

TCW Total Return: Should You Stay or Should You Go?

It's rare that any manager's departure is reason to immediately flee.

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Some investor reactions to the sacking of Jeffrey Gundlach 10 days ago seemed more suited to the winter of 2008 than 2009.

It would be one thing if Gundlach had been running a public operating company—its shares would be instantly sensitive to news about the company. The shares of an open-end mutual fund such as TCW Total Return (TGLMX), however, don't themselves trade in the open market and are priced solely on the values of the portfolio's underlying securities. And even if one owned shares in TCW Strategic Income (TSI), a closed-end fund whose shares do trade on an exchange, it might not make sense to sell along with the departing crowd. Gundlach himself is a large shareholder in the fund and stated shortly after his departure that he didn't want to sell his shares at a steep discount after so many others had dumped theirs.

So, if you liked Gundlach's management, thought he was doing a great job, and didn't believe he was taking outlandish risks by stuffing the portfolio with illiquid securities—which he wasn't—then there was nothing about his departure that really should have been reflected in the share price of the fund's mortgage holdings or, by extension, the net asset value of TCW Total Return.

One legitimate reason to swiftly pull assets out of the fund would be a leadership or operational vacuum of some kind, a major change in investment mandate, or perhaps the installation of a subpar manager or management team. Regardless of what one thought about the wisdom of Gundlach's termination, though, none of those reasons to immediately depart were or are present when it comes to TCW Total Return. Anticipating that a number of Gundlach's colleagues might follow him out, TCW immediately replaced him with an entire management team from Metropolitan West that brought the capabilities to handle just about any investment-related task or operational job that might be the responsibility of a departing Gundlach loyalist. MetWest CEO David Lippman, CIO Tad Rivelle, and representatives from TCW, meanwhile, have all emphatically declared that there are no plans to change anything about the investment mandate of TCW Total Return.

If You're the Police, Where Are Your Badges?

What about the quality of the MetWest team? Perhaps it should be no surprise that the group taking over for Gundlach's team has taken some pointed arrows from various corners, given the drama of the situation. Frankly, though, few if any of the criticisms leveled thus far have any basis in knowledge, logic, or fact.

Morningstar has followed the founders of the firm since their successful days at Hotchkis and Wiley in the mid-1990s, before they even established MetWest in 1996. Since then, they have built an impressive record—and one that helped the team earn Morningstar's Manager of the Year award in 2005—particularly at Metropolitan West Total Return Bond (MWTRX), which is run as a broadly diversified fund and benchmarked against the Barclays Capital U.S. Aggregate Bond Index. That benchmark is dominated mostly by Treasuries, plain-vanilla government agency mortgages, and investment-grade corporate bonds. It has a dash of asset-backed and commercial mortgage-backed securities, but they constitute much smaller weightings in the index than they do in the real bond market.

Apples to Apples

That's important because many have compared Jeffrey Gundlach's record at TCW Total Return with that of MetWest Total Return Bond and hastily concluded that the better trailing returns that he has earned can be simply interpreted as proof that MetWest's skills are inferior. But even though Gundlach ran TCW Total Return with the express goal of outperformance against funds similar to the MetWest offering (including PIMCO Total Return (PTTRX), in particular), he ran his portfolio almost exclusively as a mortgage fund and didn't consider himself constrained by the Aggregate benchmark.

That doesn't mean Gundlach isn't a great manager—he most certainly and emphatically is—or that it was any easier for him to beat his benchmark or his intermediate-term bond category peers. But it does mean that for most of the past several years his fund was invested very differently—from a strategic perspective—than the MetWest portfolio. Metropolitan West Total Return Bond hasn't

been a benchmark-hugger, but it has alternately held large stakes in corporates, asset-backed, and other securities that Gundlach chose to avoid as a matter of policy. In fact, there's simply no way to know whether the managers at MetWest would or could have matched Gundlach's record had they run their fund more similarly to his. In part, that's because the MetWest mortgage team hasn't run any dedicated mortgage portfolios, and the firm doesn't have historically comparable performance available.

Do They Know of What They Speak?

Yet, the notion that MetWest lacks the skill or experience to compete fiercely in the mortgage sector is a groundless misperception. The leaders of MetWest's mortgage effort, Mitch Flack and Bryan Whalen, each have numerous years of experience in the sector, including several on Wall Street. And in the nonagency subsector, meanwhile, Whalen was the driving force behind his firm's build-out of proprietary databases and analytical systems shortly after his arrival six years ago. Since then, deftly investing in both sectors has been a cornerstone of the firm's strength.

And it's worth noting that while Gundlach shrewdly shifted assets into the nonagency sector beginning mostly in 2008 and deserves every bit of credit for that decision and the fat returns it has produced, those kind of bets were not what drove TCW Total Return in earlier years. Rather, Gundlach built most of his record by shifting among various types and structures in the government agency mortgage sector, including securities with different maturities and cash-flow structures, including both the most plain-vanilla CMOs and their most complex derivative tranches.

Separating Corporate Politics and Drama from Investing

That is not to say big fans of Jeffrey Gundlach shouldn't consider investing with him once his newly formed firm, DoubleLine, becomes fully operational and has publicly available mutual funds available

for sale. The firm's establishment was announced Dec. 14, though, and will take a minimum of a few weeks to even become registered with the SEC. Even if the group somehow manages to begin subadvising a fund quickly thereafter (a first effort that Gundlach himself has suggested is likely), prudence suggests that at least some due diligence and examination of its support system and fundamental investment policies will be warranted.

What should one do in the meantime? Assuming that an allocation to TCW Total Return was meant to fill a particular need for market exposure and that the average investor would prefer well-managed market exposure to cash, then the short answer is: nothing.

A lot of so-called hot money did pile in to TCW Total Return during 2009, and it would appear the \$3.5 billion or so that has exited the fund since Gundlach's departure may have accounted for some chunk of that. And while that leaves somewhere in the neighborhood of \$8 billion remaining in the fund, it's conceivable that redemptions could continue and perhaps even surge again once Gundlach's new firm is truly open for business. It therefore makes sense to keep an eye on things. But as long as the velocity or volume of redemptions doesn't spiral wildly out of control, they are unlikely to hurt the fund or shareholders who chose to stick around.

Oh, and by the way, the best advice came from Jeffrey Gundlach himself during a conference call just a few days after his shocking ouster. Although he would clearly like to woo clients to his new business, he, too, said there was no reason for investors to flee TCW Total Return.

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