

No-Load Fund Analyst

IN-DEPTH ANALYSIS OF FINANCIAL MARKETS AND MUTUAL FUNDS V.13.N.12

Noteworthy Fund

November, 2002

Metropolitan West High-Yield (MWHYX)

CATEGORY: High-Yield Bond Fund
MANAGER: Mark Unferth

Metropolitan West High-Yield Bond Fund was launched on September 30, 2002. Based on our familiarity with the firm and manager, Mark Unferth, we have done extensive work on the fund and the team over the past two months in the course of our search for a high-yield fund. In addition to having Metropolitan West Asset Management (MWAM) complete our detailed due diligence questionnaire, our research consisted of several lengthy conversations with Unferth, both in our office and over the phone. In a separate visit, Laird Landmann, a founder and senior member of MWAM's fixed-income team, also came to our office. Additionally, we talked to two of the fund's credit analysts, discussing specific examples of their credit research. And last but not least, we spoke to mutual fund managers who Unferth worked with while he was on the sell-side to get their opinions of Unferth and his research skills. In the end, we are impressed with Unferth's knowledge of the high-yield market and view this fund as promising.

The following is a complete review of the fund as well as our opinion.

Investment Philosophy & Process

Unferth and his team employ a fundamentally driven research process that focuses on current income and capital appreciation, while attempting to minimize the loss of capital. This is done by investing in a relatively concentrated portfolio—about 40 to 50 names—across three risk/reward tiers within the high-yield universe. The first tier is the most conservative group and is made up of higher-quality/lower-yielding (7-9% at the time of this writing) issues, characterized by dependable cash flows, quality assets as collateral and seasoned

managements that are accustomed to managing leveraged balance sheets. The second tier consists of credits with capital appreciation potential that are yielding in the 10-15% range. The third tier is the distressed issues, with 15%+ total return opportunity and high current yield. Securities appropriate for this tier will have an upside:downside ratio of 2:1, meaning MWAM's estimate of price appreciation is at least twice the potential price decline in a worst case scenario. Current examples of tier-three securities are those in the fallen angel sectors including cable, telecom, and energy.

In aggregate, Unferth expects the fund to have a B-rated average credit quality. A maximum of 20% may be invested in securities rated below B, which includes "illiquid" issues such as defaulted and un-rated bonds as well as those that aren't paying a coupon.

When evaluating individual credits, the initial step in the analysis is to understand the downside risk and the "protection" of a credit. In doing so, the team's main focus is assessing whether a company is generating enough free cash flow to meet its debt payments. The team also looks for credits that are trading at a clear discount to the value of their underlying hard assets, which provides downside protection in the event of a bankruptcy. The team will not invest in companies that don't have meaningful and quantifiable assets to support the debt. Where a bond sits in a company's capital structure is also critical, as it relates to a security's claim against assets in the event of bankruptcy. The team prefers senior securities compared to the subordinate debt. Additionally, talking to company management and assessing their ability to manage a leveraged balance sheet is also an important part of the process.

In addition to in-depth fundamental analysis, Unferth spends a fair amount of time talking to people on the sell-side, where he spent the past several years before joining MWAM. His contacts include traders, bankers and lawyers that he calls on to help decipher why a security is "moving," e.g., whether it is because something has changed fundamentally or due to a large institution buying or selling. He also uses his contacts to get varying

opinions on a credit as a means of making sure he hasn't missed anything.

While Unferth expects the bulk of excess return (relative to the benchmark) to come from credit selection, he attempts to add incremental value by tactically adopting a defensive, neutral, or aggressive stance based on his view of the high-yield market. For example, he may emphasize the lower-tier (higher-yielding) securities when the economy is coming out of a recession. But as things continue to improve and higher-yielding issues no longer offer the same risk-adjusted returns, he will posture the fund more conservatively. In an overvalued market, first-tier (lower-yielding) issues will be emphasized. Unferth will also establish short positions when he views the market as overvalued, or when opportunity arises for a particular bond; he can short up to one-third of the value of the fund's total assets.

While cognizant of benchmark characteristics (i.e., individual bond and sector weightings), Unferth does not try to mimic an index. "If people want me to benchmark, they should save their 80 basis points and go buy the high-yield index." Unferth will, however, own some of the bigger-weighted names in the index, "just to have some resemblance to the benchmark." (This is important to him, especially now, in the early stages of introducing the fund.) They do pay attention to the index characteristics such as average yield to maturity, duration, and sector concentrations, to gauge how much above or below the index they may be in terms of risk.

One way they limit portfolio risk is by diversifying across sectors. That said, they will opportunistically over- and underweight sectors based on the perceived relative value given their outlook for the economic cycle. Investment guidelines do limit sector weightings to two times the benchmark's weighting, while the narrower industry groups can be up to two-and-a-half times the benchmark weighting. In looking for value opportunities (or sectors to overweight), Unferth looks closely at sectors that have been beaten up—especially when coming out of a period of economic weakness. In general, the team favors mature sectors that have a history of generating cash flow and where debt is backed-up by valuable assets such as in the capital goods, media and energy sectors. Unferth is biased against sectors that offer little value to unsecured bondholders. Examples include retail, restaurants, and grocery stores.

Initial position sizes are typically between 1-2% of assets, although by prospectus, they can account for up to 5% of assets. In practice, the largest positions will be roughly 3%, with the typical position

accounting for approximately 2%. Unferth expects to hold about 5-7% in cash, but says if he believes the market is "technically heavy" he may increase the cash position "in anticipation of finding value opportunities."

One reason for selling a security is that the investment thesis has changed fundamentally (i.e., new management or a material change in business prospects) or if Unferth believes the bond has run its course and there are more attractive risk/reward opportunities. If there is negative news or a team member uncovers a piece of information that was overlooked during the initial analysis, Unferth will exit the position quickly. His philosophy is that he doesn't want to hang around to see where the bond ends up. He would rather sell a name and revisit it at a lower price than refuse to update his opinion on the bond. He says that the key to good returns in the high-yield market is to recognize signals before a default and act on them. Selling five points below the buy price is preferable to the 30-40 point drop that happens when a company defaults. Unferth will also take money off the table if a security runs up quickly. Consequently, the fund may have higher-than-average turnover.

Firm Background & Management Team

MWAM is an independent and privately owned asset management firm. It was founded in 1996 by Tad Rivelle and Laird Landmann, the former co-directors of fixed-income at Hotchkis and Wiley, along with other members of Hotchkis and Wiley's fixed-income team, all of whom are still with the firm. While at Hotchkis and Wiley, Rivelle and Landmann co-managed the firm's Low Duration Bond Fund. Prior to that, they were employed as portfolio managers at PIMCO.

Today, MWAM is currently running \$18 billion in assets across a full range of fixed-income products, including low-duration, intermediate, and total-return strategies. Approximately \$1 billion is in high-yield (which includes separate accounts and the mutual fund). The mutual fund currently has \$11.9 million in assets.

Unferth was hired by MWAM in April of 2002 as the firm's high-yield specialist. Prior to that, he was a sell-side analyst at Credit Suisse First Boston and DLJ, where he specialized in high-yield and distressed debt. His investment experience also includes corporate restructurings and bankruptcies.

In making investment decisions, the team employs a Generalist/Specialist portfolio management system. The Generalists are a group of four

senior members of MWAM's fixed-income team that monitor the portfolio construction and risk exposures. They also apply a top-down, macro overlay that influences the tier and sector weightings in the portfolio. For example, they advise when to cut back risk levels to be more in line with the index or move away from distressed securities and towards higher-quality issues. The Generalist also performs credit analysis on individual bonds in addition to serving as a sounding board for Unferth and the analysts. Unferth has hired two dedicated high-yield analysts to support him on the high-yield fund, but the firm also has mortgage-backed and asset-backed specialists that will contribute to the portfolio.

At the end of the day, however, portfolio construction is driven by the team's bottom-up credit research. And Unferth, as portfolio manager, is responsible for selecting the individual credits for the portfolio.

Litman/Gregory Opinion

We think Metropolitan West High-Yield is a promising new fund, and worth considering for at least a portion of an investor's high-yield bond allocation. However, there are risks specific to the fund that potential investors should definitely be aware of. Following are the fund's positives and risks as we currently see them.

Positives

We've been impressed with Unferth from our numerous discussions and meetings with him. He strikes us as very smart and savvy about the high-yield market, an independent thinker and focused on delivering superior performance for shareholders of the fund. Unferth also has a lot of experience investing in distressed securities and restructuring situations, which should be particularly useful given the current environment. In addition to our direct contact with Unferth, we also talked with some mutual fund managers who interacted with him when he was on the sell-side, and they gave uniformly positive feedback on his research diligence and work ethic.

The fundamental research process employed by Unferth and the MWAM team to analyze high-yield credits is thorough and well-defined. And our discussions of individual credits indicate they are rigorous in adhering to the process. In addition, Unferth appears to have strong valuation discipline, in terms of the price he is willing to pay for a bond given his team's assessment of the

risk/return opportunity.

We think Unferth's sell-side experience is an added advantage now that he is on the buy-side—he knows all the tricks and trappings of how the "other side" operates, and continues to utilize his sell-side and hedge fund connections. Unferth also seems to be particularly tuned in to the technicals of how the high-yield market and individual credits are trading on a daily basis. At the margin, we think this can add value.

Metropolitan West Asset Management is a high-quality organization with a solid track record and the firm appears to be committing significant resources to building a high-yield team. The fact that MWAM's investment-grade bond funds have performed very poorly this year, due primarily to their corporate bond holdings, raises a red flag. But at this point, we are inclined to believe that this is much more a reflection of the extreme risk aversion in the bond market (and a flight to Treasuries) rather than a flawed research process. We think MWAM's current situation may be comparable to the situation value investors faced during 1998-99, when no matter how undervalued they thought their "old economy" stocks were, they just kept getting cheaper because investors were infatuated with Internet and tech stocks. Value investors who stuck to their discipline were rewarded after the tech bubble burst, and as far as we can tell, MWAM has not wavered from theirs.

Because this is a brand new fund, Unferth has the advantage of working with a tiny asset base. This can be quite valuable in the junk bond market, which is generally illiquid, especially in distressed names. This not only gives Unferth the flexibility to buy and sell whatever he wants without impacting the market price, it also allows him to concentrate the portfolio in his best ideas, about 40-50 holdings. For comparison, the average high-yield bond fund owns about 200 securities.

The fund's expense ratio is very reasonable, at 0.80%, especially considering the tiny asset base. The average high-yield fund's expense ratio is about 1.30%.

Risks

The main risk we see is Unferth's lack of portfolio management experience running a high-yield fund. He ran a profitable long-short "trading book" while at First Boston, but, as he acknowl-

edges, that is different from managing a diversified mutual fund. And he has no historical performance record that we can analyze.

Another uncertainty is how effective Unferth will be in managing his analyst team, and how well the team will work together. Unferth has hired two dedicated high-yield analysts, and says he is looking to hire one or two more. So the team is still gelling. Unferth managed analysts when he was on the sell-side, so he has experience in this area. But since this fund is brand new, we have not yet been able to fully assess how the team will interact, how investment decisions will be made and how analytical consistency across the team will be maintained.

The fund will be concentrated in only 40-50 names. While on balance we view this as a positive (as indicated above), it does suggest the fund may be more volatile than other more broadly diversified high-yield funds (e.g., TCW High-Yield).

It is not clear how much time Unferth will be spending on responsibilities outside of managing the fund, such as marketing to new clients and

managing the analyst team. He is also MWAM's representative on the WorldCom creditors' committee, which over the next few months may require as much as 25% of his time.

In sum, we think the potential benefits of owning a high-yield bond fund with a tiny asset base, run by an experienced analyst willing to invest across the entire spectrum of the high-yield universe, and backed by a solid research organization, make this fund worth considering for investors looking for high-yield bond exposure. However, because of the fund-specific risks we would not recommend using it as one's only high-yield fund. We plan to continue covering the fund and will report back if there are any significant new developments or changes to our opinion. ●

—Jack Chee and Jeremy DeGroot, CFA

Contact & Purchase Information

PHONE: 800 241-4671

WEB ADDRESS: <http://www.mwamllc.com>

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

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

The High Yield Fund has 0.90% in Worldcom, as of 11/19/02.

High Yield Fund Disclosure - Investment by the fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities.

Junk-Bond Disclosure - 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.

Quality ratings, such as "B," refer to the credit risk of individual securities, and not to the Fund.

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.

For more complete information about the Metropolitan West Funds, including management fees and expenses, call (800) 241-4671 for a prospectus. Please read the prospectus carefully before investing.

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

Met West Funds has no editorial control over the content, subject matter, and timing of this article and is independent of No-Load Fund Analyst and its publisher. The views expressed in this article do not constitute investment advice. Investors should consult investment professionals regarding their individual investment programs. Since the date of this article, economic and market conditions and the portfolio manager's views of the prospects of any particular investments may have changed. This is not an offer to sell or a solicitation of an offer to buy shares of any other funds described in this article. PFFC Distributors, Inc.



Reprinted with permission from the No-Load Fund Analyst, November, 2002
Litman/Gregory Research (800) 776-9555

The No-Load Fund Analyst is a research-intensive newsletter that publishes objective, fundamental research on mutual funds and asset classes. We pride ourselves in the depth and quality of our fund research which many believe is the best in the fund industry. Our subscribers are financial advisors and individual investors. For subscription information or a sample issue, call (800) 776-9555 or go to www.nfa.com.