Play Well

Filskov is a small, rural village in the geographic center of Denmark. For generations, sons followed their fathers into the family farm or craft, and in Filskov, the Christiansens were the town's carpenters for as long as anyone could remember.

At the turn of the last century, Jens Niels Christiansen was the master carpenter, and head of a family of ten children. The eldest son, Kristian, was taught carpentry, and it was expected that Kristian would help teach the younger sons. Ole, born in 1891, was apprenticed to Kristian at the age of 14, and six years later, sent first to Germany and then to Norway to work the trade. While in Norway, he picked up a wife, neé Kirstine Sörensen, and returned home to Filskov to start a family and build his business.

Life was hard in rural Denmark in the years following the First World War, and Ole would have more than his share of setbacks.

In 1926, Kirstine died from complications with the birth of their fourth son. Two years before, the older children were playing in the wood shop, and set a fire that destroyed the building. It was to be first of three fires that would raze his workplace over the subsequent three decades.

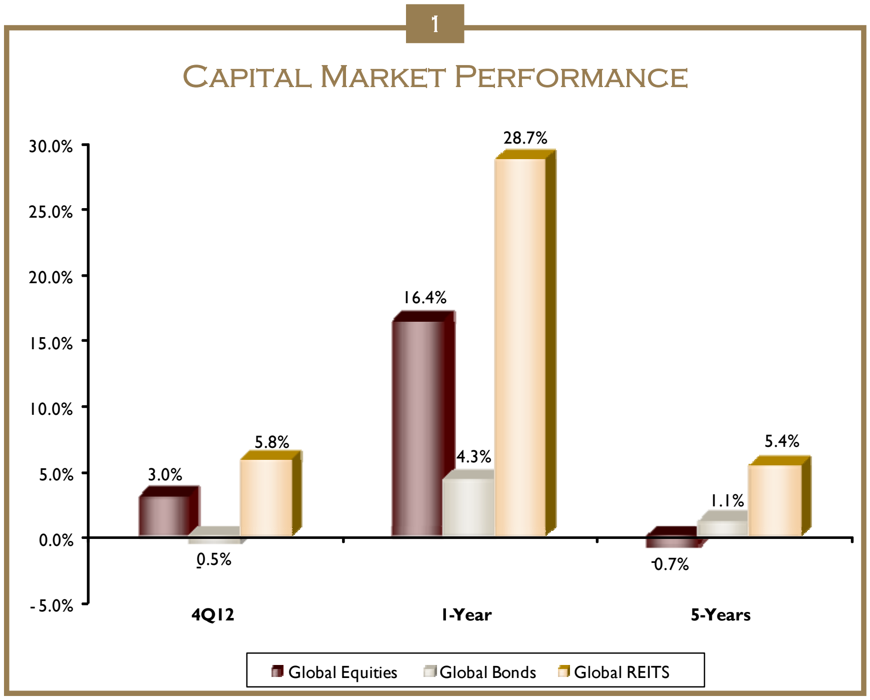
As difficult as it was for Ole, raising four boys on his own while trying to rebuild his work shop, it was to get even tougher in the 1930s as the Great Depression engulfed every economy in the world. Demand for carpentry dwindled to near nothing, and Ole, as did so many millions of others looking for work, faced a bleak future. He scraped by making small wooden toys for his neighbors, cut from the birch trees in the forests around Filskov.

Life became even harder when the Germans invaded Denmark in 1940, and occupied it till 1945. A second fire, in 1942, again destroyed his workshop. Still, Ole kept his family together and, somehow, survived the war. From the rubble that was the European economy of the 1940s, Ole was determined, again, to rebuild. Little could be expected from this uneducated carpenter in a village of a few hundred in the middle of nowhere. In this bleakest moment, amidst an economy in ruins, with famine and disease widespread throughout the continent, Ole took a chance on a new idea, and created one of the greatest products the world has ever seen, enriching the lives of nearly every person on the planet born in the last fifty years.

"Growth is sluggish, but at the margin, most data show improvement."

Capping a strong year, most equity markets posted gains in the fourth quarter. Global equities' 16% return in 2012 was better than almost everyone expected (which is how it usually works). Africa was particularly potent last year, rising nearly 50%, led by Nigeria and Kenya, but best of all was Turkey, up 60% in the year past. Among the few not to receive an invitation to the dance, Argentina and Ukraine paced the losers, off 40% and 50%, respectively. Confounding pundits, the very best market in the last quarter was Greece (a dead olive bounce?), up 28%, to close the gap and end flat for the year.

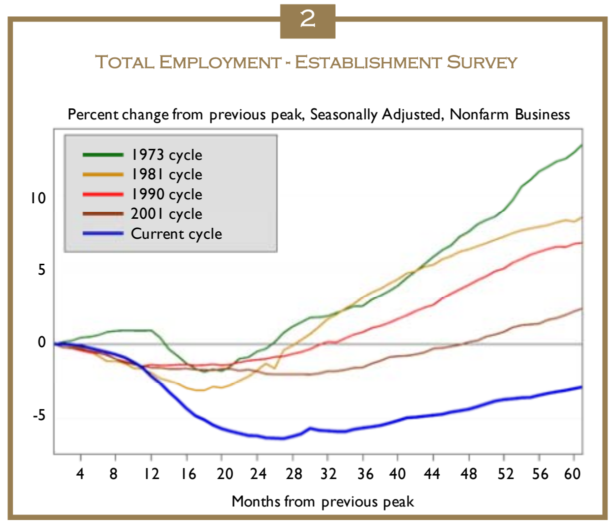
1



The US economy contracted last quarter, -0.1%, on preliminary estimates. This is the first decline since 2009, but this headline is more confusing than revealing. A fall in inventories subtracted 1.3% from growth, and there was a similar decline in government purchases due to the largest drop in defense spending (-22%) since 1973 and the withdrawal from Vietnam. Personal consumption, business spending and housing combined to grow at a 3.4% pace in the quarter. Overall, the economy is probably growing around 2.5%.

Growth is sluggish, but at the margin, most data show improvement. The unemployment rate ended the year at 7.8%, unchanged over the quarter, but down from 8.5% twelve months ago. Approximately 153,000 jobs were added each month, on average, in 2012, the same as in 2011. More than 5 million jobs have been added over the past three years, although that is still well below the nearly 9 million jobs that were lost in the previous two years. This is the weakest job recovery we've seen (Chart 2). Hours worked are still about 5% below the 2008 high, and real wages are essentially unchanged. The percentage of the population

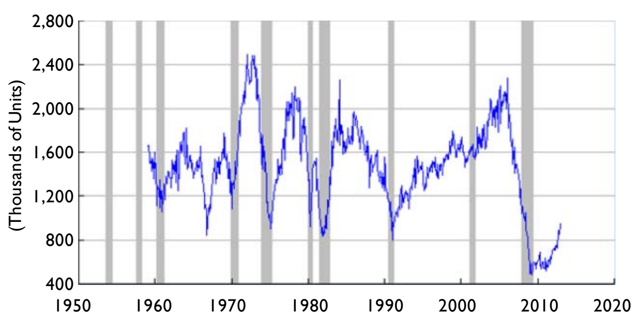
2



Cooley-Rupert Economic Snapshot; www.econsnapshot.com
Source: US Bureau of Labor Statistics

3

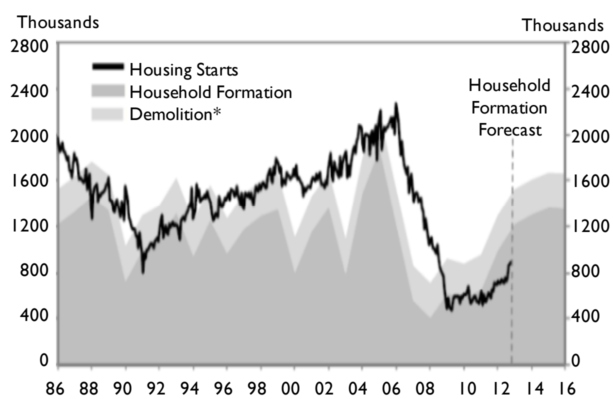
HOUSING STARTS: TOTAL: NEW PRIVATELY OWNED HOUSING UNITS STARTED (HOUST)



Source: U.S. Department of Commerce: Census Bureau
Shaded areas indicate US recessions.
2013 research.stlouisfed.org

4

HOUSING STARTS & HOUSEHOLD FORMATION
1986 - 2016 (EST.)



**Assumed demolition rate of 300,000 per year.*
Source: Department of Commerce, GS Global ECS Research.

working peaked at more than 67% in 2000, and has now fallen to 63.6%, the lowest in over 30 years. Employment is climbing out of its hole, albeit very slowly and with a long way to go.

Housing was strong in 2012, although coming off a very low base, and is expected to remain healthy in the near future. Excess supply of housing units has fallen, as have vacancy rates. New starts jumped 28% last year to 954,000, although this is still exceptionally weak compared with last 50 years (Chart 3).

The drop in inventory and the 30% or so fall in prices have cleared the market, and demographics favor continued strength in housing. Household formation plunged in 2008, and is slowly and surely rising to their "natural" level of around 1.5 million. Housing starts will follow (Chart 4).

Consumers have made progress in reducing their debt over the past four years, falling from more than 100% of GDP to around 86%. Low interest rates mean that servicing that debt takes just 10.6% of disposable income, as low a percentage as anytime in the past 30 years.

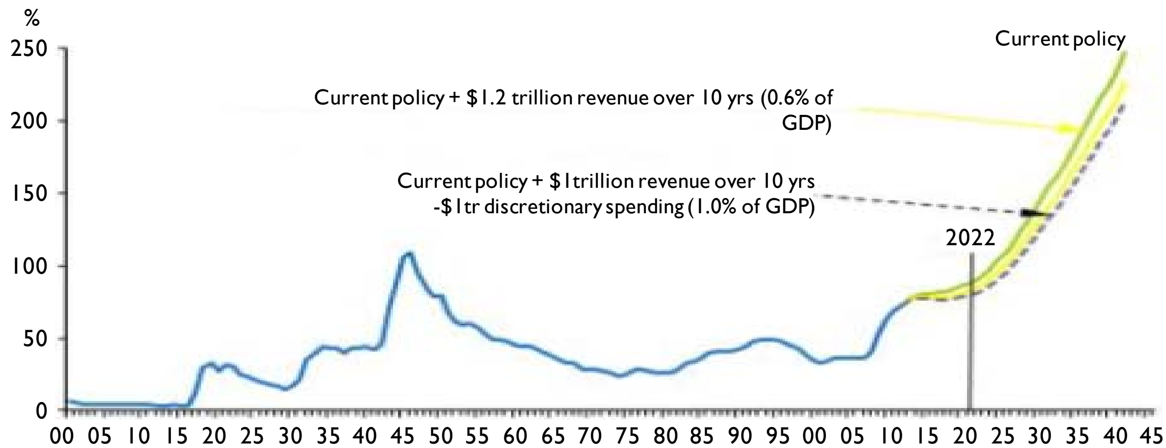
Modest improvement in employment, sustained strength in housing, consumer deleveraging and continued high levels of corporate profitability are all welcome signs of steady economic progress. Perhaps they will be sufficient to offset the $250 billion of tax increases effective at the first of the year.[1] Unfortunately, but not surprisingly, the impact on deficit reduction will be very modest, as slower economic growth translates to fewer jobs and less income to tax. Rather than reduce the deficit by $250 billion, these changes may amount only to a third of that, thus a lot of pain for very little gain.[2]

1 Half of this ($127 billion) comes from raising the Social Security tax on all workers, another $50 billion from raising the top marginal tax rate from 35% to 39.6%, and the rest from phasing out itemized deductions and personal exemptions, raising the tax on capital gains and dividends to 20%, plus a 3.8% surtax on capital gains and investment income, a 0.9% increase in the Medicare tax, and a 2.3% excise tax on medical device makers. Californians additionally voted to raise income taxes retroactively, amounting to about $12 billion over 2012-13.

2 The work of prominent economists Christina and Paul Romer (she was President Obama's chief economic adviser) show a tax multiplier of -3 over 3 years, i.e., the (negative) impact on economic growth is three times the amount of the static projection of additional tax revenue.

5

U.S. PUBLICLY-HELD DEBT TO GDP



Courtesy: J.P. Morgan

"Putting aside hyper-inflation and default as viable debt management tools.."

Revenues and expenses need to be brought in-line. That is challenge enough for politicians, but the current year's deficit, or even the deficit over the next ten years, are minor issues relative to the structural, long-term imbalances caused by demographic pressures and obligations that cannot be fulfilled. These will come to a head in about ten years. Without reform, in 25 years we will be spending 40% of GDP on Social Security and Medicare, and the debt outstanding will explode (Chart 5). Entitlement reform is a priority, now or eventually.

Effective management of government debt requires maintaining a nominal economic growth rate greater than the nominal cost of borrowing, thereby allowing income growth to exceed debt servicing costs. When debt levels become large (about where we are now), growth alone will not suffice to manage the debt burden and governments seek higher inflation, which works to devalue the future value of the debt. This is the path Japan's new prime minister, Shinzo Abe, favors, and the (notionally) independent Bank of Japan recently adopted. But not too much inflation, which would cause borrowing costs to exceed the economy's growth rate, and thus cause the debt burden to rise (think Argentina). Lastly, if all else fails, governments will simply decline to repay creditors (think Argentina—again—among many others).

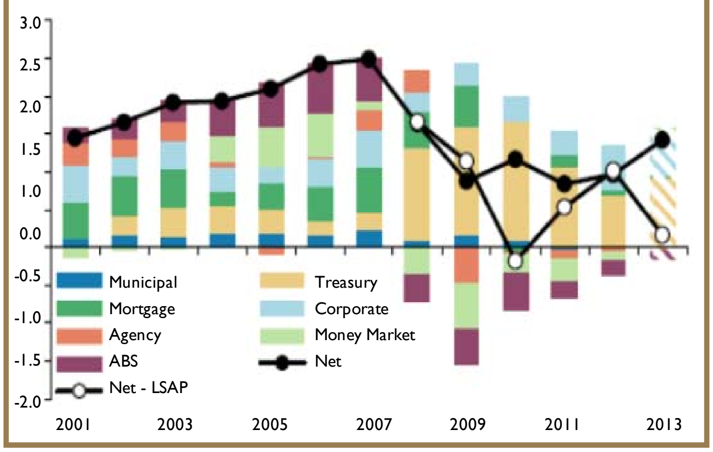
Putting aside hyper-inflation and default as viable debt management tools, policy makers are focused on maintaining a nominal growth rate that is higher than the cost of financing. Nominal GDP in the US grew 3.3% in 2012, and the average cost of borrowing is about 2%[3], so the US economy is indeed growing faster than the government's cost of servicing its debt.

But nominal GDP growth of 3% is pretty meager growth, so to ensure that financing costs are low, the Fed has engaged in a series of actions to suppress interest rates, including massive purchases of Treasury and agency debt (quantitative easing). The Fed has been buying the vast majority of all newly issued debt. Over the past five years

[3] 2.043% as of 31 December 2012; the *marginal* borrowing rate is much lower.

6

U.S. Debt Issuance & Net Supply, 2001 - 2013



Note: 2012 is 3Q SAAR. 2013 projected supply assumes $856bn in net Treasury issuance and similar net issuance is other categories similar to 2012 net supply. The Fed LSAP purchases are assumed to $660bn in Treasuries ($45bn per month in 1H13, $65bn per month in 2H13) and $600bn in MBS ($40bn per month in 1H13 and $65bn per month in 2H13).
Source: Federal Reserve Board, Haver Analytics, Morgan Stanley Research estimates

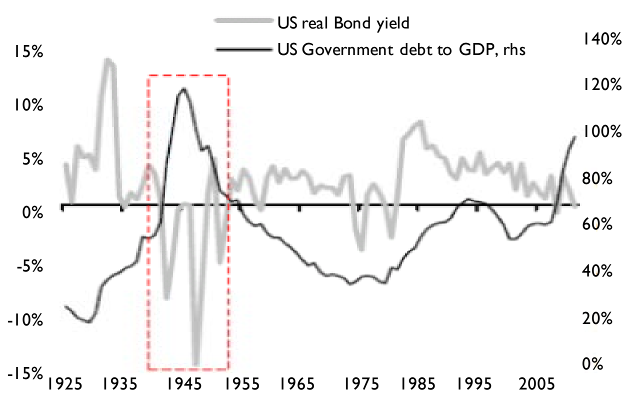
its balance sheet has expanded from 7% of GDP to 19%.[4] In 2013, total issuance of all debt—government, corporate, mortgage, et.al.—is expected to be around $1.3 trillion, about half of the $2.5 trillion issued in the peak year of 2007. However, Federal Reserve purchases will likely amount to more than $1 trillion, cutting the net supply to investors significantly, thereby helping to limit increases in yields (Chart 6).

Historical precedent for such actions can be found in the decade following the Second World War. Beginning in 1942, as debt began to mount to finance the war, the yield on the 10-year Treasury note was capped at 2.5% and held there for ten years. The cap was removed gradually starting in 1951 and yields began to rise modestly, but only after a decade of negative real interest rates helped reduce the amount of debt outstanding (Chart 7). Of course, growth prospects following the war were significantly more favorable than they are today which enabled the economy to grow out of its debt. In the decade following the war, real GDP averaged 6% p.a., about three times the pace expected today. Financial repression[5] is seen by central bankers as a necessary (but not sufficient) condition to help ease debt burdens, and is likely to be maintained for the foreseeable future.

"Financial repression… will likely linger on..."

7

Real Yields & Government Debt, 1925 - 2012



Source: Thomson Reuters, Credit Suisse Research

Financial repression, that is, the massive intervention by central banks to suppress interest rates, will likely linger on for at least another

[4] The Fed is not alone: The Bank of England has pushed its balance sheet from 7% of GDP to 26%, the ECB from 12% to 32%, and the Bank of Japan from 21% to 34%.

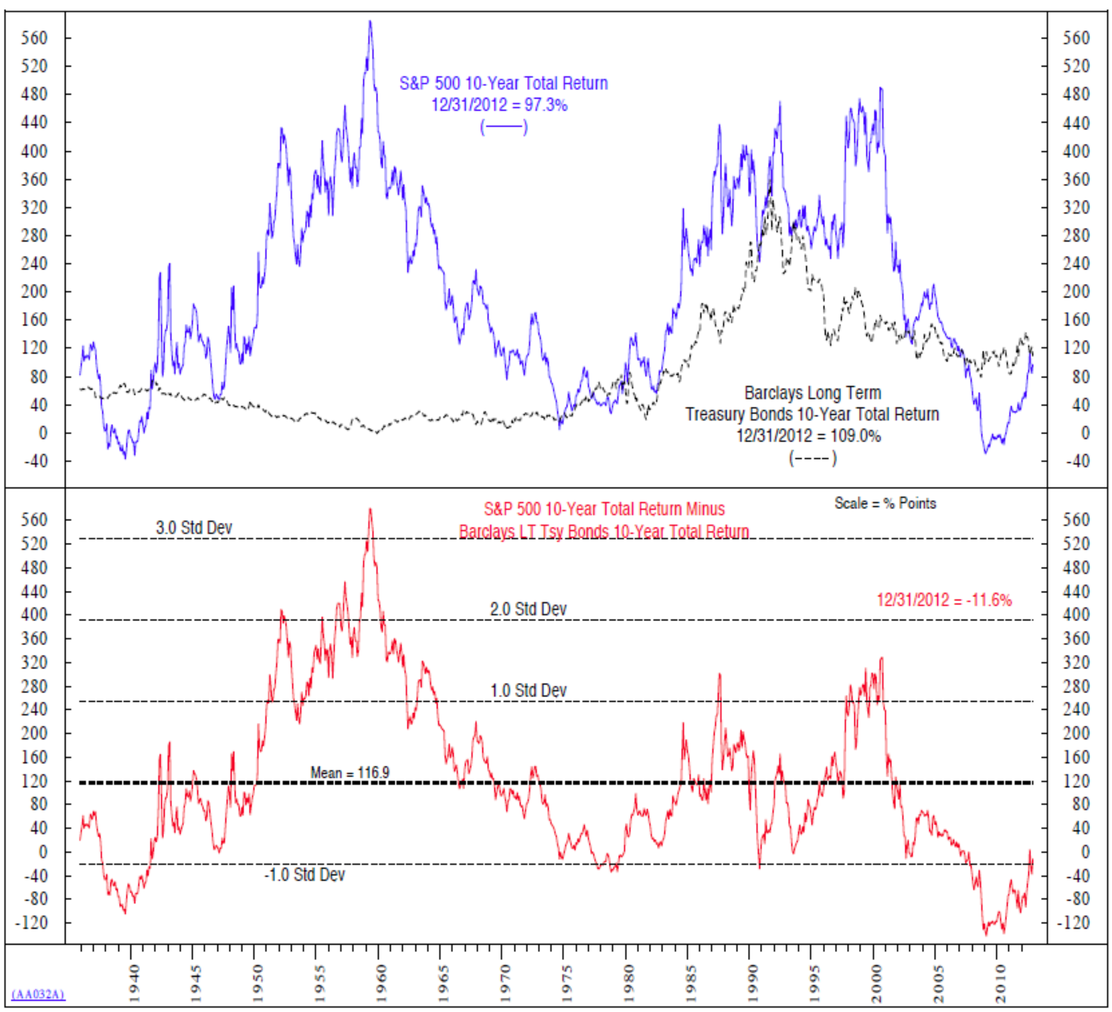
Table 1
Yields required for zero return, one year horizon

	Current yield	Breakeven yield	Yield 3y ago
Treasury			
2 year	0.24%	0.54%	0.79%
10 year	1.84%	2.23%	3.61%
30 year	3.03%	3.26%	4.53%
IG Corp	2.75%	3.50%	4.52%
HY Corp	5.90%	7.57%	8.75%
AAA 10yr muni	1.67%	1.94%	3.00%

**High yield calculation assumes 2.5% default rate, with 40% recovery value*
Figures include estimate of roll down the yield curve.
Data as of 1/22/13 Source: BofA Merrill Lynch Global Research

8

10-Year Stock and Bond Performance Difference



Monthly data 12/31/1935-12/31/2012
Courtesy: Ned Davis Research Group

TABLE 2
ASSET VALUATION, DEVIATION FROM TREND

	Deviation from trend or average, in standard deviations			Deviation in %/log differ-	
Assets	**Now**	**Mar 2009**	**Mar 2000**	**Now**	**Data Sample**
Gold	4.00	1.56	(0.39)	135%	1841, Monthly
Oil	2.46	0.40	(0.17)	127%	1861, Monthly
Copper	0.74	0.15	(1.24)	43%	1850, Monthly
US Real Equities	(0.18)	(1.50)	2.19	-6%	1850, Monthly
UK Nominal Long Bond Yields	(0.36)	(0.05)	0.17	-1%	1750, Monthly
European Real Equities	(0.81)	(1.38)	2.10	-28%	1926, Monthly
US Nominal Long Bond Yields	(1.09)	(0.67)	0.61	-2%	1800, Monthly
US Real Long Bond Yields	(1.50)	(1.02)	0.17	-3%	1919, Monthly
US Equity vs. Bonds	(1.70)	(2.59)	1.72	-57%	1960, Monthly
Japan Equity vs. Bonds	(1.99)	(1.81)	0.38	-102%	1958, Monthly
European Equity vs. Bonds	(2.01)	(2.68)	2.89	-42%	1960, Monthly
Japanese Equities	(2.10)	(1.92)	0.80	-89%	1920, Monthly
Real US House Prices	(2.98)	(2.10)	(0.07)	-23%	1968, Monthly

Source: Credit Suisse

year, possibly longer, but this policy represents the beginning of the end of the Great Bond Bull Market that began in 1981. It is worth noting how extraordinary this era has been. Over the past three decades, long-term yields have fallen from more than 15% to under 2%. The average yield over this time has been 6.5% and investors have enjoyed annualized returns of 8.6% (a cumulative return of more than 1,500%!). Even more remarkable has been the consistency of returns: in just two of the past 33 years did bond investors lose money.[6]

The catalyst for this remarkable period was the breaking of inflationary pressures by the Volcker Fed, but this last leg was driven by extreme levels of risk aversion following the meltdown of the global financial system in 2008, abetted by massive central bank buying. Following the Fed, over the past five years investors have added more than $800 billion to bond funds, while withdrawing nearly $600 billion from equity funds.

During the Great Bond Bull Market interest rates rose in eight of the calendar years, but investors still saw positive returns in six of them, as yields were sufficiently high to more than offset the principal loss. Today's low yields and extended durations leave very little cushion from losses should rates rise (Table 1). With real yields negative, bond investors are guaranteed to lose purchasing power over almost all time periods.

Investors have foresworn equities after being battered with 50% declines twice in the past decade. Just four years ago investors looked back at the worst ten-year performance of equities in generations. Even with stocks up more than 100%, the ten-year performance of stocks still trails bonds (Chart 8, page 6).

Bonds are priced well above their long-term average and stocks are priced well below theirs (Table 2). We do not believe there is

"Bonds are priced well above their long-term average and stocks are priced well below theirs."

5 The term was coined by Stanford economist Ronald McKinnon in 1973 to refer to government intervention to keep interest rates low and to direct lending to favored groups (principally the government).

6 1994: -2.85% and 1998: -0.83%.

any imminent change in monetary policy, and there are certainly plenty of political and economic risks that threaten the recovery. But the era of extraordinary bond returns is ending, and while equities are certain to be volatile, their returns are almost certain to exceed fixed income.

Ole Christiansen survived the war by crafting wooden toys for the children of Filskov. His workmanship was superb, and he soon was filling orders for his toys from all over Denmark. In 1960, lightening struck his factory, and for the third time, fire completely destroyed his building, tools and inventory. This time, Ole made the decision not to rebuild, and he closed his carpentry business for good. For the first time in centuries, the Christiansens were not the carpenters of Filskov.

Fortunately, just after the war, a salesman for a British machine-tool company visited Filskov and showed Ole a model of a plastic injection molding machine. There was nothing like it in Denmark, no one even knew what to do with a plastic injection molding machine, and furthermore, it cost 30,000 krone, more than all the profits Ole had made in his entire career.

Ole could have remained focused on crafting good, solid wooden toys for the children of Filskov, but for some reason decided to spend every last krone he possessed on a machine he had never seen or even had any idea how to use. His family and neighbors thought him insane. When the machine was delivered, a few sample products were included to show what it could do. One of those samples was a rounded plastic brick with studs meant as a child's building toy. Ole played with the design, squaring the edges, flattening the studs on top, reconfiguring the bottom of each piece so that they would snap together firmly but could easily be removed.

Economic conditions may not be as dire today as Ole faced 60 years ago, but the implosion of the global financial system and the subsequent policies of trillion dollar-plus deficits and trillions more added to central bank balance sheets have left investors with few attractive options, at least none without risks. There was clearly no short-term benefit to Ole in being the first in his country to purchase that plastic injection molding machine, but somehow he saw its long-term potential. As investors, perhaps our greatest advantage lies in our willingness to take a long-term perspective, to accept the risks of falling short in the near-term in order to profit from the correct long-term positioning. We think this is a good time to have those discussions and to make those adjustments.

Ole's plastic bricks can be found in every country in the world, and about 20 billion of them are made each year. It was named Toy of the Century by the leading industry group, and has received prestigious design awards for its iconic, "perfect" design. Numerous studies have linked enhanced reasoning and creativity to playing with it.

Back when Ole was still carving wooden toys for the children of Filskov, he wanted an appropriate name for his company. He decided on the words *Leg Godt*, contracted to *Lego*, which in Danish mean *Play Well*. Good advice for all of us.

Founded in 2001, Angeles Investment Advisors LLC provides investment advice to select institutions and high net worth families and individuals.

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
JANUARY 2013

If you would like to receive a copy of our Form ADV Part 2A free of charge, please email Steve Smetana at ssmetana@angelesadvisors.com, or call (310) 393-6300.