capital run our own business the same way, but with a little extra “kindness” on top.



610 Newport Center Drive, Suite 1000  
Newport Beach, CA 92660  
949-718-9701  
949-718-9122 fax