

Litman/Gregory's AdvisorIntelligence

April, 2004

DUE DILIGENCE

METROPOLITAN WEST ASSET MANAGEMENT STRATEGIC INCOME FUND (MWSTX)

CATEGORY: ALTERNATIVE BOND

**MANAGERS: LAIRD LANDEMANN, HAHN KANG AND
KRISTEN GALANEK**

In recent months we have spent considerable time researching Metropolitan West Asset Management's (MWAM's) Strategic Income Fund. We have conducted due diligence on MWAM in the past, focusing on their credit team, and have invested in their High Yield fund. As such we are quite familiar with the firm and its capabilities. Nevertheless, our research on their Strategic Income Fund involved several in-depth calls and meetings with senior management and investment professionals of the firm, both onsite and at our offices, to address specific issues related to the management and implementation of the Strategic Income Fund. Our research team also had several meetings to evaluate our findings. Having completed our due diligence we are adding the Strategic Income Fund to our Recommended list. Note that this is not a traditional investment-grade or short-term bond fund. We categorize it as an alternative bond fund given its absolute return objective and hedge-fund like qualities.

Firm Background

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. MWAM manages \$14 billion in fixed income assets.

Investment Philosophy and Objective of the Strategic Income Fund

We have always viewed MWAM as a contrarian-value investment firm that is not afraid to make bets away from the benchmark. The Strategic Income Fund was launched to allow MWAM to pick their best ideas regardless of benchmark considerations and generate a positive absolute return over a 12-month time frame, irrespective of the direction of interest-rate movements. Accordingly, the fund is not expected to take significant duration bets (unless in very compelling circumstances when they are adequately compensated to take price risk). The fund is expected to have a stable-duration strategy (duration for the most part will range from -2 to +3) to keep the interest-rate risk out of the picture. (Duration measures the approximate sensitivity of a bond's value to each percentage point of change in interest rates. For example, the value of a bond fund with a duration of 5 will fall by approximately 5% if interest rates were to go up by 1% (or 100 bps).) For the most part the fund relies on generating a healthy coupon yield and adding additional return from opportunities that arise from market inefficiencies and/or temporary dislocations in the market. The Strategic Income Fund aims to beat its benchmark, the Merrill Lynch 3-month T-Bill index plus 200 basis points, over a 12-month period.

MWAM believes that the phenomenon of hugging benchmarks and a focus on relative performance has become so prevalent among institutional fixed-income managers that it sometimes creates great bond-picking opportunities. MWAM also researches relatively inefficient areas of the fixed-income markets that many players tend to overlook due to benchmark considerations or because the opportunity set is too small to attract attention from large players. The small size of the Strategic Income fund and its broad mandate allows the fund to tap into these inefficient

areas and allows them to have a meaningful impact on the fund's performance.

Decision-Making Structure

All investment activities are overseen by MWAM's four generalist portfolio managers, led by Tad Rivelle, the firm's Chief Investment Officer. In general, MWAM employs a generalist/specialist portfolio management system to make key investment decisions. The generalists apply a top-down, macro overlay that influences duration and yield-curve positioning, sector weightings and positioning within those sectors. In addition to serving as a sounding board for the credit and structured teams, the generalists perform analysis on individual bonds and structures and monitor portfolio construction and risk exposures across various products at MWAM. Specialists are responsible for implementing the firm's broad macro view in their respective sectors and/or areas of specialty. Specialist portfolio managers focus on sectors such as mortgages, Treasuries, corporates, high-yield, asset-backed, etc. There are two committees that are instrumental in decision-making—the credit committee and the structured committee. MWAM's credit committee is comprised of the four generalist portfolio managers, one investment-grade corporate portfolio manager, and two high-yield portfolio managers. The credit committee meets at least once a week and occasionally more frequently when credit-market conditions dictate such action. The credit committee reviews, cross-examines and approves any purchases and sales of credit investments. Portfolio managers cannot purchase securities that have not been previously approved for purchase by the credit committee. Similarly, MWAM also has a structured-products committee that reviews, cross-examines, and approves structured products and investments. This committee is comprised of the four generalist portfolio managers, MBS (mortgage-backed securities) portfolio managers, and the ABS (asset-backed securities) portfolio managers and analysts. Decisions for the Strategic Income Fund are made by Laird Landmann, Hahn Kang, and Kristin Galanek. Landmann, who is a principal at MWAM and one of the four generalists at MWAM, is the lead portfolio manager on the fund. The three-member team is an integral part of the overall MWAM investment team

and participates in decisions that influence all portfolios at MWAM, including the Strategic Income Fund. As such, it is the job of this trio to translate the firm view, both at the macro and sector level, into the Strategic Income Fund's mandate.

Additionally, all MWAM portfolio managers and analysts work out of a trade room. Therefore, ad-hoc discussions occur frequently. Decisions are generally made by consensus. Any objections and/or issues raised during an investment meeting are analyzed further and discussed again by the team.

Investment Process

MWAM's investment process begins with the formulation of a fundamental economic outlook. This view translates into an interest-rate, yield-curve, and sector strategy. The generalists lead the discussion, but there is heavy input from the sector specialists in terms of what they are seeing in their respective areas. In addition to the bottom-up views from specialists, the team considers fiscal and monetary information, demographics, global macro data on interest rates, inflation and currencies, the housing environment, etc. The team also assesses the consensus view that is reflected in current interest rates and yield curve. This process sets the tone for sector level work. For example, a mortgage specialist would be able to stress test the cash flows of a mortgage-backed security and compare the embedded consensus interest-rate and prepayment-rate assumptions with MWAM's view on where we are in the economic cycle.

Landmann, Kang, and Galanek take the economic view from above and apply it over the 12-month time horizon for the Strategic Income Fund.

The Strategic Income Fund looks at a very diverse and sometimes extremely esoteric range of investment opportunities in the fixed-income arena. Hence it is difficult to describe a unified approach or process to analyze these investments. Based on our research, we feel confident that they adopt a conservative, contrarian-value approach to all of their investments and do thorough work before arriving at conclusions. Having said that, one can broadly break down their universe into

corporate credits (investment-grade and high-yield bonds) and structured products (asset-backed securities, mortgage-backed securities, CMOs etc.).

Analyzing credits

The initial step in credit analysis is to understand the downside risk and the "protection" of a credit. This involves 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. Additionally, talking to company management and assessing their ability to manage a leveraged balance sheet is an important part of the process. Downside risk and the expected-return assessment from their fundamental work will determine whether they invest in subordinate or senior debt of a company.

Analyzing structured investments

The structure product teams, i.e. the Asset-Backed team and the Mortgage team, analyze underlying cash flows that support a particular security. MWAM's broad economic view plays an important role in analyzing expected cash flows. For example, MWAM's economic view impacts interest rates, prepayment rate, and default rate assumptions, which are key inputs into models (both external and internal) that value structured investments. MWAM runs many scenarios to stress-test their assumptions and also assess the assumptions embedded in a structured investments' price. They also look at worse-case scenarios where actual events may turn out very differently from their expectations. After running multiple scenarios, the team is able to assess the risk of being wrong versus expected return. In this manner the structured team sifts through various structured investments/deals and picks the ones that have the most favorable risk and reward trade-off.

Portfolio Construction and Implementation

We mentioned above that the Strategic Income Fund takes the firm's economic view and applies it over a 12-month time horizon. The same approach applies to picking individual credits and structured investments. In addition, a very important part of the process is to structure the portfolio in a manner such that the Strategic Income Fund generates positive absolute returns over a 12-month time period. To accomplish that, the three-member team runs hundreds of scenarios at the portfolio level to ascertain the risk and return of individual holdings. The team utilizes a combination of internal and external tools to model various securities in the portfolio. The scenarios include varied movements of interest rates, credit spreads, yield-curve shifts etc. The objective of running such detailed scenarios is not only to generate a consistent healthy coupon yield but also hedge various risks that could have a negative impact on absolute returns of the portfolio. For example, the fund's recent position in interest-only strips (IOs) generates a healthy yield and also hedges the portfolio against a rise in interest rates because of their negative duration property. Since the fund also does not want to significantly bet against a fall in interest rates, the IO position is offset to some degree by long-duration corporates. The scenarios are run monthly, but can be run more frequently if market conditions change significantly.

Strategic Income Fund Team

Below, we provide a description of the backgrounds of the fund's portfolio management team.

Laird Landmann-Prior to co-founding Metropolitan West Asset Management, Landmann was a Principal and the co-director of fixed income at Hotchkis and Wiley, where he was co-manager on the Hotchkis and Wiley Low Duration Bond Fund. Earlier, Landmann was a portfolio manager at Pacific Investment Management Company (PIMCO). Landmann has over 17 years of investment experience. He is a generalist portfolio manager and takes part in all major investment decisions at the firm.

Hahn Kang-Before joining Metropolitan West Asset Management, Kang spent seven years in

the Lehman Brothers Fixed Income Department in New York, structuring, syndicating, and trading different types of asset-backed securities (ABS) and loans. In this capacity, he served as Senior ABS trader, where his area of emphasis included both the high-credit arena and lower-credit securities. Kang has over nine years of investment experience. He is a specialist in the corporate sector and also lends his expertise in the ABS area.

Kristen Galanek-Prior to joining Metropolitan West Asset Management, Galanek was a credit analyst and Vice President at Deutsche Bank Securities in New York, covering several industrial sectors. Earlier, she was a research associate at Lehman Brothers, primarily working in the corporate bond strategy group. Galanek has about six years of investment experience. Her primary responsibility is conducting credit analysis.

Fees

One of the biggest hurdles we faced in recommending this fund is its high fee structure, especially when compared to other fixed-income alternatives. For the M class shares (retail, no transaction fee), the management fee is 1.20% and other expenses are 0.45% (the institutional I shares are subject to transaction fees and have higher minimums, but are have an expense ratio that is 0.25% lower than the M shares). In addition, there is a performance-based fulcrum fee that can adjust up or down by 70 basis points depending on the fund's relative performance. So for the I shares, the total expenses could be a minimum of 0.70% (if they do not beat the ML 3-month T-bill index) and a maximum of 2.10% (if they add 400 bps or more over ML 3-month T-bill index). We expect the Strategic Income Fund to beat the ML 3-month T-bill index by more than 400 bps.

Types of investments this fund may make

The fund will focus primarily on U.S. securities/issues. Given the sheer number and complexity of various investments the fund can utilize to fulfill its objective, it is impractical to discuss all of them in detail. However, in order to give a better feel for the Strategic Income Fund, we list below a sample of what the fund can hold:

- Treasuries.
- High-grade corporate bonds.
- High-yield corporate bonds.
- Variable and floating-rate debt securities.
- Convertibles-fixed-income securities which may be converted at a stated price within a specific time period into common stock or other equity).
- Warrants.
- Mortgage pass-throughs-Mortgage-backed securities that an represent an interest in an underlying pool of mortgages.
- Collateralized Mortgage Obligations (CMOs)-hybrid instruments that have characteristics of both bonds and mortgage pass-through securities. CMOs are debt obligations collateralized by residential or commercial loans or residential or commercial mortgage pass-through securities.
- Stripped Mortgages-such as Interest Only (IO) or Principal Only (PO) provide different cash flows under different interest-rate scenarios and can be used to hedge interest rate risks.
- Inverse Floaters-a debt instrument with a floating or variable interest rate that moves in the opposite direction to the interest rate on another security or index level.
- Asset-Backed Securities (ABS)-these typically include receivables related to the purchase of automobiles, credit card loans, and home equity loans.
- CBOs, CLOs and CDOs-these are debt instruments backed solely by a pool of other debt securities. The type of collateral and the class of a CBO, CLO or CDO that the fund invests in are important considerations.
- Enhanced Equipment Trust Certificates (EETCs)-essentially securitization of equipment such as planes, i.e., debt of airline companies.
- Bank debt-loan participations representing direct participation in a loan to a corporate borrower.
- Derivatives such as options, swaptions, options on futures contracts.
- Credit default swaps and short equity-to hedge against credit risk.
- Capital Structure Arbitrages-markets may mis-price different capital structures of the same company that are at times backed up by similar collateral, which could lead to an arbitrage opportunity.

Litman/Gregory Opinion

There are a number of positives that lead us to recommend the Strategic Income Fund. These include:

- **People**-Over time we have had numerous interactions with MWAM's investment team. We have been extremely impressed by the quality of the investment professionals at the firm. All the investment professionals we met follow a disciplined investment process and exhibit a high level of expertise in their respective areas.
- **Ability to take advantage of market inefficiencies**-Parts of the fixed-income market are relatively inefficient. Our numerous reference checks in the market place confirmed that areas such as non-investment-grade asset-backed securities, rating discrepancies between structures that are similar from a cash flow perspective, complex structures, small-sized deals, etc. are relatively inefficient areas of the market. Inefficiency arises in part due to the benchmark-orientation of some of the larger players and the unwillingness of some players to do the extra work on complex deals. The Strategic Income is structured to take advantage of these market inefficiencies.
- **Positive Culture**-We believe that the founders of MWAM have created an environment of mutual respect and team dynamics that should foster team continuity. The firm has experienced almost no turnover in its investment team since its inception. Our onsite visit and numerous conference calls with the group suggest that people enjoy working with each other.
- **Small asset base**-The fund's small asset size (currently around \$90 million) allows them to tap into some of the inefficient areas of the fixed-income market and is one of the key factors supporting our thesis.
- **Performance-oriented culture**-MWAM professionals do not believe in hugging benchmarks. They remain focused on delivering performance for their clients and shareholders. The investment team is not afraid to take contrarian views since they conduct rigorous analysis prior to making investment decisions. We think that their willingness to look at complex deals and structures gives them an extra edge. We

discussed numerous examples with the Strategic Income Fund team that indicate that they remain focused on generating absolute returns over the 12-month horizon and they conduct vigorous scenario analysis to achieve that objective.

- **Strong vetting process**-The credit committee and the structured committee ensure that all investment ideas are rigorously debated and cross-checked by multiple investment professionals at MWAM. Moreover, there is constant dialogue among the team members. Portfolio managers (who also act as traders) and analysts work from a trading room and sit at adjoining desks, enabling the continuous sharing of information.

For investors who choose to own this fund, we think it is best used as a fixed-income replacement. We would also view it as a core holding, rather than one that could be used for making tactical bets (conventional bond funds would be a better choice for that purpose). Based on our understanding of how Met West expects to generate returns, we believe the fund will outperform over a full market cycle, and given how it is currently positioned it should provide a good hedge against a rise in interest rates. However, there are some scenarios (e.g., deflation) where a conventional bond fund would likely do better- at least on a short-term basis- and investors should be aware of this when making their allocation decisions.

Risks

While our overall view on the Strategic Income Fund is positive, investors should be cognizant of the risks inherent in this fund.

We think that the team in general does a good job of managing risks. However, some of the markets they deal in are at times "esoteric," i.e., not many players operate in some of those markets. While that allows MWAM to gain from certain inefficiencies, they take on certain risks such as liquidity risk, short-term price volatility, credit risk, extreme-market-event risk, etc. (their prospectus goes into more detail on various risks) that could have a negative impact on performance. The complex nature of some of their investments also makes it difficult for us to accurately assess

how this fund might perform in some scenarios. Our research, however, leads us to believe that Landmann and his team are cognizant of the risks that they undertake through their investments and are adept at managing those risks.

We should also point out that as the fund grows it will take on investments in areas of the fixed-income market that we have not had the opportunity to cover as exhaustively as we have covered their existing portfolio. Hence, monitoring their portfolio and having discussions with them on a regular basis is expected to provide valuable input for ongoing due diligence on this fund.

Finally, as noted above, we view the fund's very small asset base as a key factor to meeting its risk/return objectives. We expect the fund will soft close to new investors somewhere in the range of \$200 to \$300 million. Our experience suggests that investment firms tend to keep raising the bar with respect to the level of assets they can manage in any strategy and generally that hurts long-term performance. We are even more sensitive about the asset levels in the case of Strategic Income Fund given the nature of the market inefficiencies the fund is trying to tap. Consequently, we will monitor their asset base closely.

Conclusion

One of the biggest hurdles we faced in

recommending this fund is its high-fee structure, especially when you compare it to other fixed-income alternatives. We ultimately concluded that the base-case risk and reward trade-off of the Strategic Income Fund, even after taking into account peak levels of expenses, is superior to other fixed-income alternatives. Moreover, the small asset base of the fund and MWAM's willingness to look at complex deals/situations allows it to tap into certain market inefficiencies that exist in the fixed-income arena, which gives them an edge over other players. This edge is one of the factors behind our confidence that the Strategic Income Fund team will achieve its return objectives in most scenarios.

As we mentioned above, there are scenarios when this fund could underperform other traditional bond alternatives such as PIMCO Total Return. Some of these are clear, such as a strong deflation scenario for the U.S. economy where interest rates go lower and credit spreads widen. Other situations are conceivable as well (given the complexity of some of the underlying instruments) that could cause the Strategic Income Fund to underperform in the shorter term. However, we believe that the team's focus on managing downside risk and the added value from active management lends sufficient defensive characteristics that make it unlikely the fund would lose money over a 12-month time frame, and we think this fund will beat its benchmark over a full market cycle.

-Rajat Jain, CFA



This article must be preceded or accompanied by a prospectus for the Metropolitan West Strategic Income Fund. The prospectus describes the investment objectives, risks, charges, and expenses of the Metropolitan West Funds. Please read it carefully before investing or sending money. Past performance is no guarantee of future results. The Strategic Income Fund uses sophisticated investment techniques and may not be suitable for all investors. Metropolitan West Funds has no editorial control over the content, subject matter, and timing of this article and is independent of Litman/Gregory 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.

PFPC Distributors, 760 Moore Road, King of Prussia, PA 19406-1212 DFU: 5/04.

Reprinted with permission from AdvisorIntelligence, April 2004.

AdvisorIntelligence shares with advisors the research and client communications resources of wealth manager Litman/Gregory, a firm well known for the depth and quality of its manager due diligence and tactical asset allocation. For a free trial visit www.advisorintelligence.com or call (800) 776-9555.