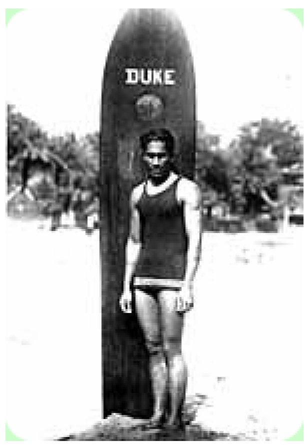
Angeles
INVESTMENT ADVISORS

FIRST QUARTER 2006

Duke

Teenage boys have been hanging out at beaches since, well, probably since there have been teenage girls and beaches. A hundred years ago, one such group of boys had dropped out of high school to spend their days on the beaches of Waikiki, long before there was anything larger than a hut there. They carved boards out of koa wood, in the tradition of their Hawaiian ancestors' olo board. The leader of this particular group was quiet and reserved, tall, and a superb athlete, with glistening white teeth and a shock of jet black hair. And his board was the biggest in the group: 16-feet long and 114 lbs. A big board for big waves, he would say. In time, his skills would lead to worldwide fame, and his influence is profound even today.



Surfing looks easy, but that's deceptive: it requires considerable skills. A surfer has to be able to gaze over the ocean and determine if conditions are favorable. It takes strength to paddle out and then patience and experience to be able to choose which wave to try to ride. Getting up, staying up, anticipating how and where the wave is moving and staying on top of it takes considerable balance and judgment. Those who don't give the ocean proper respect can be severely punished. All of these are instructive to us: we must survey the economic environment, choose which bets to make and which to avoid, and then balance our risks as conditions move rapidly. And we must always respect the power of the markets as we constantly adjust our positions.

Bonds have been struggling, with 10-year Treasury yields up nearly 50 basis points in the quarter, and rising 100 basis points over the past eight months. In contrast, equities surged ahead in the first quarter of the year, with US stocks adding more than 5% and other markets up nearly 10%. The best market was Venezuela, which gained 50% last quarter despite being run by a volatile army general-turned-Fidelista. Large oil reserves may have something to do with it, although some of the laggards last quarter were the Middle Eastern markets (Jordan, for instance, dropped 15%) that were last year's big winners.

There are probably a multitude of reasons why bond prices are falling and stock prices are rising, but we'll choose the simplest: the world economy is strong. The economies of the US, Europe and Japan are all grow-

INSIDE GRAPHS:

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From all of us at Angeles

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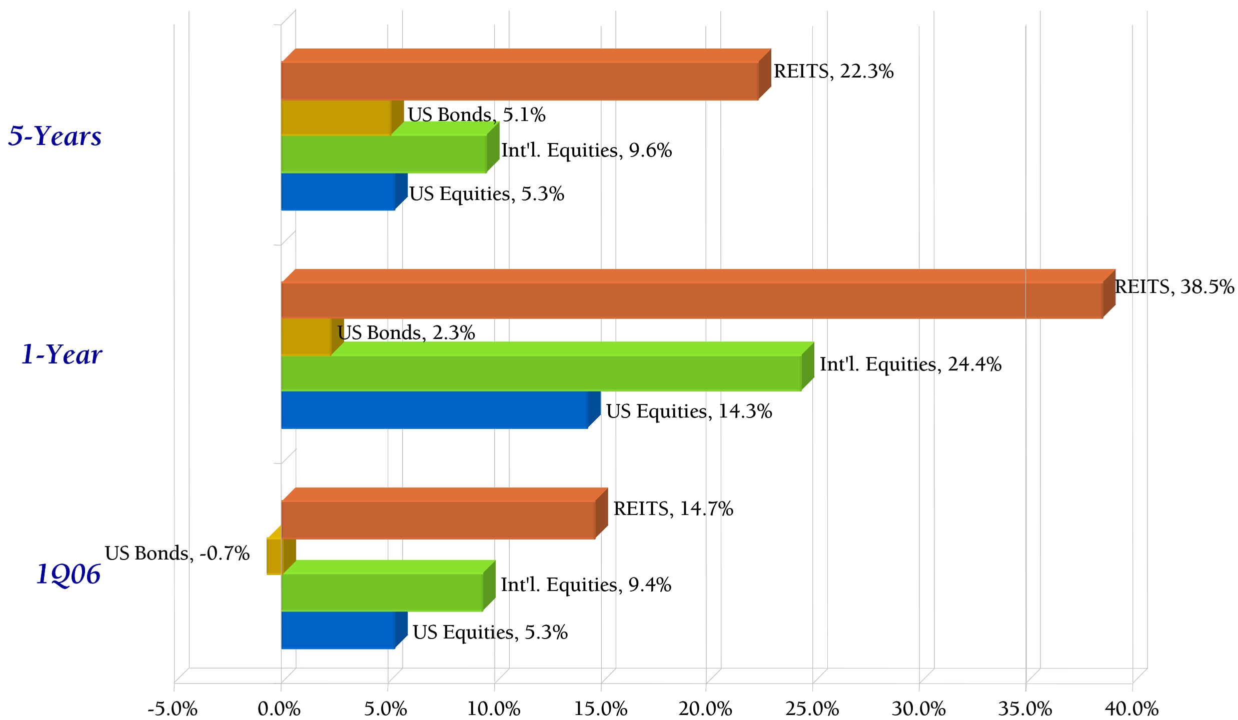
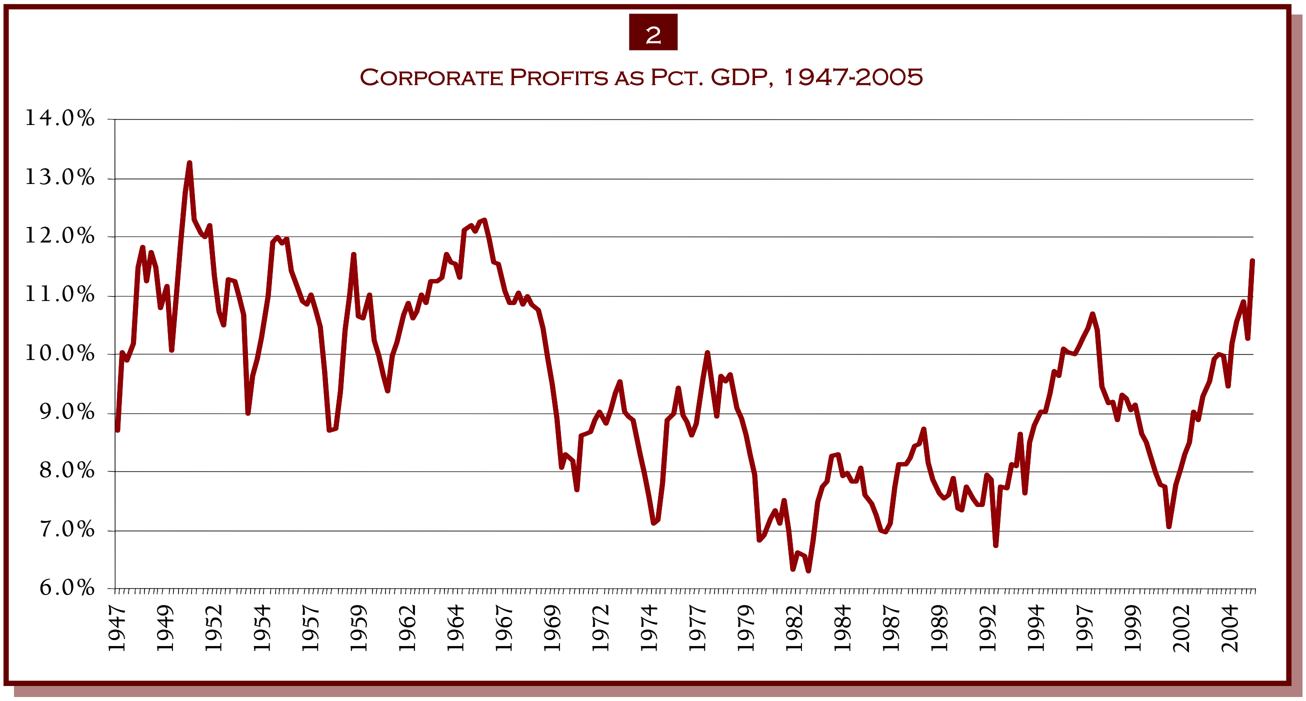
CAPITAL MARKET PERFORMANCE



ing in excess of 3% real for the first time in over 15 years. This level of synchronous expansion has occurred only three times in the past 35 years (1970-73, 1976-79, 1988-90). And for the first time since 1969, every one of the 60 largest economies in the world is expanding simultaneously.

But the clear growth leader has been the United States. To be certain, there are numerous actual and potential challenges the economy faces, and many respected economists (no, that's not an oxymoron) who believe excess liquidity has fueled a consumption binge that will soon result in a severe economic hangover. Perhaps, but let's consider some facts first rather than prognostications. Since 2003, the US has created more jobs than the rest of the G-7 combined. Real household net worth ($51 trillion) and home ownership (69%) are at all-time highs. All public debt (federal, state, local) is around 46% of GDP, less than the average in the 1990s, only slightly above the average of the past 40 years, and one-third below the average (66%) of the rest of the G-7. Last year was the fourth straight year operating earnings of S&P 500 companies expanded at double-digit rates, and corporate profits rose to 11.6% of GDP in the fourth quarter, the highest since 1966 (see Graph 2, page 3). This is no fluke, but based on solid financial improvement. Over the past four years, corporate interest expense as a percentage of revenue declined 170 basis points as interest rates fell and companies de-levered. In this period, productivity (output per unit of cost) surged by an average annual rate of 3.3%.

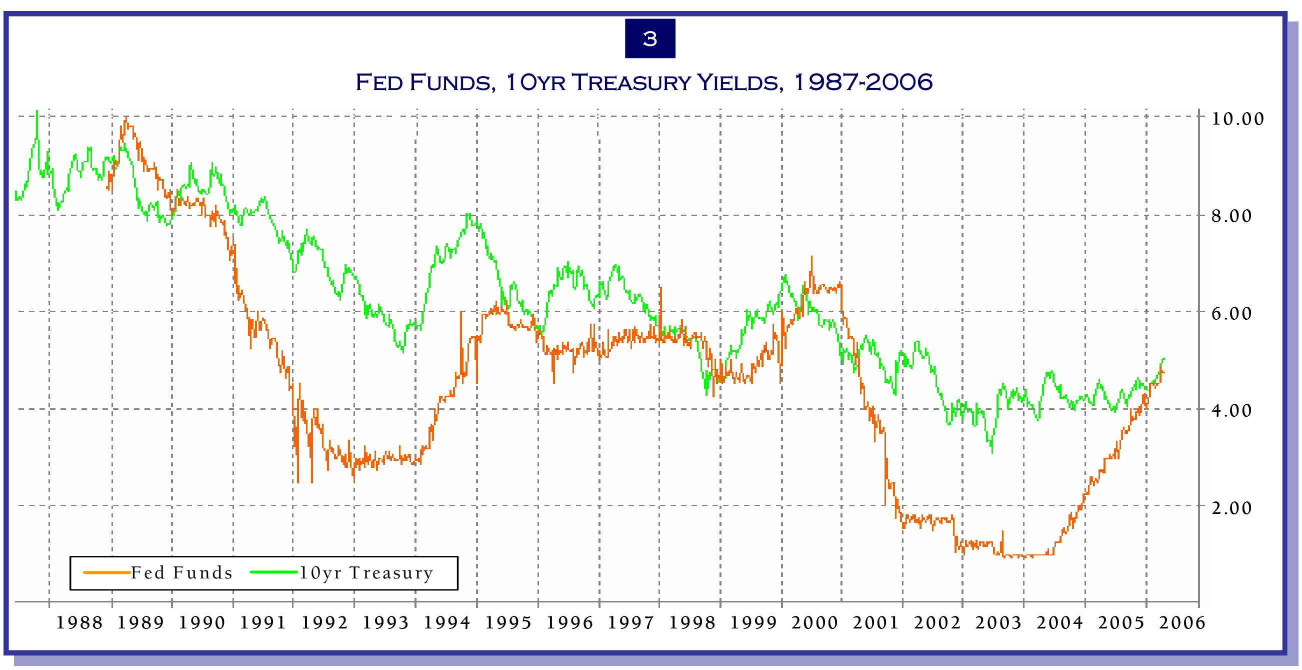
No wonder, then, that the Fed has been trying to tighten monetary policy. Some of this tightening is just a reversal of prior stimuli, and some of it may simply be the quinquennial pattern that marked the Greenspan era (1989, 1994, 1999, 2004). Perhaps the market's embrace of these factors explain the conundrum of declining bond yields. But now that Fed funds has caught up to long-term yields (see Graph 3, page 3), the focus has shifted. Some point to the flat-to-inverted yield curve as evidence of an end to this tightening cycle and the likelihood of a near-term recession. They could be right, but the bond market has consistently underes-



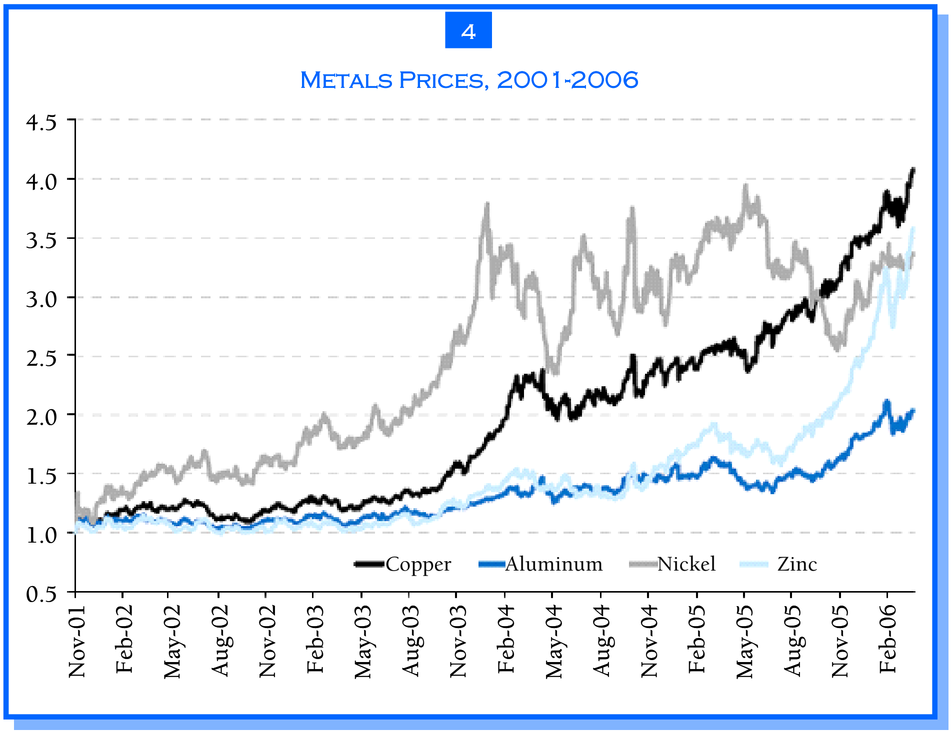
Source: Department of Commerce

timated the extent of Fed tightening and the strength of the economy.

Other markets signal otherwise. The world equity markets (MSCI World Index) have averaged 24% annual gains for the past three years. Emerging markets have more than tripled (47% annually) over this time. And, of course, commodities are on a tear. This year alone, zinc is up 60%, copper and nickel up 30%. Over



Source: Bloomberg, L.P.

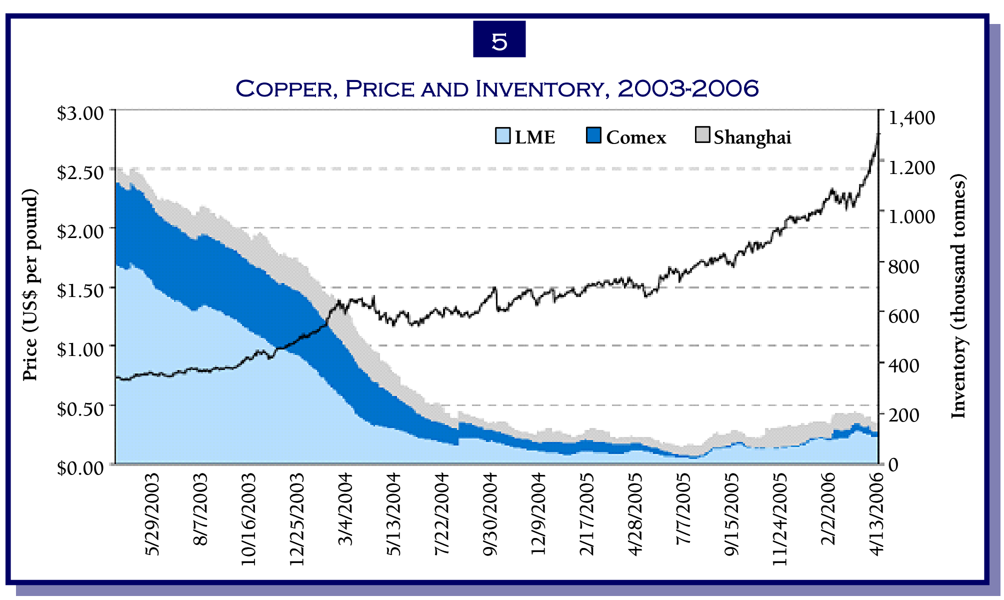


Source: Bloomberg, L.P., Courtesy: Goldman Sachs

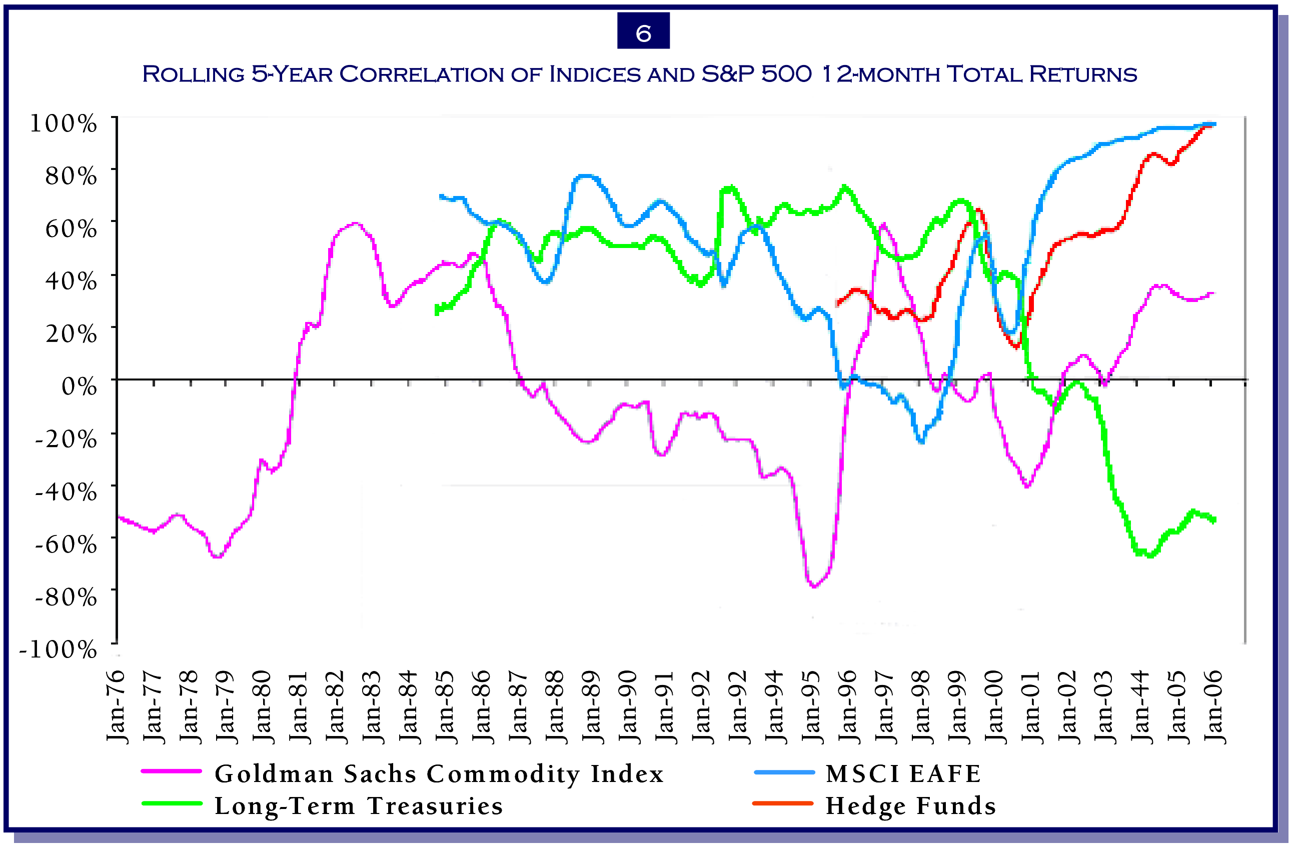
the past three years, zinc and copper have nearly quadrupled in price (see Graph 4).

Prices are set in the free market by the relationship between demand and supply. Those two curves can occasionally become dislocated, but there is a self-correcting mechanism at work over time. The 1970s saw a supply shock in oil that caused a rise in price. New areas were explored and tapped (North Sea, Arctic Slope). Demand cooled, supply increased and the price of oil and most commodities fell (in 1986, oil dropped more than 50%) throughout the 1980s and 1990s. No new major sources of commodities were exploited in this period, no new refineries built in this country, and when the demand curve finally slipped ahead of supply, prices took off (see Graph 5 for the relationship between inventories and price for copper). There is a long lead time to bring new supply to market, hence the multi-year rally in commodities.

Parabolic price movements cannot be sustained, even if China consumes ever more quantities of metals and other commodities. The rising price triggers, at some point, some combination of reduced demand and/or increased supply. So we have to be careful when extrapolating trends. This warning is equally true in the less visible aspects of portfolio management. We noted earlier that recently bond prices and stock prices have been negatively correlated. This is good from a portfolio diversification perspective (because assets that are negatively correlated dampen overall volatility), but just as prices don't move in the same direction forever, neither do correlations. This is especially problematic



Source: Bloomberg, L.P., courtesy: Goldman Sachs



Source: Merrill Lynch, US Strategy

when modeling asset allocation alternatives because if asset correlations are not static, portfolios can be riskier than we assume. This would be true in the short-term, as correlations rise in a period of stress (prices of everything fall, for example), as well as longer term, where the portfolio wouldn't see the same diversification benefits as expected.

The accompanying graph shows rolling 5-year correlations of 12-month returns for bonds, commodities, non-US stocks and hedge funds with the S&P 500 Index. Hardly a static picture, which is exactly our point. The waters are always changing, and complacency cannot be tolerated.

In August 1911, the Hawaiian Amateur Athletic Union (AAU, the official governing body of amateur sports), held a swim meet in the calm waters of Honolulu harbor. The trial that commonly defined the world's fastest swimmer was 100-yards, and at the time the world record was exactly 60 seconds, held by two-time US Olympic champion Charles Daniels. At the urging of a local attorney and part-time swim coach, the gang at Waikiki entered the competition and swept most of the races. The group's leader won the 100-yard match in a time of 55.4 seconds, shattering the world record, and matched the world record time in the 50-yard freestyle, also held by Daniels. Five AAU-sanctioned judges and a land surveyor certified the results, but when they were telegraphed to the New York headquarters of the AAU, the response was disbelief: an unknown boy swimming in an ocean harbor could not possibly have broken the world record. It was only decades later that the AAU recognized the record.

The 1912 Olympiad was held in Stockholm, and is notable because of the dominance of two Americans. Jim Thorpe won nearly every race on land and Duke Kahanamoku won nearly every match in the water. There was no Olympiad in 1916, but Duke competed in the next four, retiring after the 1932 Los Angeles Olympics at the age of 42.

Duke Kahanamoku was one of the greatest swimmers in history, but that is not his most important legacy. Surfing was known only to the locals of Hawaii back then, but Duke brought it to the rest of the world, giving demonstrations and lessons from Australia to California, from Florida to New York to Europe. He is

single-handedly responsible for its worldwide popularity, and it would be hard to imagine Southern California, that is, American, culture—music, movies, food and clothing—without it.

In June 1925, Duke was at Corona del Mar, California where freak waves reached 30-feet tall. Just off the coast was a small fishing boat that got caught in one of the waves and was slammed apart. 17 people died but Duke took his long board into the squall and alone pulled out 8 people alive. Today, every lifeguard in California carries a surfboard.

Investing and surfing. Both require fortitude and respect, experience and judgment, patience and agility. Duke Kahanamoku is an inspiration from one pursuit to the other.

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APRIL 2006