

## **Metropolitan West Capital Management, LLC Pinnacle American Large Cap Value Equity Fund First Quarter 2009**

### **U.S. Market Review**

Investors' concerns over persistent economic weakness, plunging corporate profits and the federal response to the financial crisis drove equity prices lower in the first quarter of 2009. This was the sixth consecutive quarter that the broad indices declined, with the S&P 500 Index having declined nearly 47% from its October 2007 peak. Volatility prevailed as stock prices rebounded intra-quarter, with the broad averages moving up about 8% in March. Rising unemployment, reduced household borrowing and declining confidence led to a sharp drop-off in consumer spending during the quarter. This was substantiated by U.S. auto sales plunging to their lowest level in nearly forty years. Home sales showed signs of life, yet housing prices continued to drop. Nonetheless, there was some glimmer of hope: the combination of declining home prices and the lowest mortgage rates in decades pushed the affordability index to pre-2002 levels. As shown below, however, investors were not convinced of a quick economic recovery, as every major index declined during the quarter.

### **Strong Relative Performance**

While it could not escape the market downdraft, the portfolio performed well on a *relative* basis in the first quarter. The Composite posted a total return that outpaced both the Russell 1000 Value Index, -16.77%, and the S&P 500 Index, -11.01%. The Russell 1000 Value Index was negatively impacted by its large exposure to Financials (the sector posting the largest decline) and limited exposure to Information Technology (the top performer), while the S&P 500 Index held up better due to its broad diversification.

### **International Markets Also Weak**

International financial markets continued to move in tandem with the U.S. markets. In the first quarter, negative international returns were magnified by the weakness of foreign exchange as the U.S. dollar gained ground relative to all major currencies. We see this as more of a "flight to quality" in times of uncertainty rather than a statement about the long-term prospects of international economies or markets. For the first quarter, the MSCI EAFE Index posted a total return of -13.85% in U.S. dollar terms (-10.01% in local currency), trailing the S&P 500 Index. For the past 12 months, MSCI EAFE has also fared worse than the U.S. markets, with a total return of -46.20% in U.S. dollars (-36.50% in local currency). Quarterly returns of the countries in Western Europe were mixed, with a number of markets outperforming the U.S. in local currencies. Japan slightly outperformed the U.S. markets in local terms but materially underperformed when converted to U.S. dollars, as the dollar appreciated relative to the yen. Conversely, the emerging BRIC (Brazil, Russia, India and China) markets *gained* during the first quarter in local currencies, with Brazil leading the group with a gain of 11.07%. The BRIC currencies held up better than most relative to the U.S. dollar during the quarter, resulting in dollar returns similar to the local returns.

### **Performance by Style, Size and Sector**

By *declining less*, growth stocks reversed last quarter's results and clearly outperformed their value counterparts in every capitalization range in the Russell indices. Among large caps, growth has performed better than value over the past one-, three- and five-year periods but still lags over the past 10 years. With respect to company size, midcaps fared the best, followed by large caps, with small companies trailing the pack in the first quarter.

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As shown in the chart, with the exception of Information Technology, every economic sector within the S&P 500 Index declined in the first quarter. The return spread between the best- and worst-performing sector remained wide (more than 33%), underscoring the importance of the portfolio advisor's commitment to a well-diversified portfolio as part of its risk management discipline. Financials were again the worst-performing sector as investors reacted to the increasing borrower defaults and new policy announcements from Washington, D.C.



## Performance Attribution

The portfolio's relative performance benefited principally from the portfolio advisor's company-focused, fundamental stock selection process. Security selection was strongest in the Information Technology, Industrials and Consumer Discretionary sectors in the first quarter. Over complete market cycles, stock selection has been the primary source of alpha for the strategy. However, in volatile or extreme markets, relative sector weights may also have a significant impact on the portfolio. Such was the case in the first quarter, as sector weights relative to the Russell 1000 Value Index accounted for approximately 40% of the value added. (All sector over- and underweights relative to the benchmark are the result of bottom-up security selection rather than top-down tactical allocation decisions.) An overweight in Information Technology (the quarter's top-performing sector in the Index) and an underweight in Financials (the worst performer) added to relative performance. The most significant detractor from relative performance was stock selection in Financials.

### **Major Contributors to Return Relative to the Russell 1000 Value Index First Quarter 2009**

Positive Contributors	Negative Contributors
<ul style="list-style-type: none"> <li>• Stock selection and overweight in Information Technology</li> <li>• Stock selection in Industrials</li> <li>• Stock selection in Consumer Discretionary</li> <li>• Underweight in Financials</li> </ul>	<ul style="list-style-type: none"> <li>• Stock selection in Financials</li> </ul>

*Within Information Technology, IBM was a top performer.* Investors reacted positively to International Business Machines Corp.'s solid execution in services and software (over 70% of pretax earnings are derived from IT

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services, outsourcing, consulting and software). The market also seemed to like the idea of a potential acquisition of Sun Microsystems. IBM is positioned to take advantage of the secular trend toward centralized computing, as geographically diverse companies transition to larger, centralized computer systems capable of operating more efficiently and effectively in a global environment. Also, IBM is one of the few companies benefiting from consolidation in the financial services sector as companies seek the strongest long-term providers of IT solutions.

***In Industrials, Northrop contributed to relative performance.*** Northrop Grumman Corp. is a broadly diversified defense contractor and the leading supplier of information technology products to the Departments of Defense and Homeland Security. The defense industry is holding up better than other segments of the economy and has budgeted a 4% increase for next year. Northrop's operating margins should benefit from its diversified mix of defense programs including unmanned aircraft, precision weapons systems, shipbuilding and security.

***Gentex added value in the Consumer Discretionary sector.*** As detailed in last quarter's *Portfolio Review*, Gentex Corp. is the leading supplier of automatic-dimming rearview mirrors and has developed a rear-camera display system for viewing objects behind the car in real time. The company is gaining additional market share as automatic-dimming mirrors are being added to mid- and lower-priced vehicles. Gentex is also growing its share of the Asian market while continuing to add more content to its rearview mirror platform. As an innovator and a leader in the introduction of new products, Gentex is well situated to emerge in a stronger position once auto sales begin to improve.

***In Financials, East West Bancorp and Synovus subtracted value.*** Both of these regional banks were impacted by deteriorating macroeconomic and credit conditions, and their stock prices declined in line with those of other banks. East West Bancorp Inc. is one of the largest banks serving the Chinese-American community through 69 branches in the Southern California and San Francisco regions. Its exposure to the Southern California marketplace has some investors concerned, but East West Bancorp provides some differentiating factors relative to its competitors:

- management is focused on the commercial market, with close to 70% of its loan portfolio in that segment;
- its expertise in bridging the domestic and Chinese markets should allow it to benefit from trade growth;
- it maintains conservative lending standards; and
- the bank is growing market share as it expands into the mainstream banking market.

Synovus Financial Corp. operates through 31 integrated banks with over 300 branches in Alabama, Florida, Georgia, South Carolina and Tennessee. The company reduced its dividend in the quarter to preserve capital. Deposit inflows have been strong due in part to their ability to provide greater FDIC insurance protection since each of its 31 banks is viewed as a separate entity by the FDIC. Synovus is one of the most successful decentralized banks in the U.S., generating a high return on capital. We therefore believe it will be one of the first banks to show improved results when economic conditions improve.

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## First Quarter 2009 Trading Summary

During the first quarter, the portfolio advisor sold two positions and invested in four new high-quality

### Changes to the Large Cap Intrinsic Value Portfolio First Quarter 2009

Purchases	Sales
<ul style="list-style-type: none"><li>• M&amp;T Bank Corp.</li><li>• Polo Ralph Lauren Corp.</li><li>• Questar Corp.</li><li>• Adobe Systems Inc.</li></ul>	<ul style="list-style-type: none"><li>• Archer Daniel Midland Co.</li><li>• Thomas &amp; Betts Corp.</li></ul>

companies.

We divested the portfolio's position in Archer Daniels Midland Co. (ADM) as we had been growing increasingly uncomfortable with a number of issues: our ability to accurately calculate *normalized* earnings power; the increasing lack of control of ADM's own destiny as energy becomes a more important component and driver of earnings; and new CEO Patricia A. Woertz's lack of conviction on increasing long-term return on asset targets. Thus, we adhered to our strict sell discipline, as we also were not able to justify raising our estimate of intrinsic value as the stock approached our target price. However, our long-term thesis of higher earnings power based on industry consolidation may still be intact, and thus we will continue to monitor ADM's prospects.

We also sold the position in Thomas & Betts Corp. during the quarter, as the major catalysts we had identified at the time of initial investment (second half 2007) had been realized. The catalysts included: Leviton (energy management and lighting control products) had been sold, recent acquisitions had been successfully integrated, operating margins had been increased and free cash flow was being used to reduce debt and repurchase shares. We shall continue to follow the progress of this high-quality company.

During the quarter we made a new investment in M&T Bank Corp., a bank holding company with headquarters in Buffalo, New York and over 650 branches in the New York and mid-Atlantic area. M&T has a strong track record of making regional bank acquisitions and improving profitability. The bank maintains conservative, consistent lending practices in conjunction with a disciplined acquisition strategy. Insiders own more than 20% of the shares, Allied Irish Bank owns about 25%, and Berkshire Hathaway (6%) is a longtime shareholder. Current management has engineered more than 20 years of consistent earnings growth, providing attractive returns to shareholders. We find M&T to be a compelling long-term investment selling at a discount to our estimate of intrinsic value.

We also reinvested in Polo Ralph Lauren, a company we had previously held (and sold in 2004) in Large Cap Intrinsic Value client portfolios. Polo is a global leader in the design, marketing and distribution of luxury products including apparel, accessories, fragrances and home furnishings. Polo markets its products across various product lines and price points under different brand names and has been able to do so successfully without cannibalizing sales or diluting its brand image. Catalysts include: greater brand control and expanding margins as it buys back partly owned licenses; capitalizing on the movement towards private label merchandising and the development of exclusive brands (Chaps and American Living) for mid-tier department stores; and building international brand image through selective expansion of retail stores and profitable outlet stores.

As part of our portfolio construction and risk control process, we aim to keep portfolio sector weights for the major economic sectors within 50% to 200% of their weights in the broad S&P 500 Index. Though our strategy is truly a large cap *value* portfolio, we use the S&P 500 Index to establish sector limits in order to maintain effective

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diversification. The Russell 1000 Value Index is concentrated in a few sectors (particularly Financials) and therefore, in our opinion, is too risky. Due to stock price movements, the Large Cap Intrinsic Value portfolio's Energy weight dropped below 50% of the S&P 500 Index Energy weight late in 2008. In keeping with our risk management discipline, we used some of the proceeds of the sales in the quarter to add an Energy holding, Questar Corp., to the portfolio.

Questar is an integrated natural gas company based in Utah and holds attractive acreage positions in the Rocky Mountain region. It is a low cost producer of natural gas and has consistently grown production at close to 10% and added to reserves at a 15% rate annually for the past 10 years. It is unique in that it has been able to add to its reserves. Lower gas prices in recent months coupled with a delay in new projects has created investor uncertainty, resulting in its share price selling at a significant discount to our estimate of intrinsic value. Among the high-quality characteristics Questar possesses are: almost 40% of gas sales are executed at long-term regulated rates that are not tied to the short-term commodity price, leading to good earnings visibility; natural gas is a clean-burning source of energy with little dependence on outside sources; the company has been able to successfully hedge at higher prices; and the interstate pipeline business provides consistent stable annual returns of 10-12%.

We highlight the team's decision to invest in Adobe Systems Inc. to illustrate the steps in MWCM's disciplined investment process.



**Idea generation.** Headquartered in San Jose, California, Adobe is best known for its creative software products including *Acrobat*, *Photoshop* and *Illustrator*, its business productivity tools such as *InDesign* and its video web tools such as *Flash*. We had previously held Adobe in Large Cap Intrinsic Value client portfolios and sold the stock in January 2002 primarily for valuation reasons. Because Adobe is one of the largest software companies in the world (and a high-quality one, at that), the investment team continued to closely monitor the company and its competitors in conjunction with current Information

Technology holdings.

**Researching high-quality companies.** Our investment process begins with the identification of companies that exhibit high-quality characteristics. Adobe dominates the market for software used to create much of the content seen in print, television and the Internet. Most videos posted on the Internet (as seen on YouTube) are created using the company's *Flash* product, and the growing popularity of digital photography and video should help drive sales of *Photoshop*. The broad popularity of Adobe's products make it difficult (and unlikely) that a designer will switch to a competing product. Its investment in product development, coupled with expense control, have allowed the company to generate operating margins of 40% while building a solid balance sheet, with over \$2 billion in cash and no long-term debt.

**Attractive valuation.** The next step in our disciplined investment process requires the company to sell at a discount to our estimate of intrinsic value. The economic downturn has impacted Adobe as a significant portion of their business is directly related to the advertising industry and product upgrades have been lower than expected. Consequently, the stock is now selling at only 12x earnings or 4x cash on its balance sheet, providing us with an opportunity to again invest in this high-quality company that we expect will be a long-term beneficiary of the growth of the Internet and other media content.

**Identifying catalysts.** In addition to requiring that all investments meet quality criteria and sell at a discount to intrinsic value, portfolio holdings must also possess positive catalysts, or change agents, we expect to narrow the valuation gap within a three- to five-year time horizon.

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Catalysts the portfolio advisor identified for Adobe include:

- the adoption of *Flash* as the standard platform for delivering video over the Internet;
- continued growth in the use of digital cameras, cell phones and gaming consoles should increase the use of Adobe's editing and digital management software;
- the offering of product suites to encourage broader adoption of its software while allowing for higher profit margins for Adobe; and
- productive use of free cash flow to withstand the slowing economy while continuing to develop product upgrades.

*Some of the securities mentioned herein have been held in the model portfolio and were not necessarily owned in all client portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decision 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.*

## **Outlook**

The U.S. Federal Reserve is not yet out of tools to fight the economic slump. While short-term interest rate policy seems to be played out with the fed funds rate now targeted at 0 to ¼ percent, there are many new levers that may be pulled. New programs aimed at unclogging credit, combined with innovative monetary and fiscal policy measures, may result in signs of improved demand as the year progresses. From the purchase of agency mortgage-backed securities to the purchase of longer-dated Treasury bonds to the offer of guarantees on credit receivables, the Fed is working diligently and rapidly to restore confidence to the financial markets.

As sufficient details emerge on the public-private partnership to remove distressed assets from banks' balance sheets, investors' demand for risk-taking may increase, thus setting the stage for an economic recovery, increased corporate profits and higher share prices. We are confident that between actions of the Fed, Congress and the President, and through global coordination, success will eventually be had.

The sharp decline in equity prices during the quarter created the opportunity for the investment team to invest in four high-quality businesses. Stock prices in relation to intrinsic value estimates remain attractive for the portfolio's holdings. Despite investor uncertainty over the depth of this recession, the long-term underlying fundamentals, or intrinsic value, of the holdings in the portfolio continue to remain attractive. We expect that adhering to our discipline of investing in high-quality businesses should continue to provide downside protection in difficult markets and enable us to add value relative to the benchmark and our peers over a complete market cycle.

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