Angeles
INVESTMENT ADVISORS

Commentary
Second Quarter 2009

Marathon

Hellespont, the ancient name for the Dardanelles, the narrow straight that connects the Sea of Marmara and the Black Sea with the Aegean and Mediterranean Seas, has a strong claim as the true crossroads of the world. Geographically, it is where the European and Asian continents meet. Politically, it marks the northwest border of Turkey, as it did for much of the 600-year reign of the Ottoman Empire. Culturally, it is where East meets West, where Islam and Christianity collide. Nearly a hundred years ago, it was the scene of the greatest defeat in British history, a disaster that nearly cost Winston Churchill his political life. The dead of Gallipoli are still mourned today throughout the Commonwealth. But it was twenty-five hundred years ago that the Hellespont was where the greatest empire of the ancient world, the Persian dynasty of Cyrus the Great and his son Darius the Great, clashed with the nascent democracy recently established in Athens.

Cyrus, and then Darius, had extended the Achaemenid dynasty from the Indus River and the Himalayas in the east, westward through Egypt and Libya, and across the Hellespont to the north shore of the Black Sea. A critical element of their rule, indeed the defining characteristic of all sustained empires, was the co-option, rather than the subjugation, of conquered peoples. One such culture was the Greeks, who had built thriving communities around the Aegean Sea. The Persians embraced the Greeks of the eastern Aegean, incorporating them into their great empire. But in time, these Ionic Greeks revolted, led by a wealthy landowner near the Hellespont named Miltiades, who had been a general in the Persian army but turned against his protectors. Darius suppressed this uprising, and Miltiades fled to Athens. Darius knew there would be no peace in this corner of his empire unless he was able to capture the Greek capital, and he readied an invasion across the Aegean.

To defend their city the Athenians elected ten different generals, Miltiades among them. This dispersed command was certainly democratic, but it was also ineffectual, as the ten generals could not agree on strategy or tactics. Outnumbered more than two-to-one by the most formidable military the world had seen, the Greeks' prospects were dim. The ensuing combat turned on the most extraordinary decision, and became the most important battle in European history, perhaps in world history. That decision holds lessons for us today, as does the name of this famous battle, immortalized for all time.

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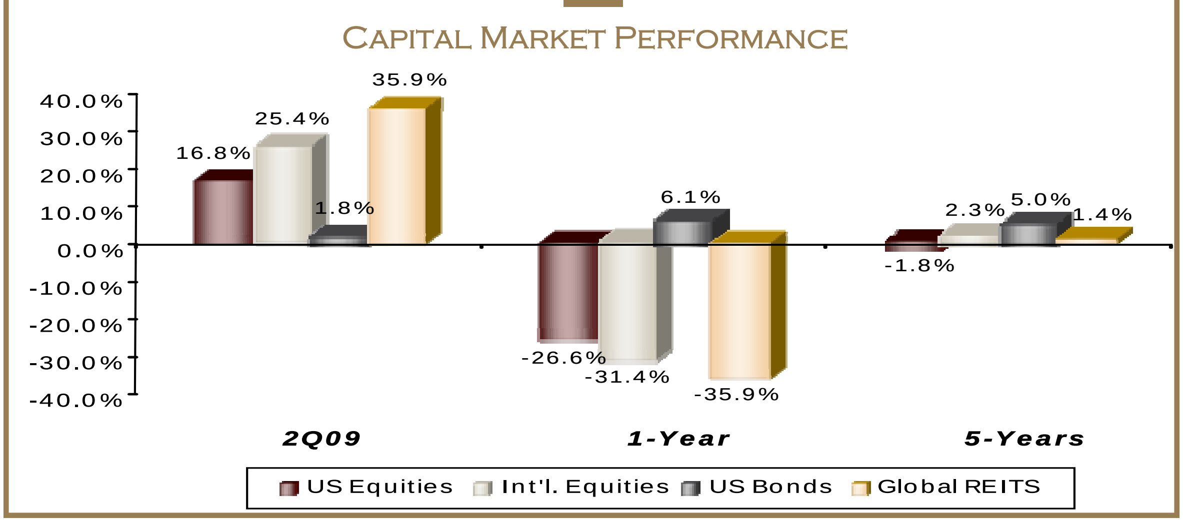

> *"Collapse of Western civilization has been avoided, we're happy to report..."*

Collapse of Western civilization has been avoided, we're happy to report, at least for now. This realization sparked a huge rally in all risky assets last quarter. US equities saw their best performance in more than a decade, up over 16%, but that paled in comparison to the markets in Hungary and Serbia, each up 66% in the past three months or, best of all, Sri Lanka, which more than doubled (+103%) in the quarter. Indeed, we could find but one market, Lithuania, that posted a decline (the 1% market drop was positively tame given that the country's GDP plunged more than 22% last quarter). Treasuries declined, but high yield bonds soared, as did real estate and commodities. Indeed, high yield ("junk") bonds are having their best year on record, and have recovered all of their losses post-Lehman bankruptcy.

Earnings have been stronger than expected, part of the stimulus behind this explosive rally. There are two aspects to these earnings reports worth noting. The first is a reminder that earnings are simply the difference between revenue and expenses. Earnings will grow if expenses are pared. But to sustain profit growth, revenue will have to rise, as there is a limit to the amount of cost-cutting that can be done. In the second quarter, revenue was less than expected, and it was better cost management that led to higher profits. But revenues will have to grow eventually if profit growth is to continue. The second point is that this earnings bounce follows a substantial decline. From June 2007 to March 2009, S&P 500 earnings fell 53%, the third

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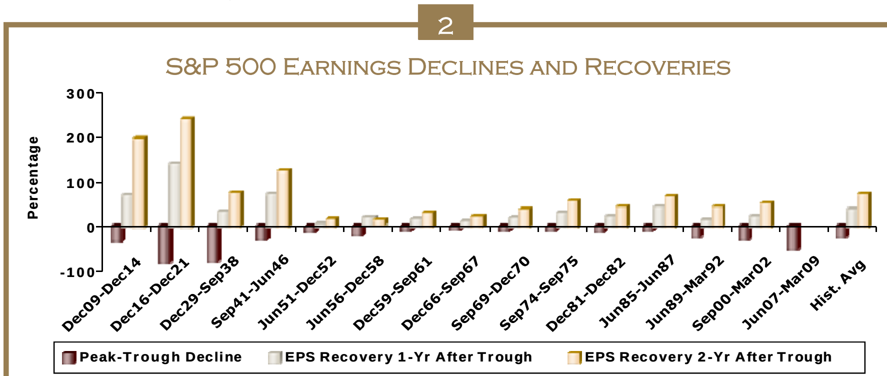

Source: Compustat, Robert Shiller. Goldman Sachs largest drop on record (behind the 79% fall from December 1929 to September 1938 and the 81% plunge from December 1916 to December 1921). We'll see if the recovery in profits is sustainable, but the good news from history is that earnings typically rebound strongly following a large decline (on average up 36% and 71%, 1- and 2-years after the trough, see Chart 2, pg 2.).

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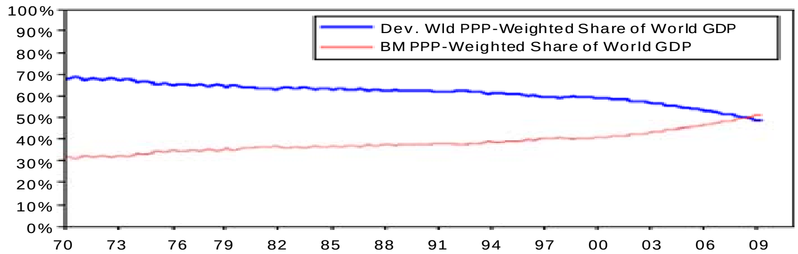
SHARE OF WORLD GDP



Courtesy: Bridgewater Associates

Rallies in the capital markets were founded on more than just averting global economic collapse. The world economy is now showing positive growth following the biggest breakdown in economic activity since the 1930s, driven by the powerful Asian economic engine. Indeed, this year marks the crossover point where the majority of world output is generated by emerging countries, not by developed ones (see Chart 3).

US GDP declined at a 1% pace in the second quarter, a big improvement from the 6.4% rate of decline at the beginning of the year. Orders for durable goods and housing starts are up, as is consumer confidence. Inventories fell a record $156 billion last quarter, and net exports added 1.4% to growth. Current conditions in the housing and auto industries are about as bad as we've ever seen, and these two sectors have subtracted about 1.5% from GDP growth for the past two years. So even stabilization, albeit at lower levels, will be a net positive to the economy, and there are hopeful signs.

The financial system has also stabilized. Equity and debt issuance has resumed, enabling access to capital that was previously closed. Spreads (risk premia) have contracted significantly, again, making it easier to raise capital. Given nearly unlimited access to "free" money and an implicit (and in some cases, explicit) government guarantee, even the weakest of the large banks have been able to "earn" billions of dollars of profits.

Still, if we see a glimmering light after months of darkness, the economy has a long road to full recovery. Real GDP declined 3.9% in the past four quarters, the biggest drop since the 1930s (see Chart 4). Industrial production has fallen 17 of the past 18 months and is down 13.6% over the past year, the biggest contraction since 1946. Capacity utilization fell to a record low (68%) in June, but even this hides the wide dispersion of utilization rates among industries: oil and gas extraction is operating at 95% capacity, but the auto industry is producing at just 28% of capacity.

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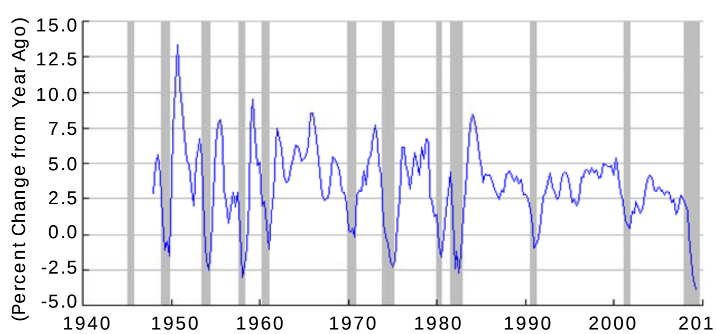
REAL GROSS DOMESTIC PRODUCT, 1 DECIMAL (GDPC1)



Shaded areas indicate US recessions. 2009 research.stlouisfed.org
Source: U.S. Department of Commerce: Bureau of Economic Analysis

The depth of this recession is apparent in the employment data. Although the trend of job losses is moderating, 6 ½ million jobs have been lost in the past 18 months. Private payrolls are down 5% over the past year, the largest drop since 1958, and aggregate hours worked has fallen a record 7% this past year to a record low, a bigger drop than seen in the 1973-74 or 1981-82 recessions. While the official unemployment rate at 9.5% is not yet at the 1982 peak of 10.8%, broader measures of underemployment are at record highs. Nearly 15 million are unemployed (a record), and if we add those working part-time who would like to work full-time, this "underemployment" rate is 16.5%. The number of long-term unemployed is nearly 8 million (another record), and the average duration of unemployment is 24 ½ weeks, also a record (see Chart 5).

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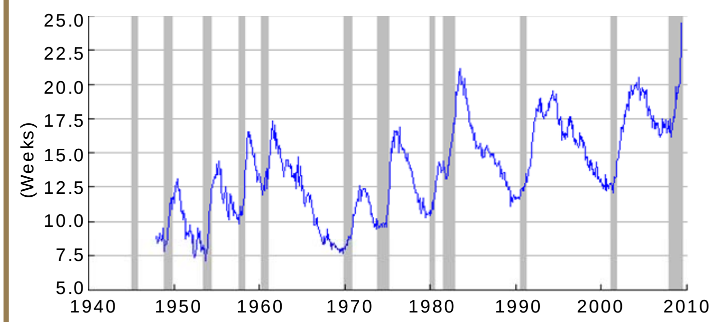
AVERAGE (MEAN) DURATION OF UNEMPLOYMENT



Shaded areas indicate US recessions. 2009 research.stlouisfed.org
Source: U.S. Department of Labor: Bureau of Labor Statistics

"Unfortunately employment woes may persist for two reasons."

Unfortunately, employment woes may persist for two reasons. First, it takes above-trend growth to reverse the level of unemployment. Trend growth in the US is probably around 3% p.a., so we'll need to see growth greater than this before the unemployment rate falls. This did occur in the severe recessions of the 1970s and 1980s, but that is not the current forecast; growth is likely to remain sluggish for some time, as we'll discuss below. The second reason why the unemployment rate may be sticky relates to the underlying dynamics of unemployment.

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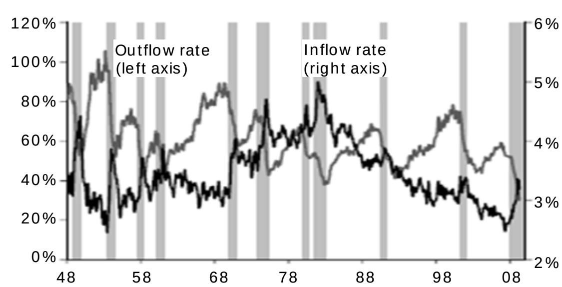
UNEMPLOYMENT INFLOWS & OUTFLOWS
NOTE: ALL DATA ARE 3-MONTH MOVING AVERAGES.



Source: Federal Reserve Bank—San Francisco

Workers are constantly moving in and out of unemployment. In recessions, the inflow rate (to unemployment) typically rises and the outflow rate (to jobs) typically falls. In the 1970s and 1980s, these two rates were mostly equivalent, that is, the unemployment rate rose because similar numbers of workers were becoming unemployed as were not re-entering the workforce. In the recessions of 1991 and 2001, the inflow rates didn't really increase, instead the rise in unemployment was caused by declines in the outflow rate, that is, workers weren't being fired so much as new ones were not being hired. Likewise, the aftermath of these later recessions were characterized by "jobless" recoveries, as the outflow rates (people leaving the unemployment rolls) did not increase much, probably because businesses never fired that many people to begin with. Today, the outflow rate is very low, meaning unemployed workers are finding it difficult to gain employment, but also, the inflow rate has been rising strongly, indicating that employers are paring their payrolls quickly. This combination of longer term unemployment and rapid job losses makes for especially weak employment conditions, thus more difficult to ameliorate (see Chart 6).

Worries that future growth will be sluggish stem not only from the magnitude of this downturn but also from the structural causes, especially the impact of deleveraging, behind this recession. A steep decline in economic output raises the risk that capacity will be destroyed as businesses close plants and shrink investments. The financial nature of the current cycle raises concerns that there will also be less capital available for future investment, as leverage is permanently reduced, causing *potential* output, not just actual output, to contract.

The benign view is that the financial crisis will cause a temporary setback to potential output, one from which we will recover in the coming years. Historically, this has been the pattern in the US, as GDP reverted to long-term trend even following the 25% decline in GDP in the early 1930s (see Chart 7). A second possible outcome is a level shift in potential output, that is, the financial crisis destroys capacity, but the economy resumes its long-term rate of growth, albeit from a permanently lower level. This path characterized Sweden's recovery from its financial crisis in the early 1990s. The least attractive result is a permanently lower rate of growth, which was Japan's experience these past two decades, as its growth rate fell from 3.7% p.a. in the 1980s to 1.5% in the 1990s (and 0.4% in this decade). We know there has been a severe hit to GDP, causing economies to operate well below potential levels (see Chart 8), but to determine if we will regain what has been lost and/or resume growth at the same rate as in the past, we have to consider the principal drivers of potential output: productivity, labor and capital.

Productivity is a bright spot in the economy, as it has held up well in this recession, giving hope that the efficiency of the US economy has not diminished. A

"Productivity is a bright spot in the economy..."

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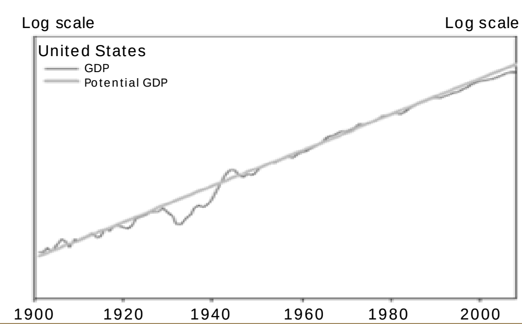
TREND GDP GROWTH



Source: Department of Commerce; Courtesy: Goldman Sachs

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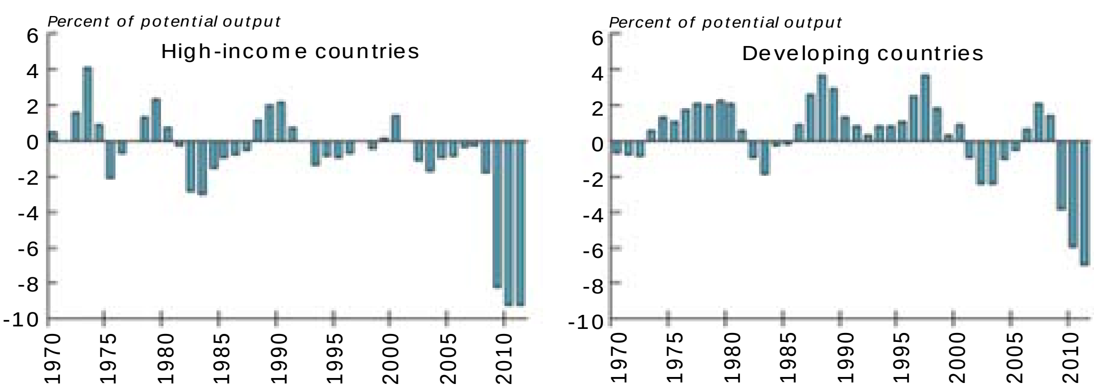
OUTPUT GAP: DIFFERENCE BETWEEN ACTUAL GDP & POTENTIAL OUTPUT AS A % OF POTENTIAL OUTPUT



Source: World Bank

permanent rise in structural unemployment, possibly due to deterioration in workers' skills, would hurt potential growth, as would a decline in the capital stock available for investment. The good news is that there is no evidence, yet, that these determinants of potential growth have become permanently impaired. But policy decisions, especially those that raise systemic costs, both to capital and to labor, such as taxes and regulations, should be considered carefully.

Fiscal policies also have long-term consequences. The federal budget deficit this year is estimated to be about $1.8 trillion, or 13% of GDP, more than twice the highest percentage seen since World War Two. Structurally, the coming growth in healthcare outlays is likely to account for nearly all of the future growth in federal spending, resulting in an expansion of both debt and deficits for years to come (see Chart 9). This rise in government debt should translate to high real rates of interest, regardless of the direction of nominal rates, and act as an impediment to real growth. Japan's low nominal interest rates is a case in point: real yields have averaged 1.7% this past decade, well above the 0.4% real rate of growth. Japan's fiscal deficit has exploded to 160% of GDP, but higher debt has not sparked economic growth. Japan is an abject lesson to those who hope that higher levels of debt will lead to a stronger recovery.

The (hoped for) short-term impact of deficit spending is to stimulate private investment. Even granting a positive multiplier to government expenditures (a specious assumption), a portion of federal spending will only offset the necessary cuts at the state level. In the US, most states are required to have balanced budgets. In this fiscal year, states will see a projected budget gap of about $120 billion that will have to be closed via higher taxes and/or reduced spending, placing enormous burdens on states. No state has ever defaulted on its bond obligations, but the risks have increased substantially, as we see California's credit default swap spread rise from 0.75% to 3% in the past year (see Chart 10), a quadrupling of the default risk. By comparison, the market is now pricing a higher risk of default for California bonds than for the debt of Egypt (see Chart 11).

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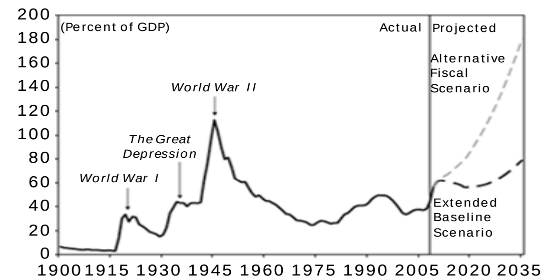
FEDERAL DEBT HELD BY THE PUBLIC



Source: Congressional Budget Office. "Extended baseline" scenario extrapolates current law. "Alternative" scenario incorporates extension of today's underlying fiscal policies.

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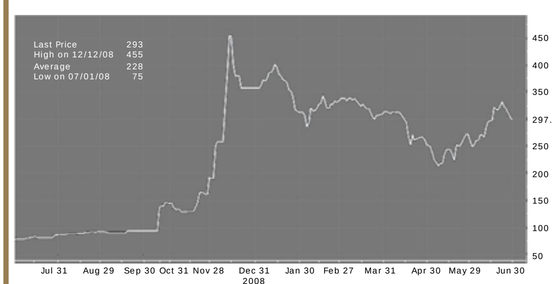
CALIFORNIA CDS SPREAD



Source: Bloomberg Finance, LP

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CALIFORNIA VS. EGYPT 5 YRS CDS SPREADS, BPS

Source: Bloomberg Finance, LP

Over the past years, we wrote frequently of the growing global imbalances, especially the extremely low levels of savings in the US and the very high savings rates in Asia and the oil exporters, and the concomitant massive current account deficits and surpluses, respectively, and the imperative for an adjustment of these imbalances lest we face a financial crisis. Well, the bad news is that we were hit with such a crisis, but the good news is that those imbalances are indeed correcting. What is less clear is how sustainable these trends will be.

The glaring imbalance and adjustment is seen in the current account. From August 2006 to May 2009, the US current account deficit shrunk from a record 6.2% of GDP to 2.2%, matched by the reductions in surpluses in China, Japan and Germany (see Chart 12). In the US, the decline in this deficit came from a combination of a huge increase in domestic savings and a large drop in borrowing. Private sector savings moved from -3.6% of GDP in 3Q06 to +5.6% of GDP in 1Q09, a swing of 9.2%, a bigger move than at any time in history. Likewise, household and nonfinancial debt growth fell from +10.6% annualized in 1Q06 to -0.7% in 1Q09, the first decline on record (since 1952). If the US can shift its growth from consumption to exports, and if the rest of the world can make the opposite move, we have a more sustainable foundation for future global growth.

Yet there are two potential pitfalls to this favorable outcome. Just as US households and businesses have boosted savings and reduced borrowing, government is filling in the slack with burgeoning debt demands (see Chart 13). We have already seen private capital flows to the US dry up, and it's questionable how long and by how much foreign central banks will continue to buy dollars at these levels. Secondly, foreign governments may be reluctant to see their currencies appreciate, both in order to maintain price competitiveness as well as, in the case of the major exporters, to protect the value of their (substantial) dollar-based holdings. The financial crisis and subsequent recession forced these imbalances to normalize. Whether that can be sustained without further adjustments to currency values and interest rate levels remains to be seen.

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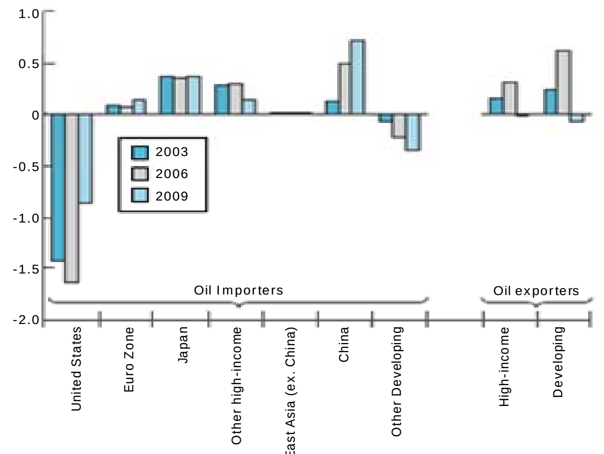
CURRENT ACCOUNT BALANCE AS % OF WORLD GDP



Sources: World Bank

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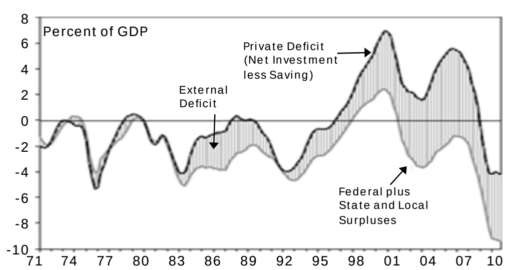
PRIVATE & PUBLIC DEFICITS



Note: 2Q09-4Q10 values represent Morgan Stanley Research estimates.
Source: Bureau of Economic Analysis, Morgan Stanley Research

> *"..there are two potential pitfalls to this favorable outcome."*

In the 1930s, John Maynard Keynes advocated opening the spigot to fiscal and monetary policies to combat that financial crisis. Our leaders today, experts on the Great Depression (Ben Bernanke and Christina Romer, especially), have adopted Keynes' 1930s playbook. But we should remember what Keynes was saying in the decade before.

Following World War One, the Allies (France and the UK, especially) owed huge debts to the US and, in turn, imposed enormous reparations on Germany (equal to 100% of German GDP). The only way Germany could pay these reparations, and so for the Allies to pay their American debt, was to run a current account surplus equal to a US deficit. Keynes saw this clearly in 1921: *Ultimately ... there must be a readjustment of the balance of exports and imports. America must buy more and sell less.* Absent an adjustment in trade flows, and a willingness on the part of the US to run large deficits, the cycle of reparations and debt repayment could continue only if the US lent Germany the money, which is exactly what happened in the 1920s. With the market crash of 1929, Americans withdrew their capital from abroad, and without credit, Germany could not service its debt. In 1931, it halted reparation payments and, in turn, Britain and France stopped paying their debt to the US.

"Large current account imbalances will be corrected eventually.."

Substitute China today for the US in the 1920s, and we see a similar dynamic. Large current account imbalances will be corrected eventually, either through cooperative policies that seek to modify the structural disparities, or via default, as we saw in the 1930s. The former is certainly preferable.

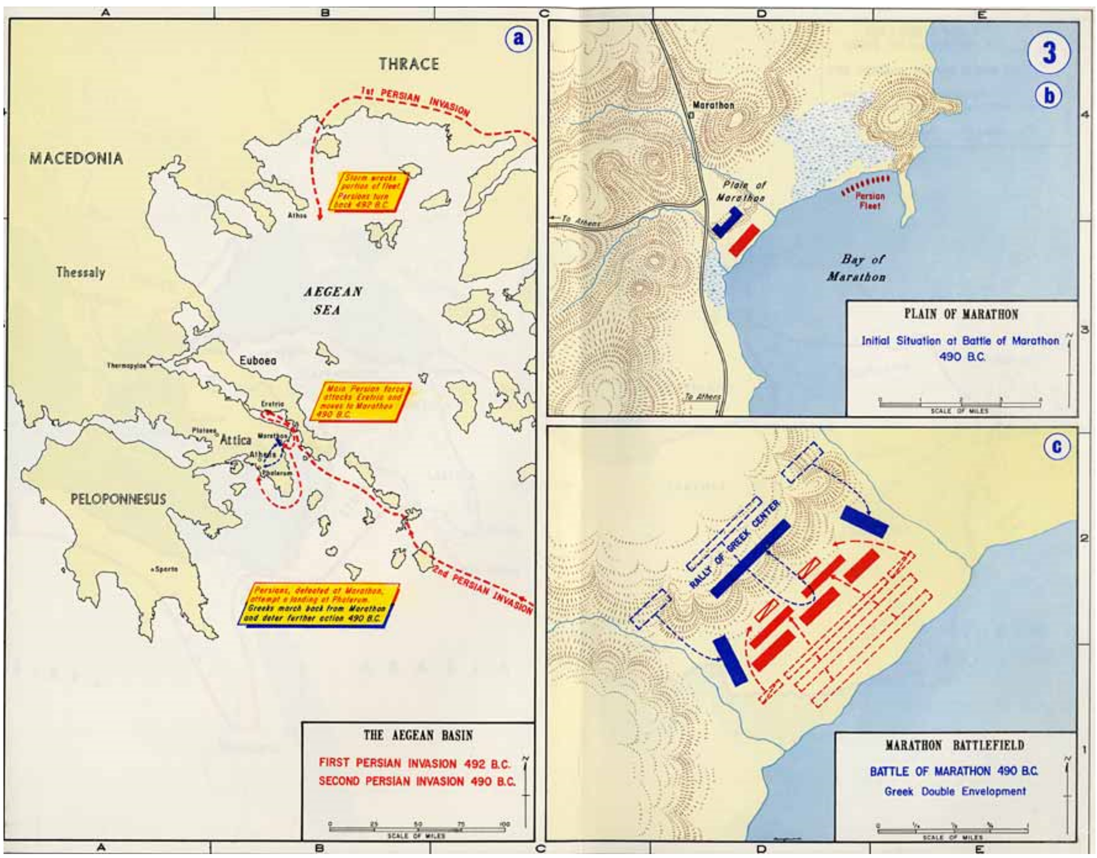
Darius vowed to crush Greek support for revolt, sending a fleet across the Aegean to attack, and capture, Eretria. He then sailed down the coast to Attica, about 25 miles north of Athens, to the Bay of Marathon. The Athenians moved quickly to block the two exits from the plain, sending 10,000 hoplite troops to confront 20,000 Persians. The great Greek runner, Pheidippides, was sent to Sparta to request support, covering the 140 miles from Marathon in two days. Sparta said it would help, but not until an important festival had passed, and would not be able to get there for ten days. It was to be too late.

For five days, the armies faced each other. It was to the Athenian's advantage to hold out, to wait for Spartan support, but Miltiades was keen to attack for reasons that are obscure since the Greeks were in the weaker position. He compounded his difficulties, and confounded his fellow generals, by shifting troops from the center to his wings, then ordering the center to charge two kilometers ahead to meet the enemy. Greatly outnumbered, both Persians and Greeks saw this as suicidal and, indeed, the center of the Greek army was soon overrun by the many more Persian troops. But on the wings, with better armor and longer spears, the Greeks routed Darius' forces, enveloping the enemy and attacking the Persian center from the rear. The great historian Herodotus estimates that the Persians lost 6,400 men, killed or drowned in the retreat. The Athenians lost 192 troops, honoring them with a large burial mound that is still a prominent landscape today.

Seeing the remaining Persians sail off toward Athens, the Greeks marched quickly back to their city, not an easy task to march 25 miles in full armor right after a battle, thus thwarting the Persian attack. Marathon marked the first defeat for the Persian Empire, but Darius had every intent on returning. Unfortunately, other events intervened (a revolt in Egypt had to be suppressed). In the interim, Darius died, and revenge for the Athenian defeat was passed to his son Xerxes. Ten years after the battle of Marathon, Xerxes was defeated by the Greeks at Thermopylae, and then finally at Salamis. The Persians would never again threaten the Greek homeland, but it was Marathon that first turned the tide of Persian expansion.

Legend has it that Pheidippides ran from the battle at Marathon to Athens to announce the Greek victory, but this is almost certainly not correct. Still, when the founders of the modern Olympics in 1896 wanted a showcase race for the Games, they came upon the idea of running from Marathon to Athens, later codified as 26 miles, 385 yards. Thankfully, they didn't choose Pheidippides' actual run from Marathon to Sparta.

The Battle of Marathon was not only a major turning point in world history. It reminds us that from near ruin, Miltiades' mad run to the center of Persian strength, victory can be won with superior resources and skills. Even victory in battle did not settle the war for another decade. The survival, and subsequent blossoming, of Greek civilization was not assured for many more years. This nascent democracy might have been stillborn, and Greek civilization may never have flourished, had it not been defended at Marathon. Survival, we learn, as with investing, is truly a marathon.



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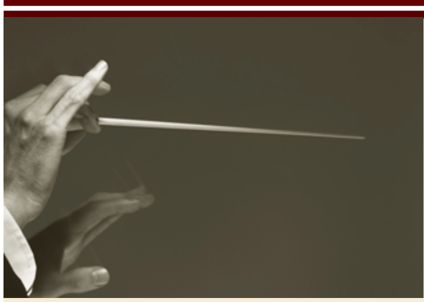

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
AUGUST 2009

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