Angeles
INVESTMENT ADVISORS

SECOND QUARTER 2002 COMMENTARY **JULY 2002**

THE FIFTH SUN

During renovation work in 1790 at El Zócalo, Mexico City's central plaza, this amazing artifact, the Aztec Calendar Stone—three feet thick, 12 feet wide and weighing 24 metric tons—was discovered. At the center is the sun god Tonatuih, his tongue in the form of a knife, while in each claw-like hand he grasps a human heart.

The Aztecs (the Spanish word for the Mexica people) believed there would be five creations and destructions of the universe, and that they were living in the fifth, and final creation, after which would follow eternal darkness. Their own world of the Fifth Sun was created at the ancient site of Teotihuacan through the sacrifice of the god Tonatuih, who flung himself into a fire in order to reappear in the sky as the sun. To sustain its movement across the sky, other gods sacrificed their own blood. In order to repay this blood-debt to the gods, to keep the sun moving across the sky and to perpetuate the era of the Fifth Sun, humans were sacrificed at the Teocalli, the vast temple built at Teotihuacan.

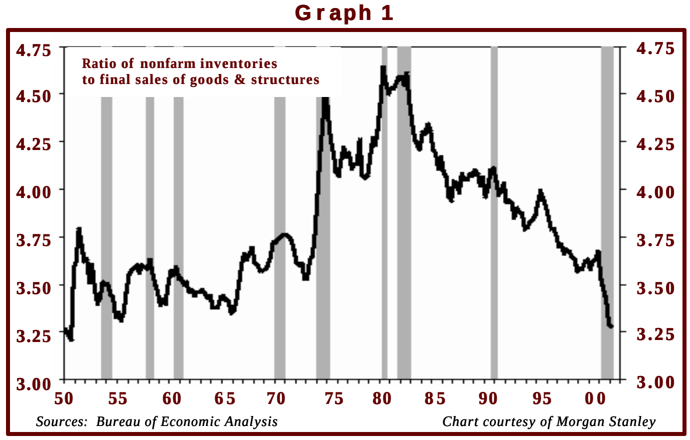
The chaotic powers of nature were of enormous concern to the Mexica, and they went to great lengths to avoid these destructive forces. The occasional human sacrifice to sate the gods, in this context, could be seen as a reasonable price to pay to forestall eternal darkness and maintain a harmonious relationship with these mysterious and powerful forces of destruction.

Ritual sacrifice has been our response to the mysterious and powerful forces of destruction for all of recorded history, and today is no exception. Following the bursting of every bubble, markets conduct their own version of these rituals, sacrificing, as the Mexica did, the guilty and innocent alike. General Electric, Microsoft, Intel, Cisco have *each* lost more than $300 billion from their market peaks, representing declines of 50-80%. The last great bear market of 1973-74 saw similar performance from the leading companies of the day: General Motors, Coca-Cola, Sears Roebuck, Eastman Kodak, Avon Products also fell 50-80%. In one of nature's surprisingly but frequently sighted symmetries, in the two-year period of 1973-74, General Electric lost 54% of its value. In the (nearly) two years since September 2000, GE has lost 54% of its value again.

After the purge come the lawyers. Bernie Ebbers, Ken Lay, John Rigas, Dennis Kozslowski and many others may end up in prison, much as Michael Milken, Ivan Boesky, et.al, did a decade ago following the collapse of the junk bond market, or Richard Whitney, chairman of the New York Stock Exchange, did in the 1930s. "The lust of gain which animated all speculators is now changing into the cruelty of a reign of terror and the ferocity of revenge …. The world of speculation is transforming into a world of litigation." So wrote a Glasgow newspaper in 1846 in the aftermath of the railroad speculation of that era. (Thanks to Barton Biggs of Morgan Stanley for digging that up).

We'll come back to the depth of depravity in the financial markets, but we didn't want to get too far along without noting the (somewhat) encouraging signs in the economy. As the markets melt in the summer sun, the economy is cooling off, and that's both good and bad.

Graph 1



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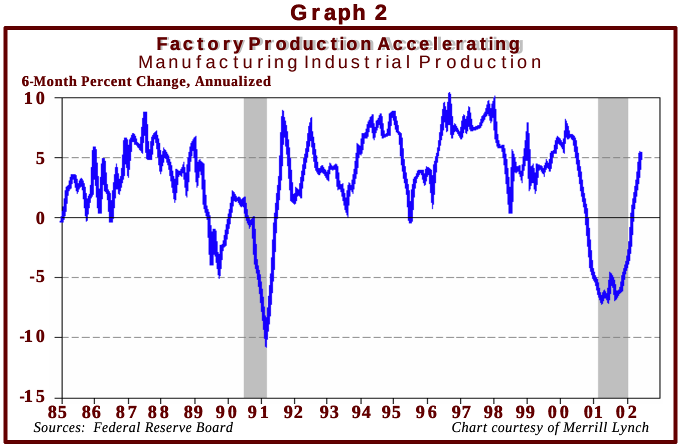
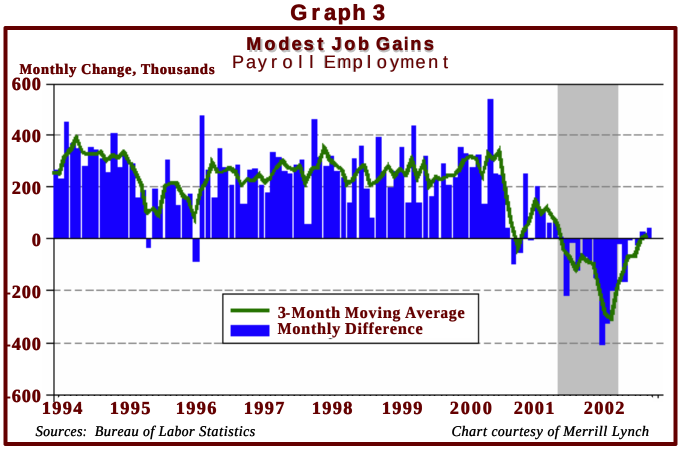
As we noted in our January letter, the fourth quarter of 2001 saw the largest inventory liquidation in our history. The good news is that this process is now over. The inventory-to-sales ratio has fallen to historic lows (Graph 1), setting the stage for a pick-up in economic activity with low inflation, as seen in Graphs 2, 3 4.

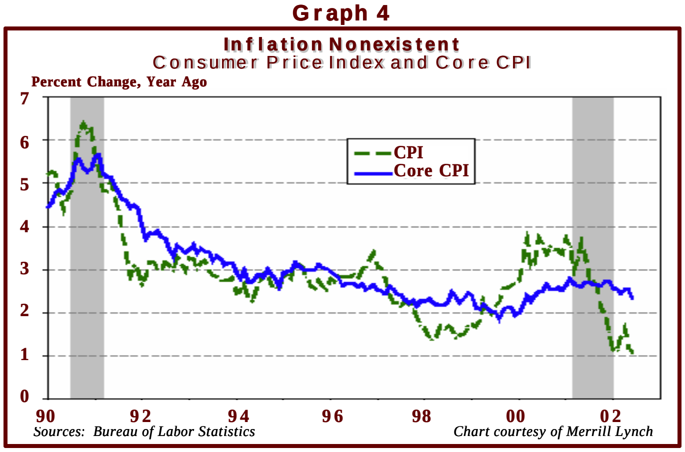
Graph 2



Graph 3

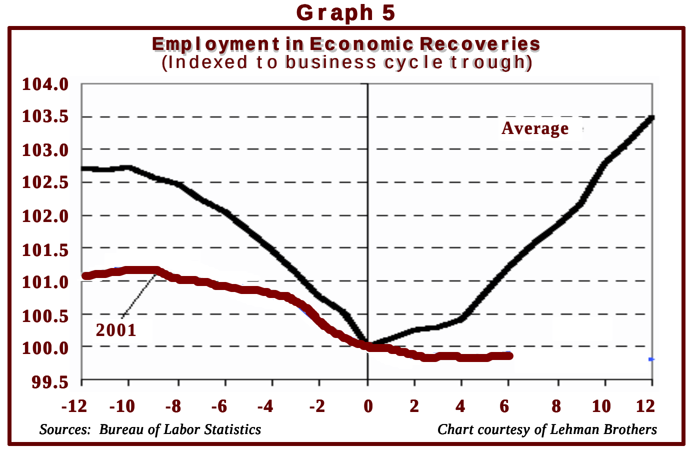


Graph 4



But economic activity is much weaker than we've seen in post-World War Two recoveries, as seen in Graph 3 and 5.

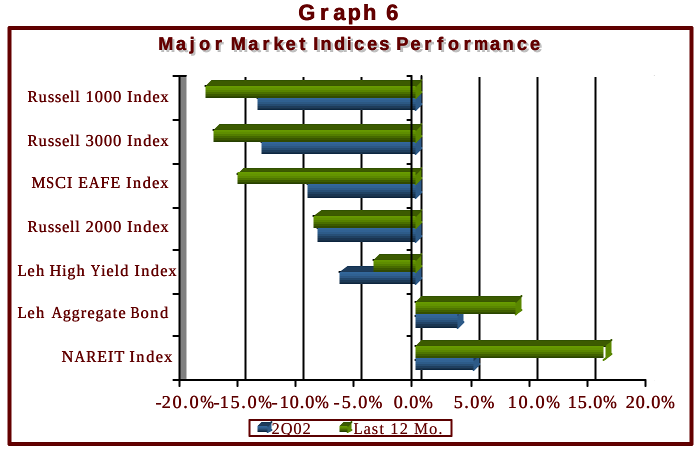
Graph 5



Outside of investment-grade bonds and real estate, last quarter had nowhere to hide, with negative returns in equities large and small, domestic and abroad. Appropriately, the best performing stock in the S&P 500 Index last quarter was Big Lots, up 40%, a retailer of extremely cheap junk (no offense to its many patrons and its many more patrons to be). The worst performer in the Index, of course, was Worldcom, off about 82%. Every one of the ten major sectors of the Index declined in the quarter, with half the drop attributed to technology and telecom. Lest we be too hard on Worldcom, its year-to-date return of -91% was still only the ninth largest negative contributor to the cap-weighted S&P 500 Index: GE, Tyco, Intel, IBM, AOL, Microsoft, Citigroup and Bristol Myers were the eight biggest drags on the Index the first half of this year.

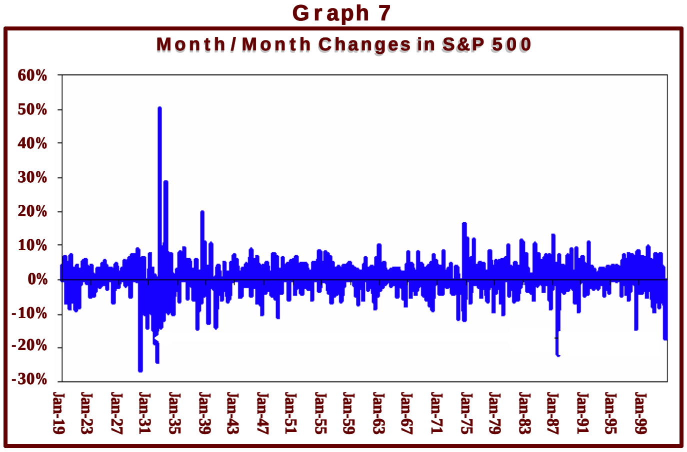
The good news about the June quarter is how good it will look to investors after they've seen their July

Graph 6



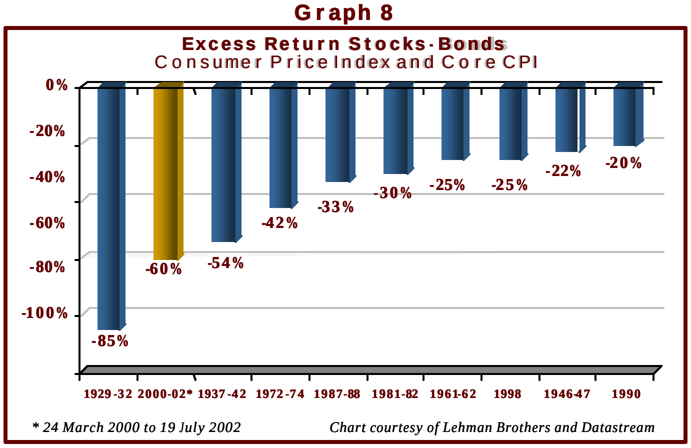
statements. A late-month rally may help, but through mid-month, July was looking like the fifth worst month on record for US stocks, according to our friends at Bridgewater Associates.

Graph 7



Equities have not only taken a beating in absolute terms, but relative to bonds this has been the worst period for stocks since 1929-32:

Graph 8



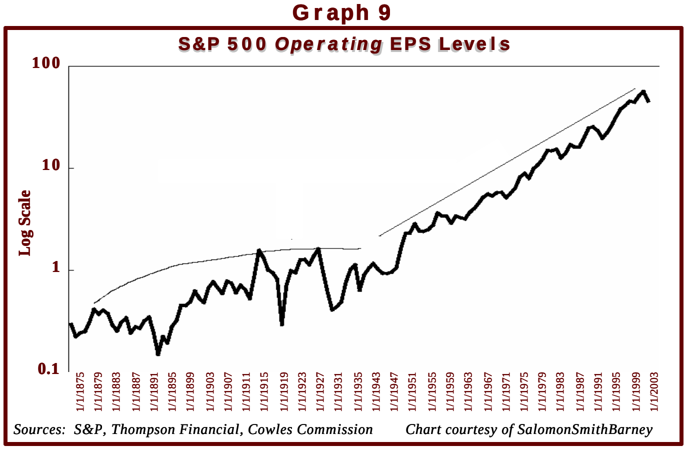
This information will either dismay or please you. The dismayed may foreswear equities forever, wondering whether stocks will ever outperform bonds again, and rationalizing that the pain of loss is hardly worth the brief elation of elusive gain. Others may view the data as vindication of their long-held view that stocks were and are grossly overvalued, probably ever since the dividend yield fell below the bond yield in 1958, but certainly well before Chairman Greenspan's irrational exuberance speech in 1996. Stocks have further to fall, say these happy Puritans, in part because they're not cheap by some measures, and partly because we deserve more pain as penance for the excesses of the last years of the 1990s.

Our view, as you might expect, lies between these extremes. Equity returns are a function of three variables: earnings growth plus dividend yield plus speculative return. Earnings growth is closely correlated with GDP; in the 20th century, both grew at about 5% annually. The dividend yield is currently about 1.8%. Just adding these two numbers yields an expected return of 6.8%, but we believe the dividend yield is unreasonably low, certainly well below the 4.7% average yield in the 20th century and even the 3% average yield in bull market of 1983-2000. Corporate finance theory says that companies should retain earnings if there are good investment opportunities, and return earnings to shareholders as dividends if there are not. In 2000, a record low of just 31.8% of earnings were returned as dividends versus an historical average payout of about 60%. One explanation for the low payout ratio was that companies had many good investment opportunities, and the fact that earnings grew at 8.7% over the period 1983-2000, well ahead of GDP growth, supports this explanation. A return to higher dividend payouts seems likely to us in this environment of slower growth.

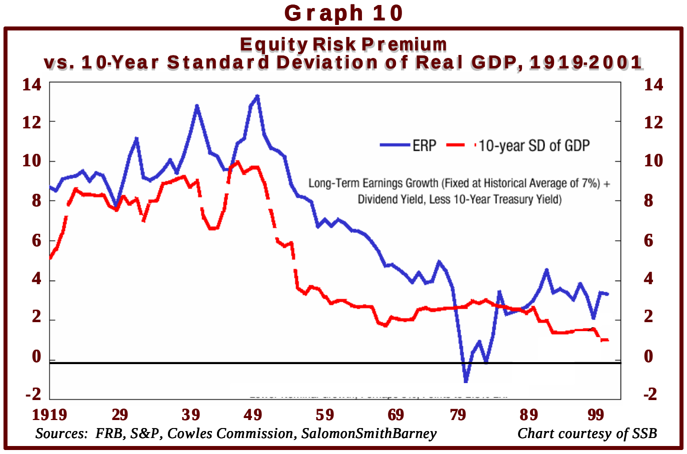
It's this last variable of equity returns, speculative change, manifested in the price-to-earnings multiple, that distinguishes the doomsayers. Multiples are still near historic highs, for despite the 40% decline in prices, earnings have plummeted by a near-equal amount. Another measure, dividend yield, is also near record lows, further evidence of an overvalued market.

We acknowledge that further contraction in the P/E multiple is possible, and that this would serve to lower *current* returns (and raise *future* returns), but we think the gloomsters miss three salient points. Barring an economic depression, earnings are near the trough, and growth can realistically exceed GDP growth in the coming years, just as earnings declined far more than GDP did in 2001. Secondly, inflation and interest rates are low, conditions that historically have, and should, correspond with higher multiples. Investors are willing to pay more for future earnings if inflation and interest rates are low than if they are high. Lastly, there has been a structural shift in our economy over the past fifty or so years, toward lower economic volatility, as we have seen less frequent and less severe economic contractions. This fact has a number of important consequences, including higher GDP (and corporate earnings) growth, and higher valuations for stocks versus bonds. Graph 9 shows earnings growth on a log scale since 1875, and you can see the accelerated trend starting mid-century. Graph 10 shows a fifty-year decline in GDP volatility accompanied by a similar decline in the risk premium between stocks and bonds.

Graph 9



Graph 10



We believe that these long-term structural trends are permanent, i.e., unlikely to be reversed, and this has profound implications for investors. For one, P/E multiples are likely to remain higher than the 100-year average, undercutting the key argument of the doomsayers that equity prices still have a long way to fall. But our view also implies that the excess return investors receive in equities over bonds is likely to be much lower than the 20th century arithmetic average of 5.8%. In other words, we expect a period of higher valuations and lower returns.

An era of low nominal returns across financial assets highlights the importance of income to investors. This is one of the factors behind our encouragement that investors consider allocations to high yield debt, real estate and convertible securities, for example. We reiterate our continued support for these asset classes.

According to the Mexica calendar, the last day of the solar cycle and the last day of the sacred cycle coincided every 52 years. On this day, the Fifth Sun was most in danger of extinction, and, of course, there would be no Sixth Sun. So on that evening, all lights throughout the empire were extinguished and a noble captive guided to the sacrificial stone at the Teocalli, the main temple. The astronomer-priests watched the horizon for the appearance of the star cluster Pleiades. At the moment of its zenith, with no time to lose, a razor-sharp knife would open the honored victim's chest, his heart withdrawn, and the priests would work furiously to ignite a fire in the chest cavity. If successful, the Fifth Sun would illuminate the world for another 52 years. A waiting line of runners would light their torches with this flame, spreading light first to the temples and then throughout the empire.

America, nearly alone among nations, has a remarkable capacity to remove, reform and rejuvenate its institutions when they fail. Our institutions have failed: accountants failed their public trust, corporations failed the truth, creditors failed to apply prudent lending standards, politicians failed to legislate necessary reforms. Investors failed too: failed to apply sufficient scrutiny and judgment to the actions and inactions of all of the above.

All these institutions will propose reforms; reforms of themselves and reforms of the others. But all these reforms will be insufficient if not led by the rightful leaders, the ultimate owners of wealth, investors.

We think the Mexica people had it right. The Fifth Sun fights a daily battle with the forces of destruction, and needs to be nourished in order to prevail. There are certain times when its existence is most jeopardized, and extra sacrifice is necessary. Investors need to lead the reforms of our institutions if we hope to rejuvenate them. After all, as the Mexica knew, there is no Sixth Sun.

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JULY 2002