TACK OR JIBE

Prince Albert, Queen Victoria's consort, thought it a splendid idea to organize a Great Exhibition as a showcase of England's power and glory. The nations of the world all sent emissaries and tributes to London that summer of 1851, but a small group of Americans had their own splendid idea: send a boat across the Atlantic to challenge all comers to a race. It was frankly a laughable notion that anyone could defeat the world's greatest sea-faring nation, much less from a country whose capital city had been burned to the ground by the British just 39 years before. Laughter was indeed what greeted the crew as they pulled into Southampton harbor and announced their challenge. At first, there were no takers, even against their audacious wager of £10,000 (about $5 million today), but on the morning of 22 August 1851, the schooner *America* (shown above in a rare photo) lined up with fifteen of Britain's swiftest ships to sail around the Isle of Wight, just off the southern coast of England.

As any sailor will tell you, reading the winds and anticipating its changes are the keys to a successful race. The faster boat doesn't always win (although it helps). The experience, judgment and talent of the crew almost always matter more than the shape of the hull or the size of the sail. Knowing where the winds are at the starting line is relatively simple; knowing where they will be at some point up-course, and therefore how best to position oneself for the next leg, is what separates the landlubbers from the sea dogs.

Two years ago, we began to write of the shifting winds in the world's financial markets. The period of capital appreciation and multiple expansion in financial assets was coming to an end, and in its place would be a period of clipping coupons (grocery, as well as bonds). While we anticipated the shifting winds, and even saw the squall lines on the horizon, we did not foresee that those squall lines were indeed the leading edges of a typhoon. We battened down the hatches as we watched the barometer plummet and the seas swell. We added new, defensive assets, like convertibles and real estate and TIPS, to our portfolios, but trimming the sails wasn't enough to prevent negative returns in our portfolios in 2002. The havoc wreaked by this storm cut deeply into our many non-profit clients, who were forced into deciding between cutting spending, and thus harming the many beneficiaries dependent on their support, or cutting into the corpus of the fund, thus endangering the even greater number of future beneficiaries. For our defined benefit pension clients, the destruction of the typhoon was devastating, indeed the *perfect storm* of falling interest rates that raised the costs of future liabilities, and plunging asset values that make it that much more difficult to pay for those rising costs. In hindsight, battening the hatches and trimming the sails were simply insufficient; turning around and heading for protective harbor would have been the better course.

Of course, as Glenn Frey and Don Henley wrote, every port of refuge has its price. We'll start with a review of the markets in the past quarter, before turning to our survey of the economic winds, both past and future.

Not a bad quarter it was (see Graph 1), although not nearly good enough to prevent equity markets from suffering the third consecutive annual decline (something not witnessed since 1939-1941), and completing the worst year since 1974. The best performing sectors in the fourth quarter were the worst performing sectors for the year. Telecom and technology soared 38% and 22%, respectively, in the quarter, the two best sectors by far, but for the full year were off 34% and 37%, respectively, the two worst sectors. Likewise, consumer staples was the worst performing sector in the quarter (up 1.2%), but the best sector in 2002 with a decline of just 4.3%. Yes, every sector of the S&P 500 Index lost ground in 2002. There was no true port of refuge in the S&P 500 last year. For the year, Intel, AOL and Tyco lost 50, 60 and 70%, respectively, making them the 2nd, 3rd and

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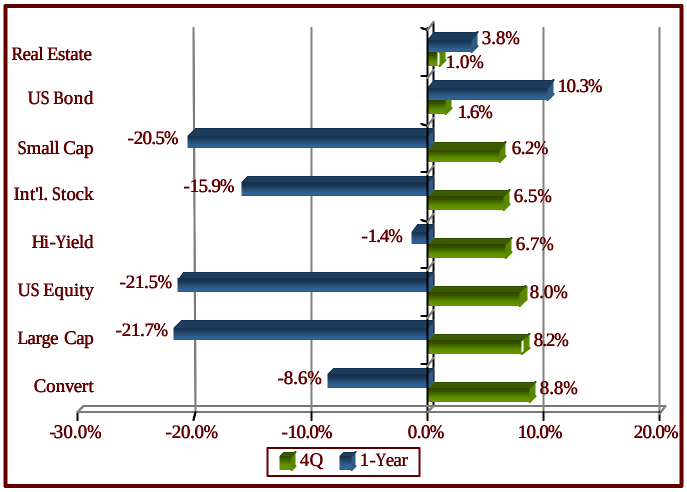
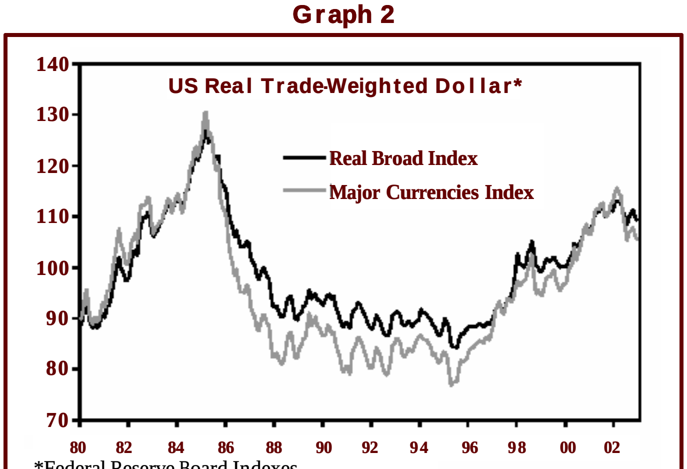
4th biggest contributors to the loss in the index. GE, with a drop of 37.7%, was the single biggest contributor to the S&P's decline in 2002. Banks took the top spots last year, with Bank America, Wachovia and Wells Fargo holding the number 1, 3 and 4 places of top contributors (Proctor & Gamble was in second place).

Graph 1



AOL deserves a special mention for losing $99 billion in 2002. The combined value of AOL and Time Warner when their merger was announced in 2000 was $99 billion. The symmetry is poetic.

Graph 2



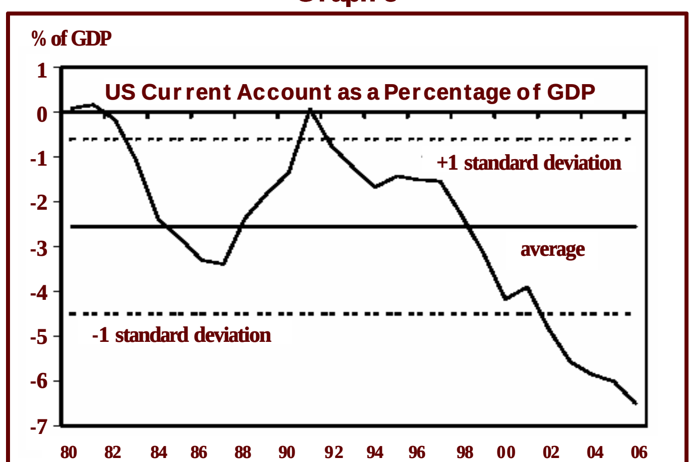
*Federal Reserve Board Indexes

Graph Courtesy of Goldman Sachs

International securities bested domestic ones, principally because the dollar was weaker against the major currencies. Over the past year, the dollar is off more than 20% against the euro and more than 10% against the yen, the two principal developed market currencies. But Europe and Japan are only our second- and third-largest trading partners, and on a trade-weighted basis the dollar is only off about 5% (see Graph 2). Against our largest trading partner, Canada, the US dollar is down about 5% this past year, but against the Mexican peso, our fourth largest trading partner, the dollar is actually up nearly 20%, and the dollar is flat against our fifth largest partner China (who pegs its currency to the dollar).

The direction of the dollar is of more than passing concern to investors. It has important asset allocation implications and, more critically, broader economic ramifications. Arguing for a lower dollar is the burgeoning current account deficit that requires the US to entice foreigners to send us more than a billion dollars each day, every day. This is not a choice, just an accounting truth. While we have frequently run current account deficits, which could be interpreted as positive support for the attractiveness of investment opportunities in the US, the magnitude of the deficit (see Graph 3) is moving into waters where currency devaluation is typically seen.

Graph 3

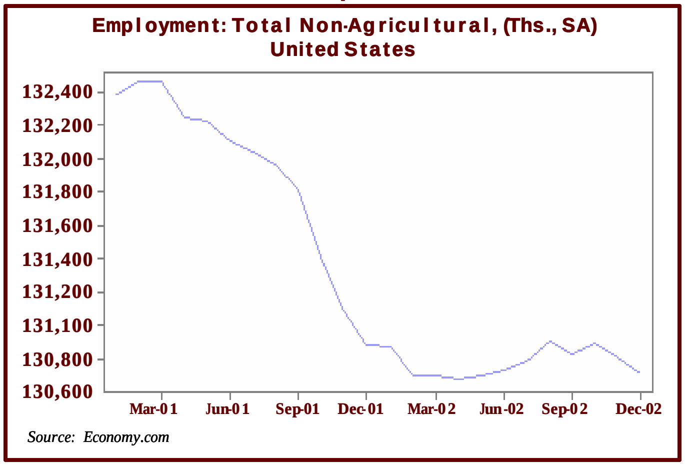


Note: 2000 onwards are GS Forecasts

Graph Courtesy of Goldman Sachs

But what are the alternatives? Economic growth may be sluggish in the US, but it is anemic, at best, abroad. The European economy will probably not grow at all this year, and Japan's economy will likely shrink. In the world of the blind, the one-eyed man is king, and while the US dollar *should* decline, the timing and magnitude of this is uncertain. We expect that US investors will benefit from holding foreign securities with a likely decline of the dollar, but we haven't baked that into our assumptions. International investing makes sense by expanding the investment

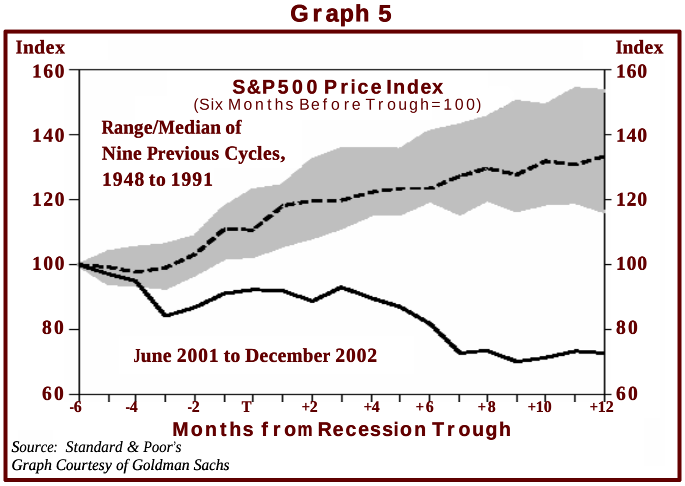
Graph 4



opportunity set and offering some diversification benefits; a declining dollar is just a little extra gift.

Anemic, from the Greek *an-haima, without blood*, could well describe our economy at the end of 2002. Growth sputtered to just 0.7% in the quarter, and core inflation came in at just 1½%. The employment picture is abysmal. Non-farm payrolls have declined two consecutive years for the first time since 1957-58, and the number of jobs lost in this period has been the most, 1.75 million (see Graph 4), since 1944-45. Manufacturing jobs have declined for 29 consecutive months, a post-World War Two record. The 6% unemployment rate doesn't look too bad, but only because people have dropped out of the work force. If we held the labor force participation rate steady at its early 2000 peak of 64.8% (it has since declined to 62.3%, a nine-year low), the unemployment rate now would be above 9%.

Graph 5

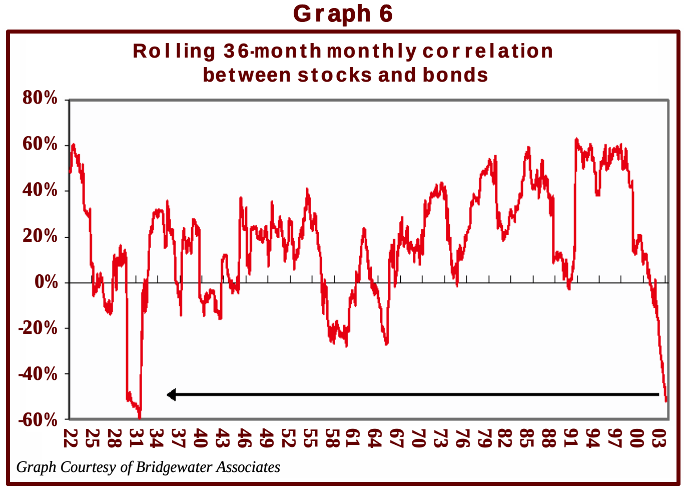


Something is amiss. The recession began in March 2001 and supposedly ended the same year. The Fed began easing more than *two years ago*, the government fiscal surplus has disappeared into deficit, yet the economy is sputtering. Stocks should be climbing in this part of the economic cycle, but the opposite is occurring (see Graph 5).

Again, something is amiss. The old linkages, the broad parameters of economic behavior and capital market dynamics, seem stretched to the point of dislocation. The economic recession that began and ended (?) in 2001, and the capital markets' dynamics since then are without precedent in most of our lifetimes. The typical (post-WW2) recession was demand driven, brought about by a tightening of monetary policy to combat inflation, resulting in lower consumer demand and lower investment and production. When the inflation cycle was broken, the Fed would ease, setting in motion the opposite effects of rising demand and higher investment and production. Monetary tightening would raise interest rates (lower bond prices) and cause stock prices to fall. Monetary easing would result in higher bond and stock prices.

This does not reflect the current economic realities: inflation is falling, the Fed has undertaken an unprecedented monetary ease, and bond and stock prices have decoupled, as Graph 6 shows.

Graph 6



Fed policy has thus far spurred consumer spending on big ticket items like homes and autos, sparing the economy from deeper gloom, but this elixir is bound to evaporate soon. One can only refinance so many times and buy so many cars, even at zero percent financing. The economic problem is not lack of demand, but too much supply. Too much supply because in the 1990s capital was essentially free, mostly for anyone with a napkin and a "com" written on it. And so millions of miles of fiber were laid across the globe, billions of dollars were sunk into new capacity and technology purchases, and eventually, trillions of dollars were lost by investors as the boom busted spectacularly. Stimulating demand is not the answer; slashing capacity is. Perversely, looser monetary policy lowers the cost of capital, thus keeping the marginal enterprise afloat, along with its excess capacity, a phenomenon all too familiar in Japan, where insolvent banks, insurers and corporations have been kept afloat for a decade. The nominal cost of capital in Japan has sunk below zero (last week the overnight funds rate sank to -0.1%; in other words, banks were paid to borrow money). Monetary easing may therefore be counter-productive, although we do not presume to give advice to the Governors of the Federal Reserve System, but certainly monetary easing in this environment could soon be ineffectual. How many more cars would you buy from General Motors, even if GMAC paid your interest and gave you a monthly rebate? Personally, zero.

The challenges facing the US economy are not just our problem, they are everyone's problem. US investors did not finance the equity bubble alone, there was significant help from foreigners. And money from abroad pours in every day to finance our deficits, tying our fate with theirs. One of the interesting dynamics of the financing of the speculation of the 1990s is how US banks managed to disintermediate their risks to an extent far greater than foreign banks did. The result is that US banks are in relatively good shape while foreign banks are struggling. Of all the US loans classified by the FDIC as either substandard, doubtful or a loss, foreign banks hold $62 billion while US banks hold $48 billion. And this is of *US loans*, not overseas ones. No wonder US bank stocks are off just 20% from their peaks while German bank stocks are off 67%.

That this has been a structural, versus a cyclical, bear market should not be in doubt. A cyclical bear market is triggered by monetary tightening and responds to monetary easing. That is not the case now. Today's market has many similarities with structural bear markets of the past, in particular, their antecedent.

In fairness, there are elements of prior structural bear markets that are not present today. Our financial system is functioning and is well capitalized (so far). Trade barriers have not risen, despite the occasional missteps on steel and lumber. And we have avoided (again, so far) the major price shocks of either inflation or deflation.

These characteristics matter because they help set our expectations. Cyclical bear markets typically see declines of about 30%, last two years and fully recover their losses in about five years. Structural bear markets see declines of more than 50% and take about a decade to recover the losses during which volatility remains high. Of course, these are generalizations. The structural bear market of 1835-42 lasted 82 months, declined 56% and took 259 months to recover the loss. The 1929-32 market only lasted 33 months, but lost 85% and took 267 months to recover. Then again, it could be worse. In just twenty months, from January 1825 to September 1826, the UK market tumbled 69%. It took 1,586 months, more than 132 years, to reach that level again. 1825 to 1957 is a long time to wait, even for a patient investor. *[N.B.: Thanks to Peter Oppenheimer of Goldman Sachs for much of the historical research].*

Interest rate cuts are insufficient to stimulate the economy and end the structural bear market. Only when capacity has been sufficiently reduced, and the expected return on capital sufficiently raised, will the economy and the markets recover.

Common Theme in Structural Bear Markets	**Today's Market**
• *An exceedingly strong preceding bull market*	• Stock prices quadrupled in the 1990s, the greatest bull market in US history
• *Profit growth well above trend*	• Profits grew 12% annually from 1992-99, the highest since the post-war boom in the 1950s, and subsequently collapsed more than 50%, the biggest decline since 1938.
• *A belief in a new era*	• Space prevents listing the endless proclamations of a new economic era in the 1990s.
• *Low inflation leading to low interest rates*	• Forty-year lows in inflation and interest rates.
• *Enormous accumulation of debt*	• The highest levels of private debt, both absolute and relative to any measure of wealth or income.

Recover they will. The economy will prosper again one day, and a new bull market will begin. We continue to believe the most likely scenario for the US economy is modest growth and low inflation, not depression and deflation. The point of the previous discourse on market history was not to suggest that we should despair forever, or even for 132 years, but to suggest that the coming years are likely to be volatile, with break outs of optimism and large, sudden gains, followed by despondency and declines. *It is an environment in which every assumption investors make should be re-examined, reviewed creatively from every angle.*

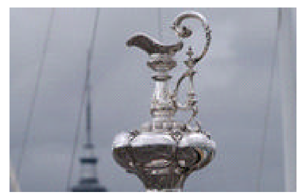
A year ago, we raised questions about the validity of benchmark construction, and evaluating managers' performance *relative* to these benchmarks (see *Relativity*, April 2002). We think these are still good questions to ask, but the lessons from the Japanese deflationary experience suggest we could extend this questioning to even some simple definitional assumptions, such as what is a growth stock and what is a value stock?

For a given target return on equity, growth investors seek companies with high P/E (price-to-earnings) multiples as a sign of high growth prospects. This required that companies with high P/E multiples also have high P/B (price-to-book) ratios (*n.b.: [P/B] ÷ [P/E] = E/B = RoE*). Value investors, for a given RoE target, seek low P/E stocks which are also low P/B stocks. So the relationship between P/E and P/B was direct: growth investors buy stocks with high P/E and high P/B ratios and value investors buy stocks with low P/E and P/B ratios. But deflationary Japan broke that relationship, as Robert Feldman of Morgan Stanley has noted. Distressed companies saw earnings collapse but book values remain high, thus causing high P/E multiples and low P/B multiples. Quality companies had low P/Es but high P/B ratios. So rather than a two-sided definition of the equity universe, growth and value, perhaps there could be a quadrant to include quality and distressed.

If any of this is relevant outside Japan, and it becomes more relevant in a deflationary environment, then not only should we question the validity of indices, we should question the efficacy of traditional investment approaches. These are some of the issues we will be discussing with managers as we broaden and deepen our research and evaluation process.

America was slow off the start, and in last place in the early stages of the race. But the course instructions were not clear, and while the British flotilla rounded the Nab lightship, the Americans cut inside it. Still, this short cut only put *America* in third place on the back stretch. Nearing the finish, one of the two leaders ran aground, and the other boat went to its rescue. *America* crossed the line eight minutes ahead of the next boat.

Perhaps more than any single event, in ways we can hardly appreciate, the race marked the emergence of the United States as a world power. That victory cup (see photo), *America's Cup*, was successfully defended 25 times over the next 132 years, the longest winning streak in the oldest continuous event of any sport.



Experience, judgment and talent win races and, as that small group of Americans proved that summer day in 1851, a little bit of chutzpah, courage and luck can certainly help. Having the most resources is no guarantee of success either, as Larry Ellison can attest after spending $95 million to lose the challenger's cup last month. We at Angeles will probably never be the largest advisory firm in the world, and we will probably never race a yacht in the America's Cup. But we will try to bring our experience, judgment and talent to the race, along with as much chutzpah, courage and luck we can muster.

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
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