

No-Load Fund Analyst

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Fund Manager Updates

May, 2003

Metropolitan West High-Yield Bond (MWHYX)

CATEGORY: High-Yield Bond

MANAGERS: Jeff Koch and Mark Unferth

DATE OF INTERVIEW: 4/17/03

WITH: Mark Unferth

Last October, when the fund was launched, “it was kind of like shooting fish in a barrel in terms of finding hard-asset companies trading at ridiculously cheap levels,” says Unferth. “But I think the easy pickings are now behind us.” Unferth and his team are no longer finding lots of opportunities to buy junk bonds at extremely cheap levels compared to their estimates of the private market value of the underlying assets. This is due, of course, to the fact that the high-yield market has been on a tear the past six months, and the fund even more so, with a gain of over 20% from its October 2002 inception through mid-April.

Not surprisingly, investors have noticed the hot performance of the asset class and cash has been pouring into junk bond funds; net inflows year-to-date of \$13 billion already exceed total inflows for 2002. This worries Unferth a bit. He thinks the market is now being driven more by technicals, as investors chase returns, rather than fundamentals. Supply of new junk bond issues has been inadequate to meet the strong demand and this has pushed prices higher and yields lower. For example, high-single-B-rated bonds are starting to price in the low 7% range. “It’s a market where companies plan to do a deal at 8.125%. Then it comes back with the book ten times oversubscribed, so they crank down the pricing by a quarter of a point and they still get it priced at that level,” says Unferth.

This means investors who are expecting 20% returns over the next 6-12 months are very likely to be disappointed. Unferth thinks it is realistic to expect annual returns from high-yield bonds in the 8-10% range over the next two to three years. And he thinks investors should find that kind of return attractive, especially given the very low interest-rate environment we are in. But for investors looking for returns in the mid teens, he says “it is illusory to think you can get

that without taking incremental risk that is so great that if there were to be any kind of economic hiccup you’d stand to lose quite a bit.”

Unferth thinks the high-yield market can see another 100 basis points of spread tightening (the junk-bond yield spread over 10-year Treasuries is currently around 600 basis points, down from almost 1000 basis points last fall). However, he believes a significant portion of the tightening (50-75 basis points) is likely to come from Treasury yields rising rather than junk-bond yields falling. Therefore, junk-bond prices won’t appreciate by the full amount that spreads narrow. This fits into Unferth and Metropolitan West’s macroeconomic view that the U.S. economy will grow at a rate of 2.5 to 3%, and that the risk of inflation is much higher than the risk of deflation. Consequently, they believe that although all bonds face interest-rate risk (from rising Treasury rates), the corporate spread tightening that will occur in anticipation of the economy improving will swamp the interest-rate risk.

From its inception the fund was well positioned for the rebound in high-yield. The credits and sectors that have done the best over the past six months are the ones that were the most beaten down prior to that (sectors such as telecom, cable, energy and utilities) and in the lowest rungs of the credit spectrum (e.g., CCC-rated securities). The fund still owns many of the names that have driven its performance, such as **Calpine**, **Fairfax Holdings**, **Georgia-Pacific**, **Williams**, **El Paso**, and **WorldCom**¹, as Unferth believes they still have “quite a ways to go yet.” However, he sold some technology names (**Nortel**, **Lucent**, **Marconi** and **Xerox**²) that generated quick returns but no longer looked attractive on a risk/reward basis.

“What’s most interesting to us now is not what was interesting to us in the fall,” says Unferth. His team is finding opportunities among companies that are repairing their balance sheets, e.g., holding companies that are refinancing their debt by issuing new debt at an operating subsidiary where an asset is. “The debt may be an 8-9% type of coupon, but by virtue of where you are in the capital structure, [which is] down at the operating sub next to the asset, you are collateralized two or three times the amount of debt outstanding where you are doing the financing.” For example, they recently bought the new issue of **Northwest Pipelines**³ with an

“Fund Updates” continued

8.125% coupon. The bond is now trading at a premium of 105. Unferth also purchased two other new issue pipeline deals, but they quickly traded up 4-5 points and he says, “We chose to take our money and run.”

The fund’s credit quality weightings reflect the change in the marketplace, Unferth’s growing caution and where the analysts are finding value on a bottom-up basis. Unferth divides the high-yield market into three “tiers” based on expected risk/reward. Compared to 12/31/02, the fund’s weighting in Tier-3 securities—the highest risk/reward tier—has decreased, while the weighting to Tier-2 names has grown. Tier-3 now accounts for just 13% of the portfolio, down from 22%. Tier-2 comprises 40%, up from 29%. The drop in the Tier-3 weighting has two causes. First, as indicated above, Unferth has taken profits in some Tier-3 names. Meanwhile, he hasn’t found many other compelling high risk/reward opportunities to replace them with. “There are things that are priced like Tier-3 credits, but they are things that three months ago were Tier-4 or Tier-5,” Unferth says. “I wouldn’t touch them

at the prices they were trading at last fall because I didn’t like them, and now they are ten points higher!” The second reason is that a number of companies that the team formerly categorized as Tier-3 have “graduated” into Tier-2 due to fundamental improvements in their credits and they remain in the portfolio.

The fund’s sector weightings are a residual of the bottom-up, bond-picking process. Relative to the Lehman High Yield Index, the fund is overweight to

Metropolitan West High Yield Bond Top Ten Holdings (3/31/03)	
Qwest	2.5%
Williams Cos.	2.5%
Denbury Resources	2.5%
HPSC	2.3%
PG&E	2.2%
Houghton Mifflin	2.2%
Fairport Communications	2.2%
Freeport-McMoran	2.1%
Anchor Glass	2.1%
Aztar Corp.	2.1%
Total	22.7%

Portfolio holdings are as of 3/31/03; they are subject to change at any time.

Metropolitan West High Yield Bond Largest Sector Weightings (3/31/03)	
Capital Goods	13.2%
Non-Corporate	13.0%
Telecom	12.5%
Consumer Cyclical	11.4%
Utility	11.1%
Communications	9.3%
Energy	8.3%
Consumer Non-Cyclical	7.9%
Basic Industry	7.7%
Financials	3.8%
Technology	1.1%

Sector holdings are as of 3/31/03; they are subject to change at any time.

Telecom, Energy/ Utilities and Capital Goods (primarily the Packaging industry), and underweight to Consumer Cyclical (they own nothing in the Gaming industry).

The fund’s 30-day SEC yield as of 3/31/03 was 9.6%, compared to 10.6% for the Lehman index. The average credit quality is B+. The fund has 7% in cash, \$50 million in assets, and holds 96 securities.

Litman/Gregory Opinion

Metropolitan West High-Yield is up 14.1% this year (through April), compared to a 12.9% gain for the benchmark Merrill Lynch High Yield Master Index. Since its inception seven months ago the fund has posted excellent performance.

In November 2002 we published a Noteworthy write-up on this fund, and we refer readers to that piece for details of the fund’s investment philosophy, process and team. Jeff Koch, formerly the head of the Strong funds’ high-yield group, joined Unferth as co-PM in January 2003. Given Koch’s extensive buy-side portfolio management experience, we view this as a positive, although it does raise potential questions with regard to team dynamics and could complicate the decision-making process. However, so far we see no evidence of any problems along these lines.

While the fund has obviously had the asset-class wind at its back during its short life, in our Noteworthy piece last fall we identified a number of positives about the fund that gave us the confidence to add it to our *Approved* list despite Unferth’s lack of experience or track record running a diversified retail fund. We are impressed with Unferth and Koch’s expertise and knowledge of the high-yield market and the fundamental credit-research process employed by the MWAM team. We like the fact the fund will invest across the entire junk-bond universe and does not have a “high-quality junk” bias. We think Unferth’s sell-side background in distressed credit research adds to their edge over the competition. Koch’s buy-side background is a nice complement to Unferth, as they can each draw on a different network of contacts for information. We continue to view Metropolitan West as a high-quality organization, and the fact that they brought on someone of Koch’s caliber and experience supports our view that they are willing to commit significant resources to build a top-quality high-yield team. The fund’s expense ratio of 0.80% is also very reasonable.

Another big plus for the fund is its tiny asset base. This gives the portfolio managers the flexibility to buy and sell basically whatever they want without impacting the market price. The high-yield market can be illiquid, so this is a big advantage. Unferth gave us a couple

recent examples of how they used their nimbleness to take advantage of short-term trading opportunities. Given the fund's small asset base we had expected the portfolio to be relatively concentrated, so we were surprised to see the portfolio with 96 holdings. We note that this is still well below the 200+ holdings for the average high-yield fund. And the managers are far from the point of having to buy every new junk-bond issue that comes to market because they have to put their cash to work somewhere (this is a problem for larger junk-bond funds). But it does remove some of the added "alpha" we had hoped for from Unferth concentrating in his 40-50 best ideas. On the other hand, the broader portfolio also reduces the fund's potential volatility compared to a more concentrated portfolio. And the fund remains relatively concentrated in its top 20 holdings, at about 42% of net assets.

Unferth's explanation for the increase in the number of holdings is that, given the run-up in high-yield prices over recent months they have been taking advantage of the new-issue market, where the pricing (bid-ask spread) is often better than if they were to try to add to some of their existing names. This seems plausible to us at the margin, but we doubt it accounts for the bulk of the increase in holdings. Unferth also acknowledges that the realities of running an open-end

retail mutual fund, where the PM is often at the mercy of hot money and fickle shareholders, have led him to own more names than he ideally would. In any case, we would not expect the number of names to increase significantly from here. We continue to have a very positive view of this fund. It is on our short list of high-yield funds that we would own. ♣

–Jeremy DeGroot, CFA

Contact & Purchase Information

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SHARE CLASSES	MIN. INITIAL	AVAILABILITY	EXPENSES
Retail (MWHYX)	\$5,000*	SO	0.80%

*Minimum initial investment at Schwab is \$2,500.

Performance Tables

	Metropolitan West High Yield	Merrill Lynch High Yield Master Index
YTD thru 4/30/03	14.1%	12.9%
Cumulative Since Inception		
	18.8%	14.0%

*Cumulative Since Inception thru 3/31/03.

Note: Inception date is 9/30/02.

Footnotes:

¹As of 3/31/2003, MWHYX held 1.8% in Calpine, 1.3% in Fairfax Holdings, 1.8% in Georgia-Pacific, 3.6% in Williams, 0.7% in El Paso, and 1.9% in WorldCom.

²As of 3/31/2003 the Fund did not hold any Nortel, Lucent, Marconi or Xerox securities.

³As of 3/31/2003, MWHYX held 1.1% in Northwest Pipelines.

Past Performance is no guarantee of future results, share prices will fluctuate, and you may have a gain or a loss when you redeem shares. Investment performance reflects fee waivers in effect. In the absence of fee waivers, total return would be lower. Total return is based on net change in NAV, assuming reinvestment of all distributions.

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Although the funds are no-load, other annual fees and expenses do apply as described in the prospectus.

The Fund invests in below investment grade debt obligations, commonly known as "junk bonds." While offering higher yields, these securities generally are considered speculative and are subject to greater risks than higher-rated bonds.

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