The Fall—and Rise—of a Topnotch Bond Fund

Bond Squad
by Eric Jacobson

When all hell broke loose in the corporate bond market last year, there were few high-profile bond fund managers as badly singed as Metropolitan West. As deep believers in value-driven bond investing, the crew at this Los Angeles-based shop had been snapping up the debt of companies such as WorldCom WCOEQ, Calpine CPN, Qwest Q, Sprint FON, El Paso EP, and Williams Companies WMB earlier in the year. Nearly all of them had been investment-grade companies, and the analytical work of Met West convinced its managers that the bonds were not only cheap, but that even in a worst-case scenario, there were sufficient assets to ensure that investors would get paid back. Known within the firm as a "belt-and-suspenders method," this set of evaluations gave the team confidence to hold between roughly 2% and 4% of assets in a number of its favorite credits.

As one scandal after another drove the market to distraction in 2002, though, corporate bonds began to swoon. In many cases, a loss of equity market value was enough to convince rating agencies to downgrade companies' credit ratings, regardless of relatively unchanged balance sheets or their apparent ability to pay their debts. The frenzy seemed to feed on itself, and corporate bonds were pummeled in the marketplace. Many bonds that had been trading close to their par values (100 cents on the dollar in market jargon) were suddenly being marked at between 30 and 50 cents. Company after company found it nearly impossible to refinance debt of all kinds. The pain was unprecedented. Some $150 billion of investment-grade bonds were downgraded to junk. Having built up stakes in the aforementioned credits, Metropolitan West Total Return Bond MWTRX found itself firmly in the grip of the bear and lost more than 4% in June 2002 alone. That may not seem like much, but the fund's overall 1% loss for the year looked to some an insurmountable hurdle for the firm going forward: By the end of December, the flagship fund had underperformed its benchmark by a shocking 11 percentage points.

There was something notable about how Met West addressed its troubles, though. From the onset, the firm's managers professed confidence in their holdings and elected not to try and unload them. To be sure, one could have read that reaction as hubris, and it was extremely tempting to view it that way. Admittedly, despite the team's history—its key players hailed from PIMCO, and had developed excellent records at Hotchkis & Wiley and during their first several years at Met West—many of us at Morningstar wondered if the group had gone too far in an effort to distinguish itself from the competition.

By and large, though, we gave the team the benefit of the doubt. For one thing, we had gotten to know the managers at the firm as well as any others, and had been impressed with them ever since their Hotchkis days. Beyond that, we have covered numerous troubled funds over the years, and those making wrong-headed decisions have typically been quick to jettison their problem holdings in an effort to clean up their portfolios and try to erase any memories that might linger. Those that have hung on have almost always done so under the veil of apology and contrition for ill-conceived analysis. Furthermore, manager changes and departures are common. By contrast, Met West kept its team in place, continued to add staff, and answered every question about every troubled credit with crisp, detailed explanations.

We frankly felt it our obligation to try and think of ways to poke holes and find weaknesses in their analysis. In every case, though, the team had a specific thesis underpinning its reason for holding on through the storm. Even in the case of WorldCom—one of the most maligned credits in the market—Met West managers were able and willing to provide a point-by-point analysis showing what they believed it to be worth in a post-bankruptcy scenario. They weren't predicting a full rehabilitation for that credit, but expected to enjoy a very significant recovery once the business was eventually turned over to bondholders. In each case, they concluded that they weren't misreading the value of the fund's beaten-down holdings—the market was. Of course, Met West's value theses could eventually prove misguided, but we had yet to see or hear anything that convinced us that they were. We did drop Metropolitan West Low Duration

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Bond Squad (cont'd)

MWLDX from our Analyst Picks list because it produced more price volatility than we thought many investors would accept. But overall, we elected not to change our collective opinion of the shop or its Total Return fund, which remained an Analyst Pick.

To be sure, it's a little too soon to call the firm's efforts a total victory. But as the unhinged bond market began to find its footing last October, shares of Total Return began to slowly regain ground. Met West had hung on to just about all of its beaten-down bonds, and the market began pricing them as though their issuers might have a future, rather than in preparation for Armageddon. Since then, WorldCom has been flying through the bankruptcy process and third-party research suggests ultimate recovery scenarios significantly higher than the bonds' recent range of 33 to 36 cents on the dollar—in and of itself a roughly 300% bounce since the lowest days of low-teen pricing. More important is that names such as Calpine and Qwest have more than doubled from their lows and are now trading in the 70s and 90s, respectively. The strongest evidence of analytical strength, however, has come from the pricing of Williams and Sprint bonds. The former paid off some bonds as they matured at par, and its other issues that remain with Met West are again trading at normal, healthy prices. The Sprint bonds in Met West portfolios are trading in a similar fashion.

Other portfolio decisions also get credit for the ascent of Met West Total Return in 2003—management has kept only modest exposure to Treasuries and mortgages, and has kept duration short of its benchmark—but its rebound has been remarkable. The recovery among corporate bonds began around October of last year, and the fund has soared to a 17% gain for the trailing 12 months through Oct. 24, 2003.

Judging its recovery at this point depends on how you define success. Although its record versus other funds has yet to return to its pre-summer 2002 heights, the portfolio's five-year return is now back in the intermediate-term bond category's best quartile. And though the fund hasn't made up for the entire performance gap that it developed with respect to the Lehman Brothers Aggregate Index, the fund has rallied so hard that its net asset value is within 1% of its level prior to WorldCom's fraud announcement. Assuming it reaches that level at some point soon, it would be fair to say that the fund had both recovered what it lost, and continued to pay a healthy level of income to boot.

The pain suffered by Met West has been felt by nearly all of its customers, and there's no getting around the price volatility they endured. But while management has elected to limit new purchases to a smaller percentage of assets in the future, very little else has changed. In fact, as noted, the firm has added staff, and has even rolled out new funds, including the thus-far extremely successful Metropolitan West High Yield MWHYX. Can we be sure that none of the firm's funds will ever hit a similarly rough stretch? No. The question that we at Morningstar asked ourselves since the day that WorldCom's troubles rained on Metropolitan West, however, is whether we still had confidence in its managers. Despite efforts to the contrary, the only answer we could arrive at was yes.

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Visit the Metropolitan West Funds website at www.mwamllc.com for more information including current distributions, daily prices and performance, and prospectus with charges and expenses. Please read the prospectus carefully prior to investing.

Net Performance

(Trailing Returns through 09/30/03)

	Q3 '03	YTD	1-year	3-year [3]	5-year [3]	Since Inception [4]
MWTRX[1]	**1.77%**	**10.18%**	**15.18%**	**6.89%**	**6.61%**	**7.93%**
Lehman Aggregate[2]	*-0.14%*	*3.78%*	*5.40%*	*8.94%*	*6.62%*	*7.97%*

1. MWTRX = Metropolitan West Funds Total Return Bond Fund Class M shares.
2. The Lehman Brothers Aggregate Index is comprised of the Lehman Government/Corporate Index, the Lehman Mortgage-Backed Securities Index and the Lehman Asset-Backed Securities Index. The Index includes fixed rate debt issues rated investment grade or higher. All issues have at least one year to maturity and an outstanding par value of at least $100 million for U.S. Government issues and $50 million for all others. It does not reflect the payment of transaction costs, fees, and expenses associated with an investment in the Fund. The securities that comprise the Lehman Aggregate Index may differ substantially from those in the Fund's portfolio. These indices are unmanaged indices that are not available for direct investment.
3. Annualized.
4. The Since Inception date is 3/31/1997, annualized.

Performance data quoted represents past performance and is no guarantee of future results. Net asset value, investment return and principal value of an investment will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Returns for periods of one year or greater are average annual total returns. The Metropolitan West Funds offer other classes of shares with different fees and expenses to eligible investors. Performance figures reflect a partial waiver of fees without which the total return would have been lower. Year-to-date returns are due in part to market conditions that might not be repeated in the future. Current performance may be higher or lower than performance data quoted.

Returns for the Fund are net of all charges and fees assuming reinvestment of dividends and capital gain distributions at net asset value. The Advisor has undertaken to limit the 12b-1 expenses to 0.21% for the current fiscal year. The Advisor has contractually agreed to reduce its fees and/or absorb expenses, and to pay a portion of the Fund's distributing expenses, to limit the Fund's total annual operating expenses to 0.65% and 0.44% of the Fund's Class M and Class I average net assets, respectively, which has the effect of increasing the rate of return.

Portfolio holdings and sector allocations are subject to change. As of October 31, 2003, MWTRX held 3.48% of WorldCom WCOEQ, 3.98% of Calpine CPN, 3.72% of Qwest Q, 0.95% of Sprint FON, 0.11% of El Paso EP, and 0.00% of Williams Companies WMB. Appearance of these securities within this reprint is neither an offer to sell nor a solicitation of an offer to buy these securities, nor does this list represent an investment recommendation.

While the article mentions that MWTRX ranked in the top quartile as of October 29, 2003, the Total Return Fund actually was in the top one percent of 807 funds in the Intermediate-Term Bond category, as of September 30, 2003. MWTRX was in the top fourteen percent of 497 Intermediate-Term Bond funds ranked by Morningstar in a total return percentage comparison for the five-year trailing period ended September 30, 2003. Morningstar Rankings represent a fund's total-return percentile rank relative to all funds that have the same Morningstar Category. The highest percentile rank is 1 and the lowest is 100. It is based on Morningstar total return, which includes both income and capital gains or losses and is not adjusted for sales charges or redemption fees.

Shares of Metropolitan West Funds are distributed by PFPC Distributors, Inc., 760 Moore Road, King of Prussia, PA 19406. To obtain a prospectus with more complete information, including charges and expenses, please call (800) 241-4671 or visit www.mwamllc.com.
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