Metropolitan West Capital Management, LLC

U.S. Equity Small Cap Value
Fourth Quarter, 2008

U.S. Market Review

The economy held up relatively well in the first three quarters of 2008, supported by exports and a fiscal stimulus package. Yet as weakness in housing and credit-related industries prevailed, employment numbers and retail spending turned bleak in the fourth quarter. To top it off, the recession that was declared in the fourth quarter of 2008 actually *began* in the fall of ***2007***, making it one of the longest on record before it was officially recognized. Seeking safety during the fourth quarter, investors moved into U.S. treasuries, subsequently driving short-term yields to zero. Oil dropped by more than $100 per barrel from its summer-time highs, leading commodity prices drastically lower as the year progressed. *De*flation fears replaced *in*flation fears as the Federal Reserve reduced the Federal funds target rate to a range between 0% and 0.25%. Preferring cash, investors sold stocks across the board in the fourth quarter of 2008, with most of the popular averages declining more than 20%. For the year, the U.S. equity market, as measured by the Dow Jones Industrial Average, experienced its worst loss in more than 75 years, declining nearly 32%, while the broader markets declined approximately 37%.

All of the major U.S. indices declined during the fourth quarter, marking for most their fifth straight quarterly decline. Large caps (represented by the S&P 500 Index) held up slightly better than the small cap Russell 2000 Index. However, performance across all equity asset classes was weak during the quarter, closing out a dismal year for U.S. stocks. Investor sentiment continued to slide while industries not previously affected by the credit crisis began to show weakness in profitability and earnings. Foreign markets were not immune to the economic downturn, either. And while good things may eventually come out of this much-needed cleansing, all in all, it was a quarter (and a year) that most investors would rather soon forget.

Market Performance by Style, Size and Sector

Within the Russell family of indices, value outperformed growth in the fourth quarter across all capitalization ranges, as was the case for the full year 2008. With regard to market capitalization, stocks of large cap companies tended to hold up the best, followed by small firms, with midcap stocks trailing the pack. For the year, however, small cap stocks weathered the storm the best, followed by large caps, with midcap firms again trailing.

While all 10 sectors in the Russell 2000 Value Index declined during the fourth quarter, performance varied dramatically by sector. More than 40 percentage points separated the sector leader from the laggard, underscoring the importance of our commitment to broad diversification to manage risk. Energy was again the big loser, with a total return of -48.9%, while at the opposite end of the spectrum, the defensive Utilities sector posted a more modest decline, -7.9%.

Performance Attribution

For the fourth quarter of 2008, our portfolio trailed the Russell 2000 Value Index.
Our bottom-up, fundamental approach typically results in stock selection being the primary source of alpha, as has been the case since the strategy's inception. However, in volatile or extreme markets, sector weight differences can have a more significant impact on relative performance. (Portfolio

sector weights result from stock selection rather than tactical allocation decisions.) Given the extreme market conditions in the fourth quarter, relative sector weights had a large (and net negative) impact on results. An overweight in Health Care added value, as that sector was one of the quarter's top performers. Strong stock selection in Financials also benefited the portfolio. In particular, our avoidance of real estate investment trusts (REITs) within the Financials sector contributed to relative return, as the REIT industry posted a total return of -33.1% in the quarter. The principal detractors from relative return in the quarter were an overweight and stock selection in Consumer Discretionary; stock selection and an overweight in Information Technology; and an underweight in Utilities. For the year ended December 31, 2008, stock selection was the primary source of alpha, though favorable stock selection was partially offset by the negative impact of relative sector weights (again, the result of bottom-up security selection decisions).

Major Contributors to Return
Relative to the Russell 2000 Value Index
Fourth Quarter 2008

Positive Contributors	Negative Contributors
• Overweight in Health Care • Stock selection in Financials	• Overweight and stock selection in Consumer Discretionary • Stock selection and overweight in Information Technology • Underweight in Utilities

Within the Financials sector, insurance provider Hartford was the top contributor to relative return. In general, insurance companies held up well in the fourth quarter, but Hartford Financial Services Group, Inc. performed particularly well. The investment team was able to take advantage of continued market volatility during the fourth quarter and add Hartford to the portfolio. Hartford has an extremely stable property and casualty business in addition to a very profitable life insurance business and boasts good expense control. Hartford's market cap was $30 billion just a year ago and $17 billion in mid-September 2008. Yet, at the time of investment, the stock had sold off with the rest of life insurers, giving the company a market cap of less than $2 billion. Hartford is an excellent example of a high-quality company we never thought would fall into the small cap universe and offered the investment team a great opportunity to "upgrade" the portfolio.

In Consumer Discretionary, Borders and Central European Media were primary detractors. Book retailer Borders Group Inc. continues to be a turnaround story, yet it has been difficult for this company to make much progress in the weak retail environment.

Broadcast service provider Central European Media Enterprises Ltd. remains a great company with strong growth prospects, but it has been plagued by "bad geography," as foreign markets trailed U.S. equities in the fourth quarter. Central European Media was a top performer in 2007, and we trimmed the position several times in the interest of risk control. Shares were weakened by the global economic slowdown, but this was exacerbated by sales of the stock by hedge funds outside the U.S. While revenue growth has slowed from its previous 20% annualized level, revenues continue to grow in the high single digits. Long term, the investment team has tremendous confidence in the company's ability to maintain its dominance in such markets as the Czech Republic, Croatia, Romania and Bulgaria. As such, we added to the position on weakness during the quarter.

Information Technology firms Avid and VeriFone were also significant detractors from relative return. Avid Technology Inc. remains the market leader in the development, sale and support of software and hardware for digital media production, management and distribution worldwide, with

70%+ of the market share. Avid's balance sheet is still strong, its turnaround is on track and the catalysts are intact. Two of the trends from which this high-quality company should benefit over the coming years are: 1) Increasing digitization of media; and 2) Transition from standard-definition (SD) to high-definition (HD) media.

Shares of VeriFone Holdings Inc., which produces point-of-sale terminals, declined in sympathy with retail industry woes as well as due to lower earnings guidance as a result of integration issues with its acquisition of Lipman Electronic Engineering, Ltd. (which was previously held in the portfolio). Long term, however, VeriFone is a good example of the type of business we want to own—a global leader in its industry with low asset intensity and tremendous growth opportunities that we believe are not priced into the stock. The investment team added to the position in VeriFone during the fourth quarter.

Fourth Quarter 2008 Highlights

During the fourth quarter, a few holdings in the portfolio approached the team's intrinsic value targets and were sold, including Infinity Property and Casualty Corp. and TrustCoBank Corp. We believe that particularly in volatile markets, adhering to our strict sell discipline is a source of value added for clients.

We also took advantage of some volatility on the upside during the quarter by trimming some positions on strength; in doing so, the investment team endeavored to manage risk as the portfolio weightings in these holdings had grown. Among the holdings trimmed were hospice service provider Chemed Corp., ethnic Chinese bank Cathay General Bancorp and forensic accounting and legal consulting firm Navigant Consulting, Inc.

With the proceeds of the sales and trims, the team added to some positions in which we continue to have high conviction, such as VeriFone, Central European Media, oil services provider Oceaneering International, Inc. and children's clothing retailer Gymboree Corp. Again in the fourth quarter the investment team took advantage of market weakness and volatility to initiate investments in some high-quality companies we never expected to see in the small cap universe, such as Hartford, automobile auction giant Copart Inc. and a leading contract research organization (CRO), Covance Inc. This quarter, we will highlight the recent investment in Covance to illustrate MWCM's disciplined investment process.

COVANCE
THE DEVELOPMENT SERVICES COMPANY

Based in Princeton, New Jersey, Covance is a leading CRO, providing outsourced drug development services to pharmaceutical and biotechnology companies. Covance offers a broad range of capabilities from early stage preclinical to late stage clinical development and commercialization services. Early stage services focus on chemistry, toxicology (animal testing) and Phase I testing to analyze the safety profile of potential drug candidates. Late stage services include central laboratories and clinical development services for clinical trials to analyze both the efficacy and safety of drug candidates on humans. The company's portfolio of services is well diversified and split almost evenly between early and late stage development services.

Idea Generation. The investment team had followed Covance for several years and further evaluated the business after valuation became more attractive.

Covance fits our investment criteria as follows:

Quality Company. Covance is the market leader in the majority of its businesses. The company has approximately 20% of the market share of a $3 billion preclinical market and is regarded as the best service provider with a reputation for superior quality and consistency, which allows the company to charge a premium price for its services. The company's leadership position has also allowed Covance to secure several large multi-year dedicated capacity agreements whereby customers agree to pay for a minimum level of capacity each year. These agreements improve earnings visibility and change the relationship with customers from purely transactional to strategic. The company's preclinical strategy has centered on building a limited number of large facilities to enhance the ability to deliver consistent quality services and take advantage of scale to generate attractive margins. The company's existing network of facilities and reputation for quality would be difficult to replicate and therefore provide a meaningful competitive advantage. Covance also has the largest and one of the best-managed central laboratories operations in the industry. Covance has roughly 20% of the market share of this $1.8 billion market and is as large as its next three competitors *combined*. The size of the company's central laboratories business provides a competitive advantage by allowing the company to enjoy economies of scale to generate superior margins compared to those of its competitors. Along with market-leading businesses, Covance has one of the best management teams in the industry, which has focused on generating efficiency and margin improvements that have contributed to mid-teens returns on capital.

Covance offers several attributes that we look for in high-quality businesses:

- Strong competitive position
- Unique business model that is difficult to replicate
- Strong balance sheet with a net cash position
- High returns on capital
- Attractive underlying industry fundamentals

Attractive Valuation. Historically, Covance has traded at a large premium to the market. Recent concerns over a slowdown in research and development (R&D) spending by customers and excess preclinical capacity resulted in a pullback in valuation. Shares have also been impacted by the near-term adverse impact to revenues and earnings from recent appreciation of the U.S. dollar. The investment team believes current valuation does not fully reflect the value of the company's industry-leading businesses, strong balance sheet, and ability to deliver attractive returns on capital. Furthermore, its competitive position should allow Covance to benefit from a secular trend towards outsourcing of drug development work. This high-quality company has not traded at such a low multiple since 1999, when Covance still had debt on its balance sheet and outsourcing was not prevalent in the pharmaceuticals industry.

Catalysts to Unlock Value. The investment team has identified multiple catalysts that we believe will allow Covance shares to appreciate toward our intrinsic value target over the coming years:

- ***Strategic agreements.*** Covance recently signed a strategic $1.6 billion, ten-year deal with Eli Lilly & Co. to perform a number of drug development services. Covance has leveraged its reputation for quality and superior service to become a leader in signing these types of agreements with customers. The company remains well positioned to secure additional dedicated capacity agreements as pharmaceutical companies explore strategic relationships to outsource preclinical work.

- ***Secular trend toward outsourcing.*** Pharmaceutical and large biotechnology companies are increasingly outsourcing drug development work to lower their cost structures and turn fixed costs into variable costs. This trend should be furthered by the current environment, as companies typically increase outsourcing in difficult times. The investment team believes Covance is among the best positioned to benefit from this secular trend, with leading franchises in preclinical and central laboratories. A diversified portfolio of services across the entire drug development chain should also allow the company to benefit from both early and late stage spending and to manage through some of the industry cyclicality.

- ***Productivity improvements.*** Management has made efficiency improvements a key focus and has implemented Six-Sigma across the majority of its business segments to drive margin expansion. Improvements in productivity should also provide opportunities to enhance the quality and consistency of work, further strengthening relationships with customers.

- ***Improving free cash flows.*** The company generates strong cash flows from operations that are used to fund additional capacity for future growth. With a new facility about to be completed in 2009 and the recent acquisition of an Eli Lilly facility, the company is in position to lower capital expenditures and improve free cash flow over the next few years to further strengthen the balance sheet.

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

In our commentary of one year ago, we said that we were surprised by the continuing strength of U.S. stocks in the face of an uncertain economic environment. We proposed that *"…either U.S. stocks are a disaster just waiting to happen or something extremely powerful underlies the continued strength."* We now know that, while there are still many long-term positives, the "disaster" scenario has unfolded. We believe that the steps taken thus far to un-seize the global credit markets were essential, because without a functioning financial system, global business cannot move forward. But the absolute fear of recession and the *"do-**whatever**-it-takes-to-end-it"* attitude may be unwarranted and, potentially, counter productive. The unintended consequences of putting policy after policy in place before being able to gauge the success of previous actions could be enormous.

In spite of the dismal market performance, there are indeed reasons for optimism: the relatively flexible U.S. economy; a still growing population; strong productivity; available cash and credit; valuation levels; and our basic **desire** to succeed and prosper. Taken together, these bode well for the future. The investment team remains committed to its long-term focus on high-quality investments worldwide, and we will maintain our proactive and individual company focus in our efforts to add value over a complete market cycle.