The Invisible Man

Countless books, movies, television programs and articles have been written with an "invisible man" in the title role. It holds the fascination of everyone. The most famous literature in modern times on this topic is the 1897 novel by H. G. Wells. Set in the English countryside, the book tells the story of Dr. John Griffin, a poor but brilliant scientist. Similar to the Mary Shelley character *Frankenstein*—also set in England in the 19th century—Dr. Griffin intended for his work to do good. Working with light waves, he created a technique to make objects (including people) invisible. But he could not **undo** the procedure, and so unintended consequences forced a sequence of events that led to mistrust, then violence and finally, Dr. Griffin's demise.

The basic story has been retold throughout the years. According to *Wikipedia*, the free online encyclopedia, numerous adaptations include: a 1933 film with the title character played by Claude Rains, a sequel in 1940 entitled *The Invisible Man Returns* with Vincent Price as the lead, and there was even a 1951 film *Abbott and Costello Meet the Invisible Man*. On stage, on television, follow-on books and translations in a dozen languages make this character one of the most "recognizable" in all of literature.

There is this fantasy of being real, yet not seen by others. To see people, but not be seen by them. Surely mischief comes to mind, but much good is possible, too. As physical invisibility is not possible (to our knowledge), invisibility is often described as a character trait, such as *"working from the sidelines as if he or she were invisible."* In politics, it's often the role of the Vice President. Heard much from Joe Biden lately? In business, the metaphor of working as the boss' "right-hand man" is often used. Lee Iacocca was a "behind-the-scenes" creator of the Ford Mustang. Only later in his career—when he took the helm at Chrysler in 1978—did he become famous in his own right.

What about invisibility in investing?

A Famous Invisible Man

There was an article written in 2009 by *Wall Street Journal* reporter Scott Patterson. The very first sentence of the piece tells it all and is the point we are making this quarter.

"Warren Buffett believes his best deals during the economy's biggest belly flop since the Crash of 1929 may well turn out to be the ones he didn't [emphasis added] do. Mr. Buffett slammed the door on one opportunity after another during the most harrowing stretch of his storied career. …"

One giant financial company after another came knocking on his door looking for financial backstops. He passed on almost all of them. "No" to Bear Stearns, "no" to Lehman Brothers, "no" to Washington Mutual, and the litany of rejections went on. The key to his success, he says, is his long-standing desire to "optimize" investment returns, even if that means not "maximizing" them. So, too, is our focus at MetWest Capital on optimization.

So we see that one of the strengths of Mr. Buffett's Berkshire Hathaway can be described by what he ***didn't*** invest in. Those "non" investments are not easily identifiable, only recounted in interviews. It is this "invisible" part of investing that has created so much value by preserving so much value.

We are often asked at MetWest Capital about our "Sale Review" process. That is, how do we protect portfolios from being damaged by significant declines in the stock prices of our investments? While we have a *Sale Review* process that has protected our portfolios well over time, the greatest protection comes from not making mistakes in the first place. We strive to avoid investments in risky companies so that our mistakes will not be outsized. This embodies the "invisible man" theory, for we do not regularly report on what we ***have not*** done. Just like Warren Buffett (and almost all investors, for that matter) does not tell others what he is looking at or has looked at, we too do not make such disclosures regularly.

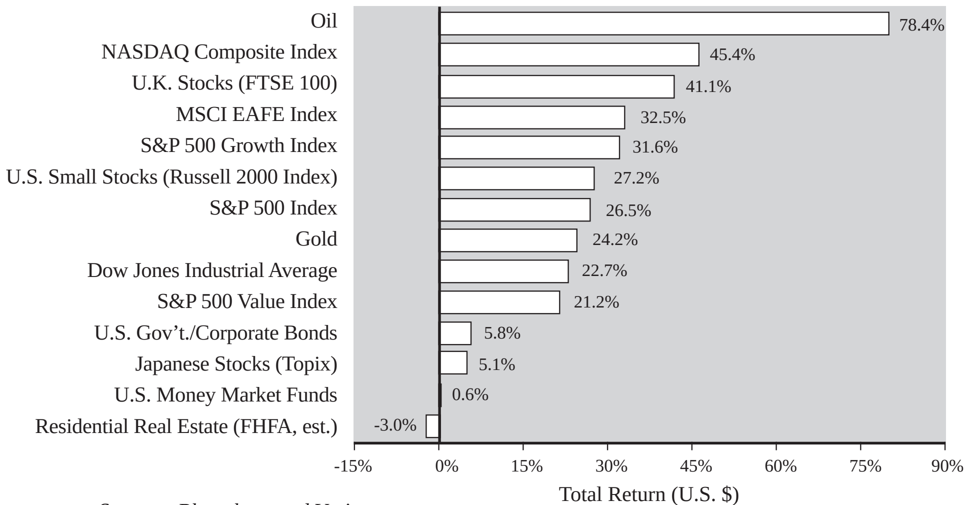
Not wishing to sound *too* self-serving or to provide selective disclosure, we will not recount all those investments we have considered, yet passed on. But like Berkshire Hathaway, we have considered many financial investments but made few. We have scoured homebuilders, too, after devastating recent returns. But we remain very selective and, in this downturn, have purchased anew only **Home Depot** (a home improvement retailer) and **NVR** (one of the few homebuilders to not own any excess land).

We would welcome your inquiries to delve further into our investment approach and those companies we investigated, yet passed over. We are convinced that this "invisible" part of our process has added meaningful value over time by steering us clear of investments that have the ability to harm.

VALUE EQUITIES STRATEGY

As shown in the 2009 Asset Performance chart, returns of various asset classes were largely very positive, practically the mirror image of those produced in 2008.

2009 Asset Performance



Sources: Bloomberg and Various

While U.S. stocks (as measured by the S&P 500 Index including income) declined -37.0% in '08, they rose +26.5% in '09. Technology (represented by the NASDAQ) dropped more than the broad market in '08 and so bounced back +45.4% in '09. Commodity prices showed the greatest swing year to year. Oil, for instance, was down -55.5% in '08, then jumped +78.4% to close at $79 per barrel in December 2009.

Even including this past year's gain, for the decade ended December 31, 2009, U.S. stocks declined by -9.1% (cumulatively, not annualized). This was the worst showing on record, even including the 1930s. It was a decade of great volatility, beginning with three down years, followed by five up years. Then the -37.0% bombshell dropped in 2008 with a partial snap back in the final year. Very different from the prior two decades with hardly a down year.

Only four asset classes listed in the chart above moved in the same direction in both 2008 and 2009. Fixed income (both bonds and money market funds) continued to confound some skeptics as longer-term rates moved up (see chart in the Fixed Income Strategy section), while short rates actually fell further. Many money funds have yields that are now pegged near zero as the interest earned on short-term investments is not high enough to cover the funds' expenses.

Gold has been very strong for most of the past two years. Its rise to more than $1,200 per ounce in late 2009 cannot be fully explained by inflation, geopolitical uncertainty or a weak U.S. dollar. The metal's practical uses are few as it is used a little in technology, a little in medical, but mostly for jewelry and speculation. Currently, this last reason must be assumed to be responsible for its high price. We shall continue to evaluate if there is an "invisible" message in this rise that may foretell future events.

Lastly, residential real estate prices, as measured by the Federal Housing Finance Agency (FHFA), declined for only the second time in measured history—the first time being in 2008. We prefer to monitor this measure of home prices—as opposed to the more oft-quoted median home price change—as it aggregates, for every region in the country, sales prices of existing single family homes *of like kind* and compares actual transaction prices in one year versus the next. On this measure, home prices declined by an estimated -3.0% last year.

Some have said that the U.S. consumer may be mired in a slow-growth environment for years to come. They say that the massive debt built up over the past decades must be paid off. As consumption represents 70% of U.S. GDP, they conclude that we may expect sub-par growth in the coming years. While we agree that growth in the coming decade may be lower than that of the period leading up to the current down cycle, we are not as convinced as others of the severity of the coming malaise. The following chart depicts one of our reasons.

Assets ex Houses / Liabilities ex Mortgages

Sources: Federal Reserve: Flow of Funds, Encima Global

The line in the graph plots the ratio of assets to liabilities of U.S. households, dating from 1970 to the present. It **excludes** housing assets and also home mortgages. Note that the line is remarkably stable, rarely exceeding 17 times or dipping below 13. David Malpass, Chief Economist at Encima Global, points out that:

"Excluding houses from assets and mortgages from liabilities, the household sector has increased assets and liabilities at about the same rate over four decades—for every $1 in debt, assets grew $14."

What is not shown in the chart is that, indeed, over this same period, the growth in mortgage liabilities has far exceeded the growth in the value of the housing stock. That is, mortgages today represent a far higher portion of the value of the underlying real estate. This was true even before the recent housing price downturn. But even so, we may conclude:

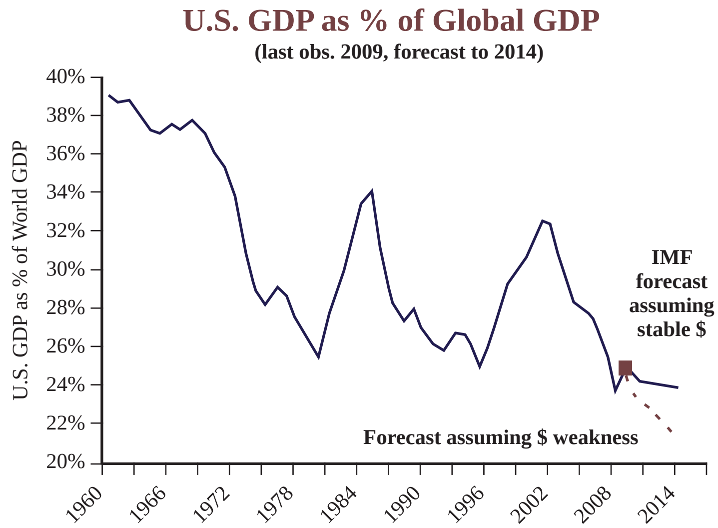
1. With all that we hear about the unchecked growth of credit card debt and exuberant spending by U.S. consumers, other than housing we are no more in debt today than we were four decades ago.
2. As the U.S. (and global) economy revives, we may expect consumers to go back to their historical shopping patterns, with the possible caveat that the "feeling" of wealth may have temporarily dissipated with the one-two "punch" of lower house prices followed by lower stock prices.
3. Real estate (mortgage) debt did get out of control and we don't expect a repeat scenario anytime soon. So the parts of the global economy that were driven by high and rising real estate prices will be held back relative to what they were.

We believe the U.S. and global economies are in the process of normalizing and will return to a sustainable growth trajectory. But, as we've described in recent issues of *Capital Visions*, the path is likely to follow a truncated "square-root" shape as shown here. To be clear, the "flat" part of the curve does not represent a zero-growth economy. Rather, it reflects our view that the growth will be positive, yet moderate. The shape represents a roughly "flat" growth ***rate*** of approximately 2% annually. This growth may not be sufficient to result in a robust economy or rapid job growth, but it certainly will be better than that of the past two years.

Further, while the economy may be sluggish, we believe that corporate profitability could be strong. This may bode well for stock prices. More to be revealed on this topic in future issues of *Capital Visions*. Stay tuned. …

INTERNATIONAL & GLOBAL STRATEGIES

Given our moderate view of the U.S. economy described above, we would tend to agree with the projected trajectory depicted in the following chart.



Sources: IMF, Encima Global

The line represents the U.S. share of global GDP. Back in 1960, with most of the world still rebuilding after WWII, the U.S. ***was*** essentially the world with respect to economic output. With only about 5% of global population, the U.S. produced nearly 40% of its output. Today, the U.S., while still amongst the most productive countries per capita in the world, represents just 25% of global output. Two points are noteworthy from the chart.

First is the obvious downward trend in the U.S. share of global GDP. This does not mean that our country's GDP is declining in absolute terms. Rather, it's that in the 1960s through 1980s, Japan, Germany, Spain and others were growing faster than the U.S. More recently, China, India, Russia (most years), Brazil and other countries are growing faster. The second point of note is the two "humps" evident around 1984 and 2001. Those were two prior global recessionary periods. In past times of economic turbulence, the U.S. (while weak) held up well relative to the large declines in the output of many other countries. This did not hold true for the most recent recession as U.S. output fell as much, if not more, than that of most other countries. This is a big change and almost unprecedented going back to WWII.

For the forseeable future, we may expect "more of the same." While the U.S. and the rest of the industrial world will expand and prosper, "emerging" economies may grow even faster. If, as depicted by the red dashed line in the chart, the U.S. dollar declines precipitously, the relative output gap between the two would widen at a quicker pace. We do not expect this to occur but will monitor as events unfold.

We will continue to invest in great companies around the world, being mindful of the trends we see. But, as always, we seek those companies whose business models are less predicated on regional or global GDP and more reliant on unique factors they can better control. So, to that end, let us highlight some of those businesses we find attractive today.

INVESTMENT ACTIVITY

In this section we highlight investments that were recently added to any or all 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:

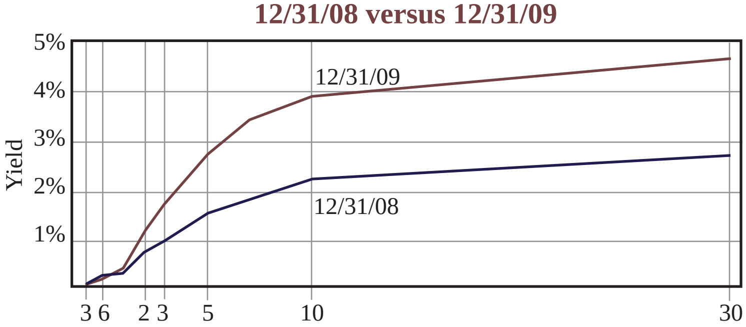
- **Westinghouse Air Brake Technologies Corp. (Wabtec)** is a leading provider of components and services for locomotives, freight cars, subway cars and buses. Dating back to the invention of the air brake in 1869 by George Westinghouse, Wabtec has been the leading developer of braking equipment for freight and passenger transit vehicles. With brakes being a key safety component, quality is more important than price, resulting in an industry with high and stable margins. Its strong profitability has allowed the company to diversify into adjacent markets related to passenger and freight rail vehicles. Wabtec still has significant market penetration opportunities in international markets and has increased its investments in Europe, which has a transit market five times larger than that of the U.S. Wabtec's strong balance sheet has allowed it to weather the current cyclical storm and we believe the company's stock price does not accurately reflect its strong and improving business position.

- **Hershey** is one of the largest confectionary companies in the U.S., specializing in its signature brand of chocolate. The company has made headlines recently as a potential bidder for all or parts of **Cadbury plc**, the U.K.-based chocolate and chewing gum company. Whether this merger takes place or not, it is significant as it is indicative of a changing, more shareholder-oriented company. Recently appointed CEO David West, who came from the Nabisco division of Kraft Foods, has increased advertising and promotional spending, introduced new products (such as Hershey's *Bliss*) and moved manufacturing to lower-cost facilities. These are all actions his predecessors were reticent to take. We believe that the current stock price does not reflect these and other actions taken that are likely to improve the company's long-stagnant market position and profitability.

FIXED INCOME STRATEGY

Over the course of 2009, short-term U.S. Treasury rates went from approaching zero to literally zero (less than five one-hundredths of one percent). There were a few days last year that one had to pay the government for the privilege of keeping one's money safe. As the following yield curve chart shows, however, long-term yields increased. U.S. 10-year Treasury yields closed the year at 3.8%, up from the near-historic low of 2.2% where they began the year.

U.S. Treasury Yield Curve
12/31/08 versus 12/31/09



Source: Bloomberg

It is clear that the risk of elevated inflation is increasing. A record federal budget deficit being financed largely from abroad typically does not bode well for a currency's stability. A weaker dollar (modestly, we believe, as opposed to the collapse that a few may suggest) could serve as a source of "imported" inflation. This could require higher long-term interest rates to entice others to hold onto U.S. debt.

At the same time, the persistently low short-term rates and ***currently*** low levels of inflation imply that instability in the world's financial system persists. These factors, together, imply a risk of substantially higher interest rates at some point within our investment time horizon of three-plus years. We shall therefore keep a conservative posture with regard to the fixed income portion of MetWest Capital's balanced portfolios. This seems clearly "visible" to us.

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

We use "The Invisible Man" this quarter as a metaphor for an important component of MetWest Capital's investment methodology not easily seen from the outside. For what we do **not** invest in may be as important as—if not more important than—what we do invest in. This was true for Warren Buffett for the past two years, and is equally true for us.

Most markets were very strong in 2009, a mirror image of the results produced in 2008. We think equity markets may now be caught up for what we expect to be a "square root"-shaped growth trajectory for the U.S. economy. We expect slower growth in the coming decade than that prior to the recent recession. But the American consumer is not "dead." Only in mortgage debt did we see truly irrational behavior, as most other debt has grown in line with consumer assets for most of the past four decades.

International GDP growth is likely to outpace that in the U.S. as it has since the end of WWII. Earlier, it was Japan and Germany that fueled such expansion. Now it is China, India, Brazil and Russia. This is positive and gives us opportunity for continued investment in great companies around the globe.

Wishing you and your investments a "visibly" prosperous 2010.

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