Capital Visions

It's Always Something

Mr. Richard Fader of Fort Lee, New Jersey, wrote in to a local TV news program. He asked for a comment on the Greek economic crisis and the manner in which it was being handled. Believing the question to be of broad interest, the anchor of the evening news, Ms. Jane Curtin, called in her colleague to respond to Mr. Fader live during the six o'clock broadcast.

"Good evening, Mr. Fader," began the commentator. *"I am glad you wrote in again, and this time with a question I can address. Just last evening I was in a restaurant. The waiter noticed me and asked me the very same question. So, I, Roseanne Roseannadanna, began to tell him what I thought. I started by describing the tragedy of the loss of income followed by the ancillary harm to the rest of Europe and the danger to the stability of the euro currency. Then the food was served.*

I ordered a hamburger, medium-rare with Swiss cheese and onions. No pickles. It smelled good—just the way I like it. So before continuing my conversation, I took a bite. Delicious. But on my second chew, I felt a little, teeny, tiny hard piece of something. Another chew and there it was again. So I spat it out into my hand and took a peek. To me it looked like a piece of a toenail. You know, the type of nail that was allowed to grow too long and is yellow and curled up at the end. Well, I thought I was going to die! I mean, where did that toenail come from and what was it doing inside my hamburger?"

The evening anchor, Ms. Curtin, then interrupted, demanding that the commentator get back to the point of the question.

"OK, Jane," smiled Roseanne Roseannadanna, and she continued with her story. *"So I was talking to the waiter last night about the issue of the financial intervention when I excused myself to visit the ladies' room. On the way, I passed a nice, petite woman with a tight, skimpy dress. She looked to be ready for a night on the town. I glanced at her shoes and noticed she had a tiny piece of toilet paper hanging off the back of her heel. She was walking around but the toilet paper wouldn't dislodge. 'Hey, Missie,' I yelled, 'what are you trying to do, make me sick?'"*

Ms. Curtin, obviously frustrated, couldn't let this go on any longer.

"Roseanne!" she screamed, *"What does any of this have to do with Greece?"*

"Well, Jane, it just goes to show you, it's always something. You either got a toenail in your hamburger, or toilet paper clinging to your shoe, or a Greek debt crisis. It's always something!"

By now our readers may recognize this dialogue as akin to those in the very early years of the NBC comedy program, *Saturday Night Live*, circa 1978. Gilda Radner, now deceased, played the Roseanne Roseannadanna character (and others) to perfection week after week. While the original skits were designed as parodies for entertainment, we find there's actually truth in the concept. It even may be applicable to investing. How so?

We give credit for the compilation of much of the preceding to Wikipedia, The Free Encyclopedia at http://en.wikipedia.org, with additions from other public sources and personal recollection.

Remain Focused

There truly is "always something" to consider in economics, financial markets and investments. But what is important to consider is whether current headlines are analyzable, truly differentiated and meaningful for long-term investors, or merely interesting conversation topics. We understand that news becomes headlines because it is important to someone, some group, a nation or the world at a given point in time. But at MetWest Capital, we must remain focused on achieving the long-term objectives of those who entrust assets with us. We ask ourselves every day if we can add meaningful value to portfolios by studying these issues.

Consider the following list of topics that made the "front page" of their time:

- China's potential for invading Taiwan
- India and Pakistan engaging in a nuclear war
- SARS, H1/N1 and other pandemics
- The Irish Republican Army disrupting Great Britain
- OPEC
- Y2K
- The tech bubble … The bursting of the tech bubble
- A shortage of electricity resulting in massive countrywide blackouts
- "Rust" destroying crops in the southern part of the U.S.

- ➢ Immigration waves into the U.S.—Pick your decade (or pick your **century**) and there was fear emanating from unfettered immigration from another part of the world
- ➢ The global financial crisis of 1987
- ➢ The global financial crisis of 1998
- ➢ The global financial crisis of 2008
- ➢ The Middle East "crisis" in perpetuity
- ➢ Euro too weak … Then too strong … Now too weak again
- ➢ Global terrorism and state-sponsored terrorism
- ➢ Japan's corporate "machine" taking over U.S. assets—Will we see these headlines reference China soon?
- ➢ … And the list goes on …

While we don't think it prudent to ignore these worries, we prefer to take a longer-term approach to our analyses of them. In our view, chasing the news of the day is the job of a reporter, not an investment manager. Many of these issues build up over years, affording ample opportunity to gain clarity of their impact. On the other hand, some issues (SARS was one) build quickly, but fade just as fast.

Our work at MetWest Capital is focused on individual companies. Where broader issues are relevant, we take a long-term view, attempting to minimize the distractions of what may be on others' minds. Of course, with individual businesses as well, "it's always something."

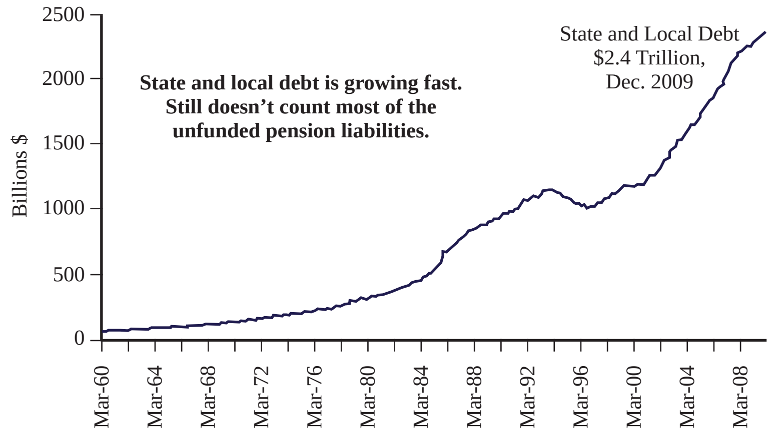
VALUE EQUITIES STRATEGY

Politicians all too often chase the news of the day as well. Resultant policies may be designed to prevent the errors of the past (some of which are unlikely to be repeated even without new laws), are often put together in haste and almost always have unintended consequences. As an example, there are strict credit card consumer protection measures being proposed today. Overseas, Japan had previously enacted a series of such measures to "protect" consumers from overly aggressive consumer lending practices. The unintended consequence has been a dramatic decline in the availability of credit to low income borrowers. Indeed, one recent study showed that fewer than 10% of loan applications are being approved. While not wholly responsible, this new protection has also contributed to Japan's anemic consumer spending environment, now entering its **third decade**.

Unforeseen results (not readily apparent by their nature) could take years or decades to show up. The U.S. is now faced with runaway spending in part due to entitlement programs enacted as many as *forty* years ago. This is a seemingly intractable problem that few countries have found a way to cope with.

These spending programs and entitlements extend down to state and local government as well. This, despite the fact that many state constitutions require a balanced budget. Until recently, state and local spending represented nearly two-thirds of total governmental expenditures. In the past year, federal spending has ballooned (partly due to increased transfers to local agencies), while state and local spending has contracted.

State and Local Government Debt



Source: Federal Reserve; Encima Global

Still, as this chart shows, state and local government debt growth has been robust. Further, this graph includes only current debt and not future unfunded liabilities, such as pensions. As Roseanne Roseannadanna would say, with state and local spending, *"it's always something!"* These are important issues and most certainly will impact our future.

As for our thoughts about the U.S. economy as a whole, we agree with the following recent comments from *The Bank Credit Analyst*:

"Every economic cycle is different, but the recovery process has been following a relatively normal pattern. … Not surprisingly, the process has been very muted this time around, and there are still lots of problems and downside risks."

We have long argued that the unique strengths of the U.S. are underpinned by its system of "checks and balances," not just in government, but in the economy as well. We do believe that the country was headed down a path of unfettered capitalism whereby the financial markets were gaining power at too rapid a clip. Of course, "pendulums" may swing too far, and we believe the current "demonizing" of corporations from Goldman Sachs to BP to AIG to Las Vegas resorts is not helpful in solving complex issues.

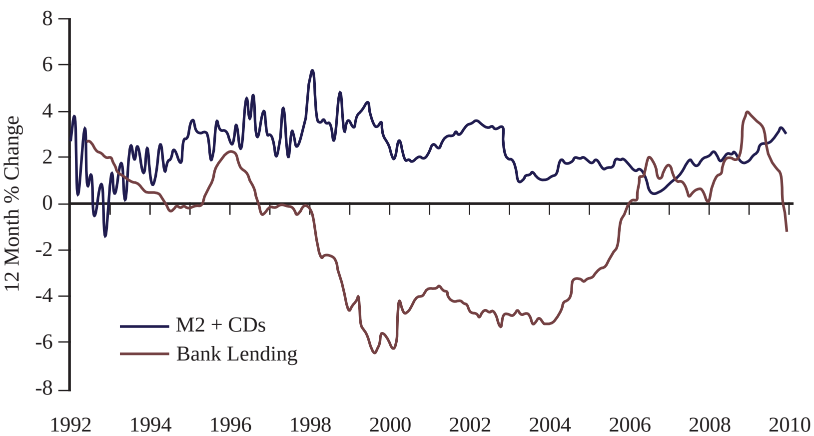
While we will always identify and highlight "something" to worry about, over the long run we are hopeful that good judgment will prevail and the U.S. economy will resume its long-term upward trend.

INTERNATIONAL & GLOBAL STRATEGIES

With some outliers (Germany and Sweden on the upside and Italy and Spain on the downside), developed international markets (as measured in local currencies) declined nearly twice as much as the U.S. market's -6.7% drop for the first half of 2010. The very weak euro and pound have exacerbated recent declines when converted to U.S. dollars, while the strength of the Japanese ¥en has allowed that market to outperform.

We remain sanguine in our long-term view of the Japanese economy and stock market. This chart shows, as depicted by the red line, the year-over-year change in bank lending in Japan.

Japanese Money Supply and Bank Lending



Source: DataStream; Morgan Stanley

After the bubble burst in the early 1990s, Japanese bank lending turned decidedly negative and stayed there for the better part of a decade. "Deleveraging" was the only game in town (sound vaguely familiar?), and this hit Japanese consumption hard. Finally, beginning in 2006, lending turned positive. We believe the recent downtick shown in the chart to be cyclical in nature and thus expect Japan's loan growth to resume in the near future.

Many Japanese companies are well positioned around the world and in many diverse sectors. Of course we know of their prowess in automobiles (Toyota's recent troubles notwithstanding). But also in consumer electronics, construction, housing supplies, electricity generation (including nuclear) and other industries, Japanese companies lead the way. Even in financial services, Japan's banks (long mired in their own difficulties) have been uniquely able and willing to lend during the recent downturn. They have gained market share in this environment and are likely to retain that advantage for some time to come.

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 *Intrinsic* Equity and Global *Intrinsic* Equity. As always, the following investments were selected as representative and do not necessarily reflect our "best" or "worst" ideas:

- **STERIS Corp.** is a leading provider of disinfecting, sterilizing and cleaning equipment and services to the health care industry. The company generates $1.3 billion in revenue annually through three segments, the largest of which provides products used to disinfect equipment used during surgeries. As the products directly impact both patient safety and the highly profitable operating room of a hospital, customers place a high value on the quality of STERIS's equipment. Thus, many of the company's businesses enjoy high barriers to entry and generate recurring revenues through long-term contracts, sales of consumables and maintenance services. About 60% of total company revenues are now of a recurring nature. "It's always something" within health care, and so it was with STERIS's stock price when it was learned that one of its products must be replaced over the coming year. As the issues with this product are resolved, we believe the focus will return to the quality of the overall STERIS business. We took this opportunity to build positions for our Small Cap *Intrinsic* Value client portfolios.

- **Banco Santander, S.A.** is Spain's largest financial institution (by both assets and market capitalization), the second-largest in all of Europe and the ninth-largest in the world. Of course, heft does not necessarily equal strength, but this bank is also one of the healthiest. Taking advantage of its unique position, Santander has made recent acquisitions in the U.K., Germany, Brazil, Mexico and the U.S. to further strengthen its global footprint. As a sole bidder in many instances, the low prices paid should result in significant long-term accretion for shareholders. The negative sentiment surrounding all European banks (and particularly those in southern Europe) has afforded us this unique opportunity to invest in one of the world's best-positioned financial institutions. Further, as one of the few banks adamant about not lowering its common stock dividend, its 6% yield "pays" shareholders to wait out the downturn.

FIXED INCOME STRATEGY

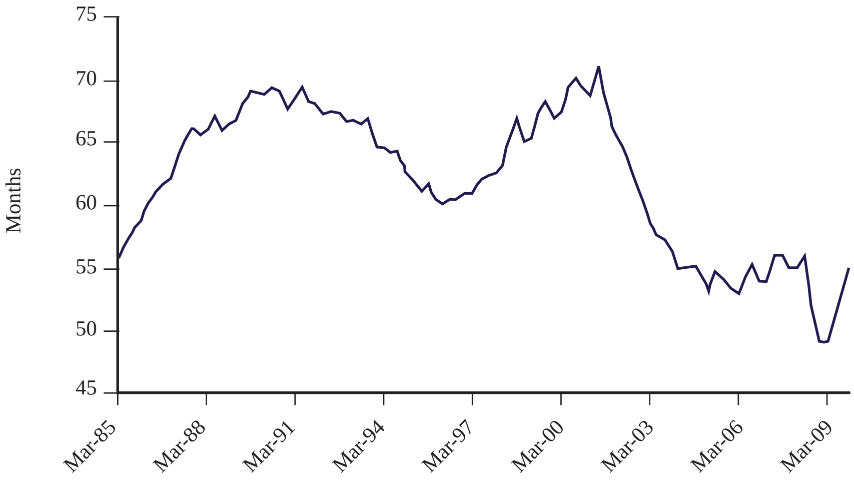
We believe the U.S. federal government may be compounding the impact of its decision to dramatically increase its indebtedness by the manner in which it is doing so. The next chart highlights our point.

This is a graph of the average maturity of U.S. Treasury debt from 1985 through the end of 2009. Note that today, at just under 55 months, the Treasury's average maturity is relatively short. The Treasury's thinking may be that at less than 2%, such debt is less costly to issue than 4% 30-year debt.

But even the most optimistic scenarios have the federal government in deficit as far as the eye can see—10 years at the very least. So the debt being sold into the marketplace today will most assuredly

Average Maturity of U.S. Publicly Held Debt

(last obs. Q4 2009)



Source: U.S. Treasury; Encima Global

have to be refinanced at maturity. Why put the U.S. taxpayer at risk of indeterminate future financing costs when it can be locked in today at historically low rates for long-term maturities? These are the types of long-term issues we ponder and then factor into our investment decisions.

As for the fixed income portion of MetWest Capital's balanced portfolios, we see little chance of further declines in interest rates of any maturity. We are thus being very selective in the bond investments we make, keeping maturities short (taking the *opposite* side of the "bet" being made by the U.S. Treasury), keeping quality high and being opportunistic when appropriate.

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

Gilda Radner was one of the entertainment industry's most recognized comedians. Though her career (and marriage to Gene Wilder) was cut short by ovarian cancer in 1989, her characters live on even today. In addition to Roseanne Roseannadanna, Ms. Radner portrayed the snot-nosed geek Lisa Loobner opposite fellow actor Bill Murray, little old lady Emily Litella (*"never mind!"*) and others. She was nominated for an Emmy award in 1977 and won it in 1978.

We recount Gilda's character this quarter, and her famous tag line *"it's always something,"* to highlight one of the differentiating features of MetWest Capital's investment methodology. We are often asked our views regarding news subjects prevalent in the current media. We do agree that it ***seems*** utterly important at the moment of heightened interest. But were we, as investment analysts, to spend all our days on what others deem relevant, we could lose our focus on what really matters—the long-term prospects of individual businesses.

We raised many concerns in this quarter's report. Growing indebtedness at the federal, state and local levels, new "protective" regulatory measures, short-maturity Treasury debt, etc. Yes, all worries. But, *"it's always something"* when it comes to analyzing the financial markets. We will continue to monitor our concerns, but not be distracted by them. Through it all, we still believe that five and ten years from now we will have new issues to look at—but from the vantage point of a higher stock market.

We wish you a worry-free summer … and beyond!

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