

Capital Visions

THE HOA EFFECT

It's 7:00 p.m. and we now call to order the meeting of the Board of Directors of the Fairview Homeowners' Association of Whittier, California," said the Board President.

In many parts of the country, and particularly in California, communities (even of single family homes) have a Homeowners' Association (HOA) representing all owners within the community. Boards of Directors are elected and empowered to carry out the affairs of the Association.

Originally formed to maintain "shared" areas such as pools, clubhouses, light poles and the like, these HOAs have taken on "lives" of their own. Many new laws have been enacted to protect homeowners from the growing influence of these HOAs, but also to protect the HOAs from increasingly disgruntled members. It's very similar to politics.

Here follows a typical discourse between the Board President running the meeting and one of several disgruntled homeowners in attendance:

*"Who is first to speak in the Homeowners' Forum part of our meeting? Remember that we have a lot to cover tonight, so limit your questions and comments to **three** minutes, please."*

"Well, my first comment is that three minutes is hardly enough time. Will you answer my questions, or, as you did last month, simply acknowledge, then ignore them?"

"It appears as though you are already angry, and we haven't even said anything yet."

"Yes, I (and everyone here) am angry as we come here every month to point out the obvious shortcomings of your policies, yet nothing changes."

"We, the Board, have considered carefully all that has been commented on and taken the actions we deem appropriate. The Board votes have been unanimous."

"But your 'votes' do not reflect the will of the people."

"We have repeatedly explained the rationale for all policies."

"But we don't want your policies!"

"Have you truly listened to what we've been saying? Are you open-minded?"

"We just don't want ANY new rules."

... And so the meeting continued ... on and on ... with very little accomplished. The specific policies being discussed could be just about anything from dog walking to car parking to mailbox painting. The exchange would have been identical.

Minds were made up *prior* to the discussion. The Board of the HOA was frustrated that the same issues were being objected to over and over again without anything really new being proposed as alternatives. The homeowners believed they were being ignored. Sound familiar? Sounds like politics.

Politics, in any country, is difficult to understand, sometimes fraught with corruption and most always hampered by bias. Especially today and particularly in the U.S., so much of the country affiliates with a particular political party that looks upon many issues not objectively, but from preconceived points of view. The danger in this is obvious, as highlighted by our HOA example. What lessons may we learn from this that pertain to investing?

Objectivity

One of the many biases needed to be overcome in long-term investing is the issue of preconceived notions. If we're analyzing a chemical company, one might believe that its earnings go up and down along with economic cycles. If it's a technology company, it must be high growth and subject to swift shifts in customer preferences. Banks, these days, would all be bankrupt without government assistance, correct?

Historical success of management can also be a bias. When former GE executive Bob Nardelli took over at **Home Depot**, he was expected to bring great and positive change to his new company. Yes, changes occurred, but (in our opinion) not great and not for the benefit of the company, its customers or shareholders.

Understanding that bias exists, embracing the causes for bias and knowing that one has to work diligently to overcome such impediments to objectivity are critical first steps toward mitigating what we term the "HOA effect." [We prefer not to call it the "political effect."]

For example, when we owned **Archer Daniels Midland (ADM)**, we understood that it *used* to be a highly cyclical play on agricultural prices. Our process at MetWest Capital attempts to identify meaningful changes in companies—those that are not yet appreciated by others. The “HOA effect” meant that others were likely to maintain the belief that ADM was purely cyclical because it had been so historically. What was being missed by others was the dramatic consolidation that had occurred in the agricultural services industry. Today, nearly the entire planet’s food supplies pass through one of four companies, ADM being the largest. This means less competition, higher margins and greater profits.

As another example, consider **ConAgra Foods**. The “HOA effect” here was the preconceived notion that a company in lackluster food categories could not be innovative. But CEO Gary Rodkin has only begun to prove the “angry homeowners” wrong. From *Hunt’s* canned tomatoes to *Healthy Choice* Café Steamers to the recently introduced *Banquet* frozen fruit pies (these “pot” pies with fruit fillings are actually quite tasty) at less than \$1.00 each, new products in otherwise staid categories are driving sales.

The Board of the HOA could not quiet the angry homeowners this past year. Their unhappiness was too entrenched. We as American citizens have not yet found a way beyond the intractable political views of both major parties. But we as MetWest Capital investors have found a way to benefit from bias. We understand it and know that others possess it. We work every day to ensure that we don’t get caught by it. We have called it the “HOA effect” and are finding ways to use it to our clients’ advantage.

VALUE EQUITIES STRATEGY

The Bank Credit Analyst sums up our thinking about the economy and the financial markets:

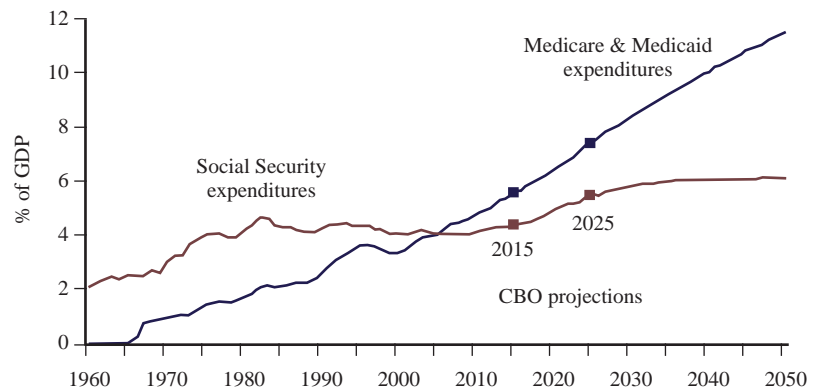
“Our views may appear strangely conflicted. On the one hand, we expect that the economic recovery will continue at a moderate pace for the next few years, allowing corporate earnings to move higher, while ensuring that inflation (and thus interest rates) stay muted.

On the other hand ... we remain greatly concerned that fiscal trends will culminate in a major financial crisis at some point. ... Demographic trends imply a massive rise in government debt and deficits in the decades ahead, given current entitlement programs. It is inconceivable that debt burdens will rise to projected levels, and the issue is what causes trends to reverse.”

While we do not typically embroil ourselves in political rancor, the topic of our letter to you this quarter is well exemplified by a measure of political gridlock rarely seen in this country. There are crucial issues to be tackled, yet we have witnessed a “taking sides” approach (by **both** major political parties) that seems less than helpful in solving problems. It’s the “HOA effect” on a massive scale.

Entitlement programs that were begun decades ago did not consider that the child born in 2010 has a life expectancy approaching **one hundred** years. Just 20 years ago total U.S. health care expenditures represented 10% of GDP. The following chart depicts, as shown by the blue line, Medicare and Medicaid spending as just one-fifth of that total, or about 2% of GDP in 1990. Quite manageable.

Entitlement Spending



Sources: Congressional Budget Office, Encima Global

Today, total medical expenditures are rapidly approaching 20% of GDP, with government spending (Medicare and Medicaid) about one-third of that amount. If left unchecked, can health care grow to comprise 40% of GDP twenty years from now when the average baby boomer is in his/her mid-70s?

We applaud those who recognize the problem. We do not, at this moment, feel so good about the proposed solutions. We shall use one example from what we know of current proposals: the “doughnut hole.” While we realize we will now anger our parents (and most certainly those in the Fairview HOA), we see the Medicare prescription drug benefit “doughnut hole” as a **brilliant** conception and are very sorry to see proposals to diminish or eliminate it. Why?

For approximately the first \$2,500 in insured prescription drugs, a benefit (with co-pays) is paid under Medicare Part D. For approximately the next \$2,000, there is a coverage gap (known as the “doughnut hole”) where benefits are not paid at all. After that, benefit coverage resumes. We view favorably the coverage at low levels as the benefit entices those who need medical treatment to seek it. We also view favorably the coverage at high levels of expenditures as it is just these “catastrophic” medical bills we as a society wish to help avert. But the best part of all is that “doughnut hole” which proposed legislation wishes to diminish. It’s this coverage gap that forces market behavior which ultimately is required as part of the solution to out-of-control health care spending.

The solutions to this issue could be many and varied. But it seems that regardless of what is proposed, if one political party makes the recommendation, the other will automatically be against it—with all of its members following suit. [NOTE that we are not blaming

one party more than the other as we see this behavior unfortunately exhibited in both.] It's just like the "mad" homeowners at their monthly meetings against whatever the Board proposes—not even considering if such proposals are, indeed, in the community's best long-term interest.

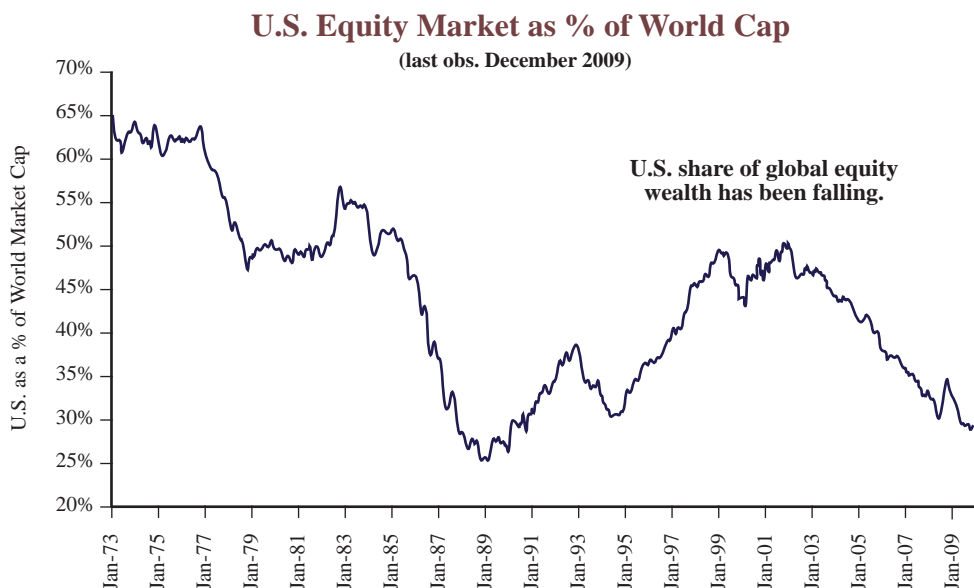
INTERNATIONAL & GLOBAL STRATEGIES

Walt Disney-owned ABC News scored a somewhat controversial coup late last quarter with the announcement that 20-year CNN veteran Christiane Amanpour will be joining the network to host the Sunday morning news program "*This Week*." She will take over from George Stephanopoulos, who is now anchoring "*Good Morning America*."

Stephanopoulos, an advisor to former President Bill Clinton in the early part of his presidency, always had a decidedly U.S.-centric show. Of Iranian and British descent, Amanpour will broaden the program to include an international perspective. "*All of us know how much the international and domestic have come to affect one another—whether it's global conflict ... humanitarian crises, or the economy,*" said an ABC spokesperson in making the announcement. "*We will now be bringing news of the world to the American people.*"

This little-noticed change of a news program anchor underscores our position that the world is on an unalterable path toward globalization. From economics to business to politics to media, countries are becoming more dependent on one another as each year passes. Even heretofore myopic Americans are slowly recognizing this.

Last quarter we presented a chart of U.S. GDP as a percent of global GDP. We pointed out that while the U.S. economy has grown over time, other countries have expanded their economies even more rapidly. This chart shows a similar pattern.



Sources: Bloomberg, Encima Global

Here we present the broad U.S. equity market capitalization as a percent of the world's market cap. Note that with the exceptions of the technology bubble of the late 1990s, then the financial-driven bubble of the early 2000s, American companies' share of the global equity market has been in decline. As with the GDP chart we presented last quarter, we point out that from 1973 through today, even including the recent declines, U.S. stocks are up nearly tenfold. So, if the U.S. share of global equities has declined from 65% to 30%, international stocks have more than doubled the returns of those in the U.S.

We believe that, over time, this trend will continue. This will not occur every quarter, nor every year, but could continue cumulatively over the coming decades. This is one reason why we will look globally for investment opportunities and seek out those businesses that may take advantage of this trend.

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:

- **KAR Auction Services** is primarily in two businesses, both of which auction cars. ADESA, the name of KAR's largest division, runs auctions of "whole" (functioning used) vehicles. Insurance Auto Auctions, Inc. (IAAI), its second division, runs auctions of salvage (largely disabled or crashed) vehicles, mostly on behalf of insurance companies. Both the whole and salvage car auction markets are consolidated, with the two largest players (of which KAR is one) controlling roughly 70% of their respective markets. High barriers to entry have served to limit competition. These barriers include access to properties in attractive locations with proper permits and zoning and having a large network of buyers that creates an incentive for sellers to use a provider's auction services.

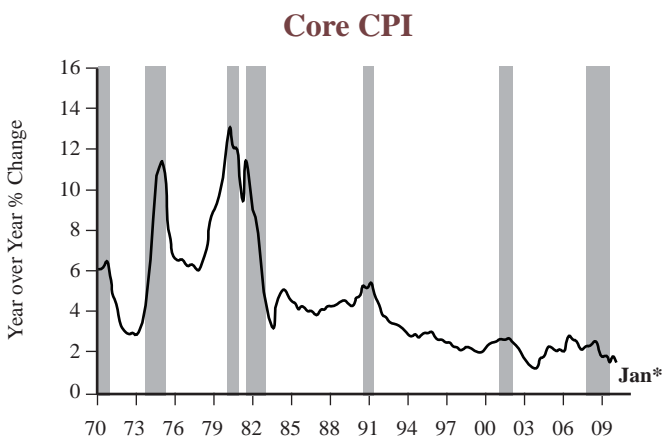
Vehicles sold through auction are primarily purchased by thousands of small used car dealers, dismantlers, rebuilders and exporters, giving ADESA and IAAI leverage on the fees they charge. The company generates fees from both the buyers **and** sellers. With high and stable market shares, the management at KAR can focus on standardizing operations, improving efficiencies, increasing margins and improving cash flows that may be used to pay down the company's debt. We have studied this business, and KAR in particular, for years, giving us a depth of understanding and comfort to make an

investment in KAR Auction Services for the second time in our Small Cap *Intrinsic Value* portfolios.

- **Intuit** developed what are today some of the most iconic brands in personal and small business financial software. At this time of year, if you prepare your own tax returns, you may be ever too familiar with *TurboTax* as it has, by far, the leading share of tax preparation software in the U.S. Intuit's *Quicken* is the leading personal financial software, and *QuickBooks* is used by small- and medium-sized companies for recordkeeping. As no competitor has come close to matching Intuit's success, the company is proud to say its biggest competition comes from "pencil and paper." Sometimes, great businesses like this are simply overlooked by other investors. We have therefore recently made an investment in Intuit in our Large Cap *Intrinsic Value* portfolios.

FIXED INCOME STRATEGY

There is much debate today on the future of inflation and hence, interest rates. As the following chart shows, it is undeniable that today in the U.S., the Consumer Price Index (CPI) is growing at an historically low rate. This is true whether we **include** or **exclude** (noted as "core" depicted in the graph) food and energy costs from the equation.



*Quarterly except latest. Note: Shaded areas mark recessions.
Sources: UBS, The Bureau of Labor Statistics

We see the Federal Reserve Board's (Fed's) job as particularly challenging right now. It is just not obvious what, if anything, it should do. On the one hand, as CPI is typically a lagging economic indicator, and the economy has only just recently shown signs of stabilization, the published inflation rate will almost certainly

remain low for some time. If the Fed were to raise interest rates too soon, the fragile recovery could be choked off, akin to Japan's experience in the 1990s.

But once inflation takes hold it is stubborn to control. See from the chart the experience throughout the 1970s. Would it not be prudent to take at least a little stimulus "off the table," particularly at a time when fiscal stimulus (budget deficits) abound?

As a student of the Great Depression, we believe that Fed Chairman Ben Bernanke will err on the side of allowing for some **inflation** so as to be certain that **deflation** does not occur. Interest rates, therefore, are likely to rise only modestly for some time. We remain conservative in the positioning of the fixed income portion of MetWest Capital's balanced portfolios with a bias towards capital preservation over income maximization.

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

Having conviction in one's beliefs is far from a sin. Having views different from others can be healthy if it promotes rational dialogue. But we introduced what we term the "HOA effect" this quarter as representative of entrenched viewpoints formed **prior** to discussions and therefore deemed to be biased. These attitudes are often not helpful in addressing important issues.

The meeting of a California homeowners' association is where we got the idea of the "HOA effect," but we've witnessed it elsewhere, such as in politics. Recent health care debates in this country were conducted largely along "party" lines with preconceived notions according to historical philosophical beliefs. We blame BOTH parties for this and think it may have resulted in sub-optimal solutions. One example is the decision to partially close the "doughnut hole" portion of Medicare Part D, one of the few "market-based" programs.

Yet with apparent problems come opportunities. MetWest Capital, as part of its *Intrinsic Value* approach toward investing, has come to understand bias as it may pertain to the analysis of individual companies. We strive to eliminate such prejudicial thinking from our own process while taking advantage of its existence in others.

We wish you, and all fellow homeowners, an UNBIASED remainder of 2010.



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