Angeles
INVESTMENT ADVISORS

SECOND QUARTER 2001 COMMENTARY JULY 2001

KEEPING THE TOP DOWN

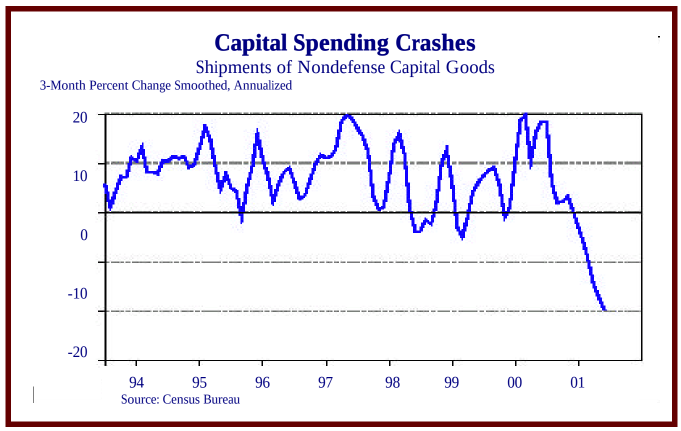
Summer means morning fog along the California coast. It usually burns off by afternoon, but not always. No matter; the top of my convertible is always down, because the view is better. Not always good, especially in this market, just better.

First, the bad news. The world is on the cusp of a global economic recession, the fifth since 1970 (noted Stephen Roach of Morgan Stanley, defined as world GDP growth of <2.5%). All were triggered by an exogenous shock: in 1975 and 1991, it was a spike in the price of oil; in 1982, it was the shock cooling of monetary policy by Fed chairman Paul Volker; and in 1998, it was a currency shock that started in Thailand the year before, and spread throughout Southeast Asia, culminating in the Russian default and implosion of Long Term Capital Management in the summer of 1998.

To combat the contagion of the 1998 currency crisis, central banks reflated furiously, and the IMF chipped in $180 billion (about 0.5% of world GDP) in a massive, coordinated effort to inject liquidity into the world economy. It worked, and led to two significant events. First was an enormous boom in capital (especially, IT) spending that helped fuel the subsequent NASDAQ bubble. Secondly, the easing of the crisis also relieved the pressure on making much-needed structural reforms, especially in Asia, where banks were allowed to make and then hold onto delinquent loans, often to perpetuate the crony capitalism that permeated many countries. The fall-out from all this is a world economy that was growing at a 4.3% clip a year ago, and is now estimated to grow just 2.4% this year, the fastest deceleration of growth in over 15 years. And no place is untouched, say the folks at Bridgewater, as 99% of the world economy is experiencing slower growth, a synchronized slowdown not seen since 1975.

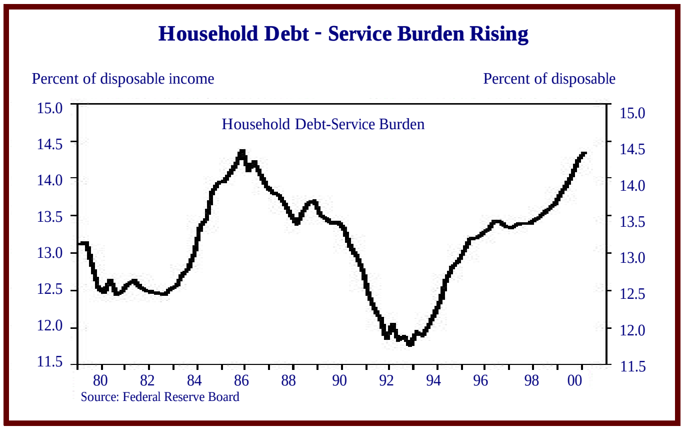
US economic data are generally discouraging. Orders for durable goods are off 23% over the past year, the biggest drop in the forty years of data. Capacity utilization has fallen to its lowest level since 1983, import growth is negative for the first time since 1991, and productivity declined 1.2% in the first quarter, the worst result in eight years. Even worse, household net worth declined 8% in the first quarter, the biggest drop on record (notes ISI).

Capital spending and consumer spending are the two big cylinders of the US economic engine. As the first chart shows, capital spending has fallen off a cliff, pulling the US economy along with it.



While consumer spending has remained stronger than most predicted (it's unwise to bet against the American consumer; we love to buy things), one can legitimately wonder how much longer it will hold up in the face of mounting layoffs, declining net worth, and rising debt (see the next chart).

Alan Greenspan, bless his heart, is pedaling as fast as he can. The Fed dropped interest rates 125 basis points in the second quarter, on top of the 150 basis point decline engineered in the first quarter. In less than six months, the Fed funds rate has declined from 6½% to 3¾%, with more promised on the way. George W. pushed through a tax cut, and we're told the check is in the mail (although so is the pink slip, as Steve Roach quipped). The bull case is based on the classic counter-cyclical dynamic of monetary and fiscal stimulus to stave



off a recession. Add to this the extra benefit of falling energy prices, and the American economy will be back on track in no time. Marty Zweig pointed out the power of monetary easing, noting that there have been ten cases since 1945 where the Fed has cut rates five times, with the impressive reaction in the stock market shown in the nearby table.

Following 5th Rate Cut	DJIA Gain	Avg. Prob. of a Rise
3 months	5.17%	78%
6 months	11.81%	86%
12 months	28.10%	100%

But it does seem a little improbable that the excesses of the IT spending binge will be purged so quickly and benignly. Sure, capital spending is unwinding much faster than anyone imagined (just ask John Chambers, Cisco's CEO), but 70% of corporate expenses are labor, and more layoffs appear likely. Would anyone like to bet that Lucent, which a year ago had 155,000 employees and today has 60,000, won't need to make further cuts? (my guess is that until Henry Schacht, the CEO, is one of the cuts, no job there is safe).

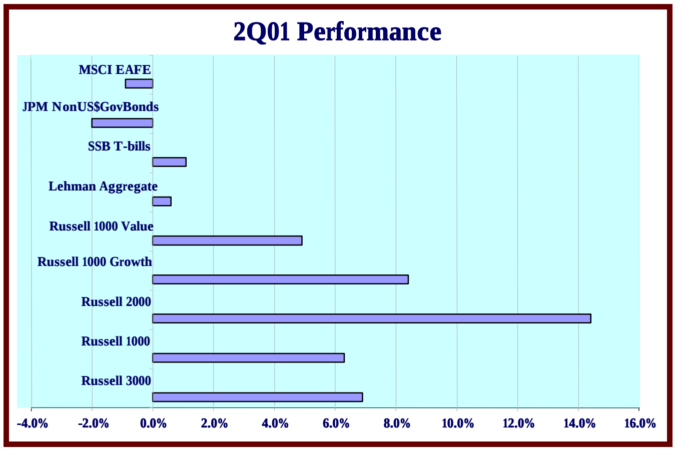
We really shouldn't pick on Henry Schacht and Lucent. Let's pick on its competitor, John Roth and Nortel. It's hard to appreciate the magnitude of disaster perpetrated by this ersatz blue-chip company, Canada's largest, that a year ago accounted for 40% of the entire market capitalization of that country. We pick on Nortel, not because its stock has fallen from 87 to 7 (there are many examples of even greater drops in stock prices), or because it's a large corporation with incompetent management (General Motors and AT&T, to name just two, would give them a run for length of incompetence). No, we pick on Nortel because last quarter Nortel announce a new record for the magnitude of ineptitude: a $19.2 billion charge against earnings, including a $12 billion write-off of investments in technology companies. Over the previous two years, Nortel spent $19.7 billion buying companies with a combined tangible net worth of $167 million, and profits of…sorry, that was a joke.

But just as we were going to print, I guess we owe Nortel an apology. Title to the most inept corporate management must now pass to JDS Uniphase. In 1992, General Motors posted a $23.5 billion loss, the largest by any American company ever. JDS Uniphase, which closed the books (and perhaps the company) on June 30, announced a loss for the year of $50.6 billion, including a write of ill will of $44.8 billion. I have no further comment, and am, for once, speechless in the wake of this calamity.

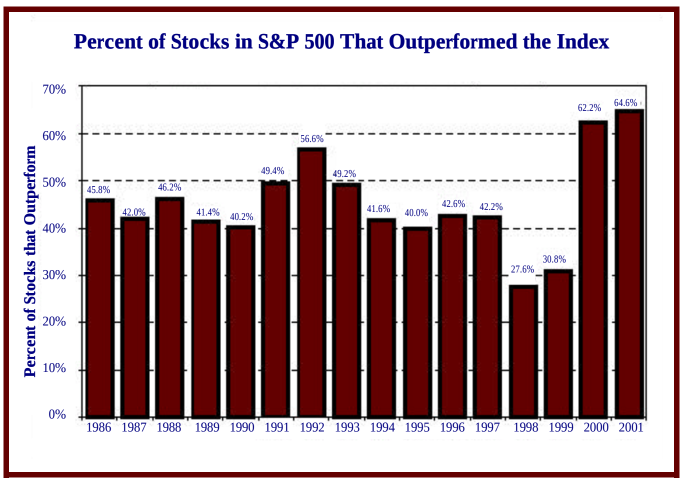
Meanwhile, across the Atlantic, our European friends are busy redefining (or is it re-defying?) logic. General Electric was prohibited from buying Honeywell on the grounds that the new company might be able to sell aircraft engines and avionics to Boeing and Airbus at prices lower than what European suppliers could offer. Shall we await the law prohibiting McDonald's from bundling hamburgers *and* (French) fries in a Happy Meal? If this weren't stupefying enough, the French government has proposed a law prohibiting companies from laying off workers unless and until "all other means" have been tried to preserve the jobs. Egalité, even if it kills us, I guess.

While the Fed continues to prime the pump, its global counterparts don't seem to feel the same urgency. The European economy, which was set to grow faster than US this year, has hit the skids and will now lag the US. Yet in the name of supporting a currency that is testing all-time lows against the dollar, the central bank refuses to match the Fed in monetary easing, thus ensuring both an even slower economy and a weaker currency. Well done. At least the Bank of Japan has cut lending rates to 0%. Needless-to-say, Japan's ZIRP (zero interest rate policy) hasn't stopped the economy from shrinking or the yen from sinking.

Japan illustrates well the adage "pushing on a string." There are times when all the effort a central bank can muster just won't spur an economy. Japan is an extreme case, unimaginable in the US, but the challenges facing the US economy do not lend themselves to being solved by a dose (even a healthy one) of liquidity. It certainly won't help Nortel or JDSU, or the who-knowshow-many others out there. The massive capital spending binge has to be worked through, and consumers will need to rebuild their balance sheets. Monetary easing will help, but alone is not sufficient to jump-start the economy. No "V"-shaped economic rebound here; think "L", and be happy if it isn't a "backslash (\)."



After falling four consecutive quarters, US stocks rebounded in the second quarter. Still, the first half decline of 6.7% in the S&P 500 Index was the worst since 1984, and we're hardly out of the woods. But the market is broadening, as the accompanying chart shows, with about 70% of stocks in the S&P 500 outperforming the index last quarter.



The second quarter was a time for turnarounds, with many previous losers posting strong gains, and vice versa. Technology was the best performing sector in 2Q, up 12.4%, but that follows a 67% plunge in the twelve months ending March 31. The 16.2% drop in technology in the first half of this year puts it at the bottom of the sector heap. Technology was where you would find the quarter's worst performers, led by Palm and Network Appliance, each off 79% in the quarter. Yet Microsoft, the worst drag on the Index last year, jumped 34% in the quarter and is up 68% the first half of this year. On the winning end (where I had my money, of course) was the blue light special, as the best performers in the S&P 500 were K-Mart (+116%) and J.C. Penney (+147%). Last quarter's letter noted the doubling in prices of coal stocks, but we trust you weren't tempted to jump into that pit: the group is off about 50% from its May peak.

If you find the surge by Penney's and K-mart a little baffling, how about the leaders in emerging markets last quarter: Russia (+32%), China (+22%) and Turkey (+20%). Taiwan was the worst emerging market, down 19% in the quarter, an interesting pairing with China. Lest you be inclined to feast on Turkey, we'll note that it is still off 63% in the last twelve months, and apparently in a race with Argentina on which economy and currency will blow up sooner.

Think Small, was an ad campaign for Volkswagen some years ago, but an apt slogan for today's market. Small cap stocks outperformed large cap by 8% last quarter, and by 15½% these past twelve months. Relative performance this year by capitalization can be seen in the nearby table:

Small Stocks' Outperformance

Capitalization Quintile ($million)	01H1 Return (%)
1: Above 25,977	-8.7 %
2: 11,613 - 25,977	-9.6 %
3: 6,364 - 11,613	0.7 %
4: 3,405 - 6,364	15.4 %
5: Below 3,405	20.7 %
Total	**-6.7 %**

Source: Morgan Stanley Research

Value has outperformed growth, by 13% this year and by 46% over the past twelve months. We think this strong performance by small cap and value stocks is no fluke. Partly, it's simply payback for four years of extraordinary performance by large cap growth stocks. But there is another dynamic that suggests this trend favoring small cap and value stocks could continue, the rise of the risk premium.

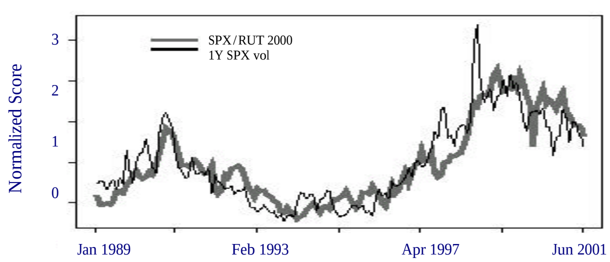
We have just come through a four-year period of rising volatility not seen since the 1930s. Couple this with the fact that the market indices are about where they were three years ago, it's no wonder investors have responded to the roller coaster ride with a greater aversion to risk.

We saw the same dynamic a generation ago.

The 1960s marked an important transition period, probably in all areas of American life, but specifically in the stock market. Through most of the 1950s and into the 1960s, the market, mirroring the economy, boomed. In 1966, the Dow reached a peak not to be seen again till the early 1980s. 1968 marked the peak year for the S&P 500 Index. Yet it wasn't until 1973-74 that the market indices collapsed in the wake of the oil crisis. In the late 1960s, the market was unwinding the great structural bull market. The spread between high-grade corporate debt and Treasuries widened, much like we are seeing today. In this unwinding process, small cap stocks outperformed large caps. Certainly, it's an imperfect analogy, since history never repeats itself (although it does rhyme). But perhaps we can say that when a structural bull market unwinds, small cap and value stocks will outperform, as they did when the last great structural bull market ended in the late 1960s, and as we are experiencing today.

Accompanying this transition is a reduction of volatility. The previous chart shows the implied volatility of the S&P 500 corresponding nicely to the performance of large cap versus small cap stocks:

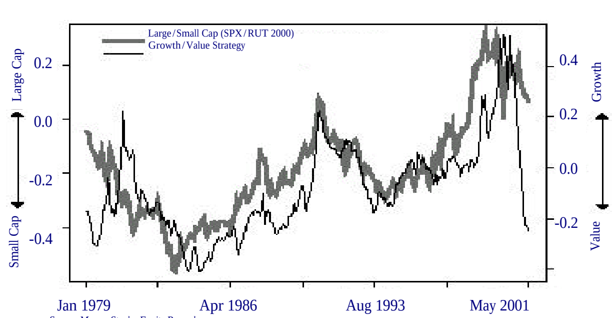
Large / Small Cap Performance and Implied Volatility



Source: Morgan Stanley Equity Research

This next chart links the performance of capitalization to style, showing a pattern of large cap and growth style aligned, distinct from small cap and value:

Large / Small Cap and Growth / Value



Source: Morgan Stanley Equity Research

Our bias toward small cap and value rests on three premises:

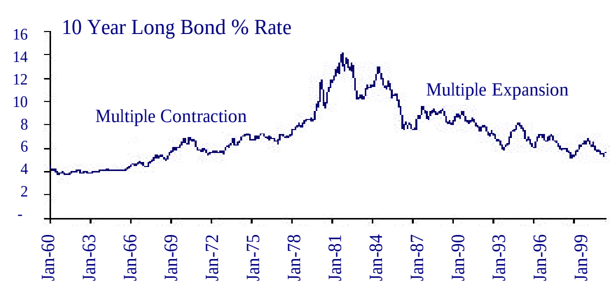
- Extreme valuation due for a correction;
- The unwinding of the structural bull market of the 1980s and 90s;
- A decline in volatility during this transition period.

We do not expect that small cap and value stocks will outperform their counterparts by 45% over the coming year, but to the extent that there is a bias in our portfolios, it continues to favor small cap and value.

Relative performance is interesting, but what about absolute returns? Many investors are being squeezed by poor investment performance coupled with greater demands for spending (either due to actuarial assumptions in pension plans or the spending needs of endowments and foundations). We think absolute returns will be much less than we've seen over the past twenty years, although not quite at the dire predictions of the many gloomy curmudgeons who are right every other decade or so.

One useful way of thinking about investment returns is to think about the source of those returns. The return to investors in a stock is a function of dividends and capital appreciation. The source of both components is the profit generated by the business. So logically, the growth in profits drives the return an investor receives from buying a stock.

Interest Rates Drive P/E Multiples



Source: DRI Morgan Stanley Research

Over the long term, this simple equation has held up pretty well (my thanks to Steve Galbreath of Morgan Stanley for this research). But, as we have all learned too well these past few years, the actual return in the market does not necessarily equate to a company's profits. The crucial missing variable that squares all this is the change in the multiple (i.e., the price-to-earnings ratio) assigned by the market. A rising multiple means the market return of a stock can exceed the growth in earnings, and a falling multiple means the market return will trail the growth of earnings. Over the past forty years, we've had two distinct, pretty evenly spaced periods of contracting, then expanding multiples that coincided fairly closely with rising, then falling, interest rates.

The numbers in the next table tell the story more precisely.

	1961-2001	1961-81	1891-2001
Beginning Dvd Yld + Earnings Growth	11.2%	12.1%	10.3%
Market Return	11.2%	7.5%	15.2%
Change in Multiple Contribution	0.0%	-4.6%	4.9%

Source: Morgan Stanley Research

This is not meant to say that we are forecasting a period of multiple contraction, although it does seem unlikely we'll see multiples expand. Rather, it's to draw attention to the other variables—dividend yield, earnings growth and inflation—to see what level of returns we might expect.

The current dividend yield on the S&P 500 Index is 1.3%. The long-term earnings growth forecast for the S&P 500 Index from I/B/E/S medians is 15.4%, close to the actual growth rate over the past five years of 15.5%. This number seems highly implausible (and implausibly high), suggesting that analysts still have a ways to go to lower their growth forecasts. Over the very long-term, the earnings growth of the S&P 500 has been about 3.6% over inflation. That seems more probable. So a 1.3% dividend yield plus 3.6% real earnings growth plus an inflation rate of 2-3%, gives us a return on stocks of about 7-8%, assuming no change in the market multiple.

At Angeles, for modeling purposes we've taken the upper number of 8%, and added another 1% or so for productivity gains that will enable a higher rate of growth than in the past (let's save the productivity discussion for another time, although we recognize it's controversial). But unless one or more of these variables shift, a high single-digit return from equities for the next few years seems the most likely scenario to us.

What this means is that we are all going to have to work harder to earn less. One way we work harder is by evaluating areas of the investment world that may have been overlooked during the great bull market, but might make sense today. As we seek value for our clients, we are not attempting to discover the *new* new new thing, rather we think that in a world of 6% bond yields and 8 or 9% equity returns, assets that generate cash with a high degree of stability are going to be very attractive. We'll mention three such opportunities: TIPS, Convertibles and Real Estate.

TIPS were covered in last quarter's letter (see our website for a copy), so we don't have to go into the details of how TIPS work. But we remain surprised (well, actually amazed) that more investors have not purchased these securities. Today, ten-year TIPS yield 3.4% over inflation, and the ten-year Treasury note yields 5.1%. That difference of 1.7% is the breakeven inflation rate, i.e., if inflation averages more than 1.7% over the next ten years, TIPS will pay more (theoretically, an unlimited amount more) than the Treasury note. If inflation falls to zero or less, TIPS will still pay 3.4%, or 1.7% less than the Treasury note. So which is the better deal? Well, in the deflationary decade of the 1990s would anyone care to guess the average annual rate of inflation? 1%? 2%? Try 3%. The adjoining table gives us the average annual inflation rates, by decade.

Inflation Through the Decades

	1930s	1940s	1950s	1960s	1970s	1980s	1990s
CPI	-2.0%	5.4%	2.2%	2.5%	7.4%	5.1%	3.0%

Source: Ibbotson Associates; Dimensional Fund Advisors

The average throughout this period was 3.3%. So let's ask the question again: with a breakeven inflation rate of 1.7% over the next ten years, are TIPS or the Treasury note the better bet? But beyond this question is another one: is a 3.4% return over inflation, guaranteed by the United States Treasury, an attractive return in the current market environment? We reiterate our comment from last quarter's letter: back-up the truck and load 'em up.

I'm partial to convertibles, and it's not because I live in Southern California. Convertibles have been overlooked because (a) they're complicated because of their embedded option; (b) equity investors shun them because their returns are usually below straight equity; and (c) bond investors shun them because they are more risky than simple debt. So no one spends much time analyzing these securities, meaning the convertible market is less efficient, which, of course, creates opportunities for those willing to work a little harder.

A convertible security is usually a bond, and sometimes a preferred stock, that may be converted into the common stock of the issuer. Whether it is desirable for an investor to convert this bond into common stock depends on the conversion price relative to the actual price of the common. If a stock price appreciates, that's good for the convertible owner because now those shares of stock are more valuable. If the price of the common falls, well, that's bad for everyone, but not so bad for the convertible owner because he receives a nice yield on the bond while waiting for the stock price to rise. So think of a convertible as a regular bond plus a call option on the stock.

Logically, then, the return on a convertible is a function of the yield plus any price appreciation of the common stock. Intuitively, if stocks will outperform bonds over time, one would expect that this hybrid security would return less than stocks but more than bonds, with less risk than stocks but more risk than bonds. And that, in fact, is what has occurred, as the first table shows.

Asset Class	Compound Annual Return (1973-2000)	Standard Deviation
Convertible Bonds	11.89%	12.68%
S&P 500	12.97%	17.03%
Long-Term Corporates	8.99%	11.90%

Source: Ibbotson Associates

One would also expect that convertibles would participate in some, but not all, of the upside and downside movement of stocks, and this, too, is what has happened. Importantly, this participation in the equity movements is asymmetrical, i.e., convertibles have participated in 70% of the upside but just 52% of the downside of equity markets, as the second table shows.

Convertibles are closely, but not perfectly correlated with stocks, and so offer diversification benefits to portfolios, as the third table notes.

Convertible Monthly Returns Relative to the S&P 500 1973-2000

Months When S&P:	Increased		Decreased	
Asset Class	Mean Return	Standard Deviation	Mean Return	Standard Deviation
Convertibles	**2.65%**	**2.33%**	**-1.60%**	**2.93%**
S&P 500	**3.81%**	**2.90%**	**-3.09%**	**3.08%**
Participation	**70%**		**52%**	

Source: Ibbotson Associates

We think this asset class is attractive today, for two broad reasons. First, the convertible market itself has grown to about $600 billion worldwide, encompassing sub-sectors of domestic and international, investment-grade and high yield, arbitrage, or hedged, and "busted", or distressed, securities. What was once a small market of mostly well-below investment-grade credits, convertibles are a legitimate, growing asset class, although one still with many inefficiencies and opportunities. The second attraction to this sector is the market environment described above. The convertible index yields about 5%, although there is a wide range on individual securities. This yield is not far below bond yields, and there are even convertibles with yields above their bond yields (mostly where the risk of bankruptcy is high, as convertible holders stand behind bond holders, but ahead of share holders, in bankruptcy court).

Convertibles therefore meet our criteria of generating good cash returns, with lower risk than equities, the opportunity for price appreciation, and yet are still a relatively inefficient market. Regulated investors, such as insurance companies, will find convertibles attractive as equity substitutes since they are assigned a much lower risk for capital computation purposes than equities. Other investors will appreciate the attractive proposition of good returns, less risk and some diversification benefits that convertibles offer portfolios. We believe that this is a good environment for investors in convertibles.

Real Estate is the third non-traditional asset class we'll mention. Historically, only the very largest institutions have been able to invest in real estate because it was all handled on a private basis. That is, large institutional investors invested directly in specific properties. It takes a lot of money to be able to buy a diversified portfolio of individual properties, and it is generally a very inefficient process. Fees are high, valuations are mere guesswork, liquidity is near zero, and portfolios are never really sufficiently diversified.

Real Estate Investment Trusts (REITs) were created in the 1970s, and offer investors an opportunity to purchase real estate trusts and operating companies on listed exchanges. Their combined capitalization is small, about $155 billion, representing a little over 1% of the Russell 3000 Index. Standard & Poor's has refused to include any in their 500 Index, although that is under review presently.

REITs offer investors liquidity and diversification otherwise unavailable. They have also opened this asset class to investors with less than the billions of dollars needed to fund a proper private real estate program.

The returns on real estate are a function of three

Convertibles Can Enhance Portfolio Efficiency

Asset Class	Correlation with Convertible Bonds*
Large-Capitalization Stocks	0.82
Small-Capitalization Stocks	0.85
Long-Term Treasury Bonds	0.33
Intermediate-Term Treasury Bonds	0.29
Treasury Bills	-0.06
Long-Term Corporate Bonds	0.39
Intermediate-Term Corporate Bonds	0.44
Mortgage-Backed Securities	0.32
Real Estate	-0.07

Source: Ibbotson Associates

**Calculated using monthly total return from 1973-2000, except mortgage-backed securities (monthly returns 1976-2000) and real estate (quarterly returns March 1978-Sept. 2000*

factors: (1) the cash generated; (2) the rate of growth of the cash generated; and (3) the appreciation of the property values. The first variable, the cash generated, is usually the rent received. There are REITs that derive cash from asset sales, usually raw land sold to developers, but rent is the usual source of cash. The growth rate of that cash is typically linked to inflation, as most rents have a built-in annual increase. Lastly, property values historically increase at about the rate of inflation.

Ignoring the effects of leverage on the equation, which could help or hurt returns, the current yield on REITs is approximately 6½%. The increase in rents and the appreciation of property are both around the rate of inflation, let's call that 3% each. Adding it all up gives us an expected return of 12½%. That's too high (he said subjectively). Let's assume vacancies rise and rents fall, bringing the yield down to 5%. Let's assume inflation is 2%, not 3%, that still brings us to an expected return of 9%, about the same as equities.

We don't mean to insinuate that there is a mathematical precision to all this, because there is not. But even acknowledging that our assumptions are wrong, it seems to us that here you have an asset class with expected returns pretty close to equities, with a lot less risk because the preponderance of returns is generated by cash and not by price movement, with low correlation to other asset classes (around 0.6 to stocks, 0.4 to bonds). The NAREIT Index returned 24.4% over the past twelve months, 5.3% over the past three years, 11.0% over the past five years and 12.4% over the past decade (annualized). In contrast, the Russell 3000 Index declined 13.9% for the past twelve months, and gained 4.3%, 13.8% and 15.0% annualized over the past three-, five- and ten-year periods, respectively. From 1975 through 2000, REITS have returned 16.5% annually, compared to 16.1% for the S&P 500 Index and 9.0% for the Lehman Gov/Corp Index.

TIPS, Convertibles and Real Estate all seem particularly attractive to us in today's environment, and we encourage investors to consider allocations to these non-traditional asset classes. Generating an acceptable level of return in the future will likely be as much about controlling risk as identifying high performing sectors, and these three assets provide a good combination of reasonable return and lower risk. Within equity portfolios, we continue to favor small cap stocks and a value bias. And while we painted a pretty grim picture of the world economy, we remind ourselves that markets do not reflect the past, but discount the future. Our attempt to highlight overlooked areas of the investment world reflects our desire to position our portfolios for the future environment, not the past one. The fog will eventually lift, and we'll keep the top down so we can be the first to feel the sun shine. ◆◆◆

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JULY 2001