Angeles
INVESTMENT ADVISORS

THIRD QUARTER 2005

Conversion

William Fisher, recently promoted to the rank of captain in the British Army, set out in 1840 with his new bride for Ceylon, where he was to take up the assignment as aide-de-camp to the governor. The following year, the first of their eleven children was born. John, forever known by his nickname, Jacky, was an insufferable child, as later events would confirm, and at the age of 13, he was sent off to serve in the British Navy.

His first ship was the *HMS Victory*, Nelson's illustrious flagship at the Battle of Trafalgar some 50 years before and his first action in battle occurred at Taku, China in 1859. Unfortunately, Taku was the only major defeat of the Royal Navy in the nineteenth century, and the only battle Fisher ever fought in. He never got the chance throughout his long naval career to command a fleet, much less a single ship, in battle. Along the way, his blunt and abrupt manner managed to offend virtually everyone he met, from sailors to kings.

Yet, Jacky Fisher would become the most important naval figure in British history, arguably in world history, surpassing even Nelson or Mahan in influence. Fisher's accomplishments were profound, tied together by a timeless theme. We'll come to this theme in a moment, but for now, we'll say that military planners and investors both would do well to study the career of Jacky Fisher.

Equities, everywhere, had an impressive quarter. US stocks added 4%, but the non-US developed markets surged more than 10%, and emerging markets 18%. In these three months, Japan jumped 20%, but the real stars were Argentina and Brazil, up 49% and 36% in USD terms, respectively.

In contrast, the bond markets were fairly dismal, posting negative returns as interest rates rose across the curve and around the globe. This divergence between stock and bond prices has at its roots the same factors: strengthening economic growth and rising inflation. Real GDP grew at a 3.8% annual rate in the third quarter, the tenth consecutive quarter of +3% real growth, a span not seen in over 20 years. The economies are not nearly as

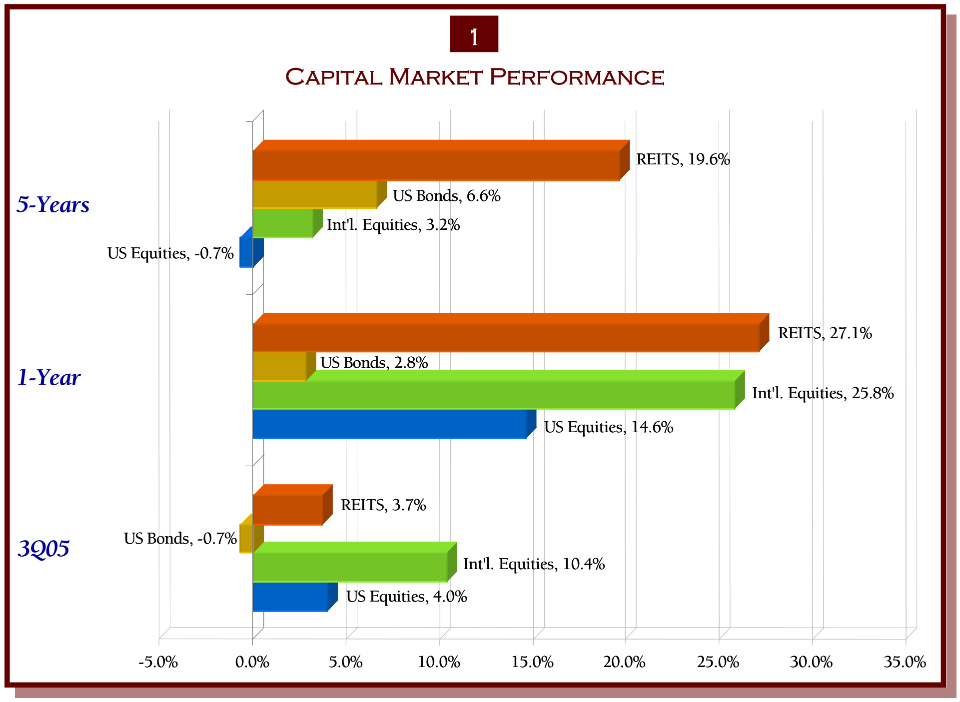
INSIDE GRAPHS:

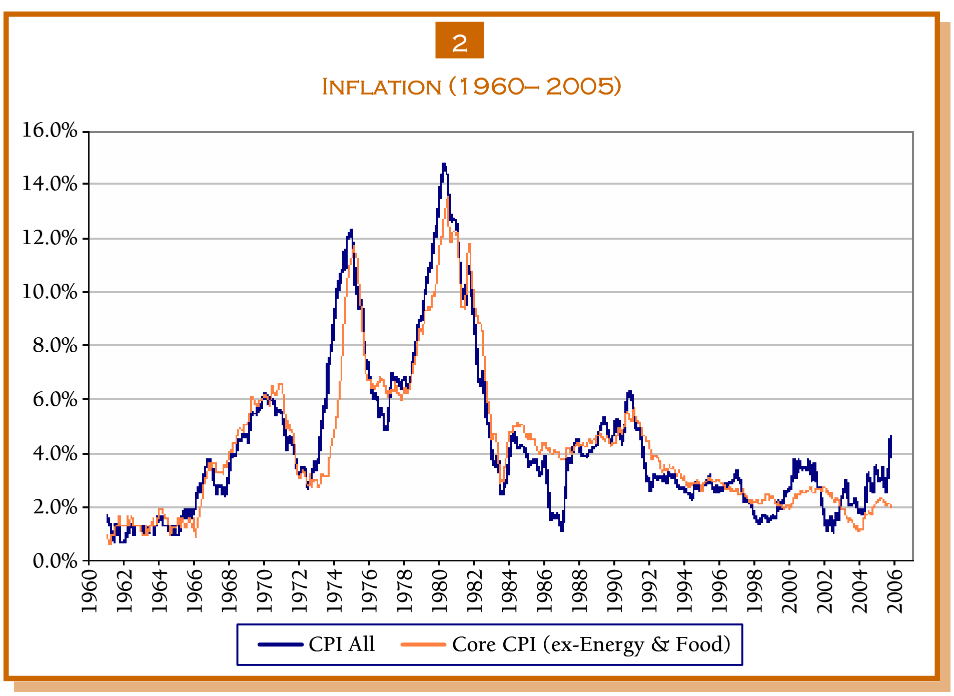
strong in Europe or Japan. Europe will see growth of barely over 1% this year, and Japan has posted three straight quarters of economic contraction, despite some evidence of an economic rebound in the employment data.

Of course, economic growth does not cause inflation (inflation is purely a monetary condition), but inflation is indeed rising. In the UK, inflation has been above the Bank of England's target for five consecutive months, and is running at a rate of 2.6% in Europe, ahead of the ECB target of 2%. In the US, a 12% jump in energy costs in September pushed the annual inflation rate to 4.7%, the highest since 1991 (see Graph 2).

In recent years, there has been a colossal struggle between the secular forces of deflation, led by a huge shift in the supply of labor as China and India, in particular, but also Russia, Brazil, Eastern Europe and elsewhere have joined the global economy, and the cyclical inflationary pressures seen most prominently in the prices of raw materials (see Graph 3, page 3) caused by the surge in demand in emerging economies and in world trade flows.

The secular, deflationary impact of growing labor supply has a long way to play out. Nearly 75 million people migrate from the countryside to the cities in China *each year*, adding to the workforce, and this pace will continue at least through the rest of the decade. The pressure this brings to global wages will be present for years to come.





US Department of Labor, Bureau of Labor Statistics

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REUTERS–CRB® INDEX (CCI) (1987=100)
(MONTHLY CLOSE) SEPTEMBER 1956–OCTOBER 2005

Source: Reuters-CRB

But inflationary pressures, five in particular, are building. Four of these relate to supply/demand constraints: soaring commodity prices, low unemployment, rising factory utilization and falling productivity. All these factors suggest higher input costs and higher output prices. The fifth factor is loose monetary policy. Despite the 300 basis point increase in overnight rates, *real* rates (adjusted for inflation), remain low (see Graph 4).

Low real yields have been a boon to investors chasing yield and engaging in carry trades (the purchase of high yielding assets by borrowing in or shorting low yielding assets). Hence, the tremendous compression in spreads in credit and emerging market debt. Real yields are still low, but the return opportunities available the past few years have nearly vanished. In October 2002, perhaps the peak in risk aversion (equity volatility was 40% versus 13% now, and this marked by the bottom of the vicious bear market in equities), US "junk" bonds yielded 12% over cash, emerging market debt was priced at 15% over cash, utility stocks yielded 5% and the ten-year Treasury yield was 250 basis points more than cash. US high yield and

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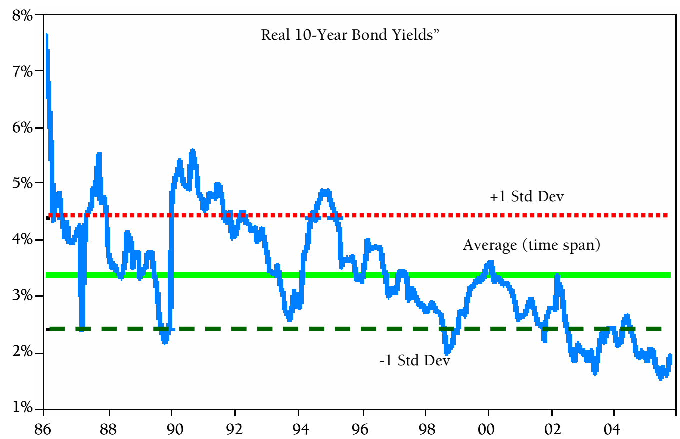
OECD BOND YIELDS



Graph Courtesy Goldman Sachs

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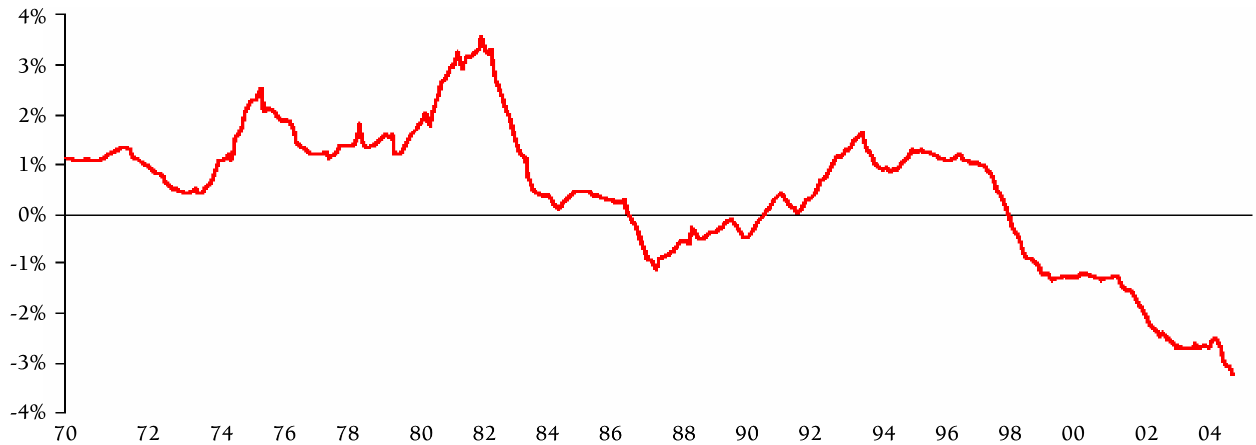
EMERGING MARKET RELIANCE ON FOREIGN CAPITAL % GDP



Graph Courtesy Bridgewater Associates

emerging market debt now offer only about 3% over cash, utility stock dividends pay less than cash yields, and the ten-year Treasury yield is less than 50 basis points above cash. Russian debt, for example, pays a mere 120 basis points over US Treasuries. There are many sound reasons for the compression of these spreads, including much stronger corporate balance sheets and emerging market current account balances, but it seems to us that the market fully (or more than fully) reflects this.

Still, the big difference between today's emerging market boom and past cycles is the reliance on foreign capital (see Graph 5). In contrast with previous periods, emerging markets are exporting capital, reducing debt and accumulating wealth. Lest we identify China and emerging markets synonymously, let's remember that there has been an enormous rise in the capital accumulation of OPEC countries, which now run surpluses greater than any country or region in the world (which should be no surprise to anyone who has been to a gas pump—see Graph 6).

What is common throughout periods is that emerging market cycles are driven by liquidity and exports. Despite the compelling secular story, internal markets are underdeveloped, and it has been liquidity flows that have driven these economies by lowering the cost of capital, boosting investment and exports, which earn more capital, and the virtuous cycle continues. But should exports falter, perhaps as supply and demand become imbalanced (through excess supply and/or weaker demand), the cycle could turn down and liquidity dry up. We don't know that this will occur, and certainly there have been many an expert embarrassed about predicting an end to the apparently insatiable consumer demand (especially

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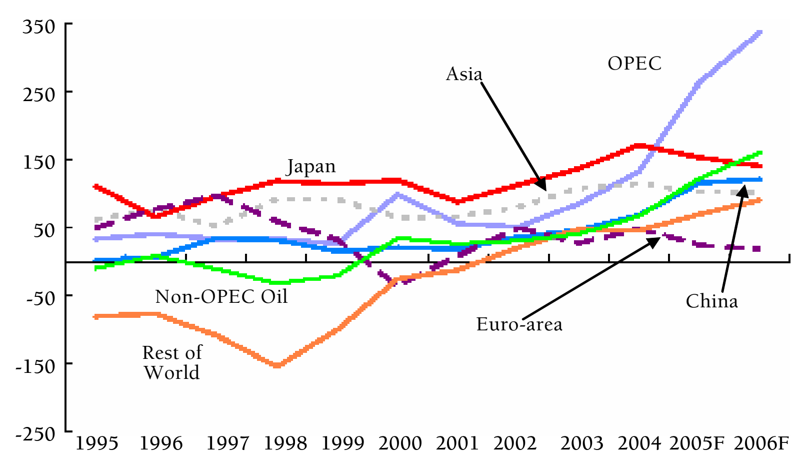
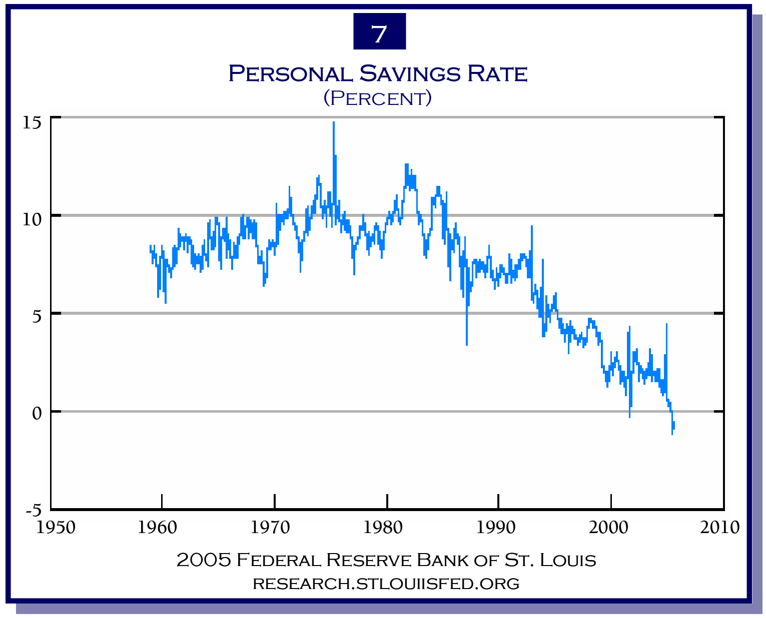
CURRENT ACCOUNT SURPLUSES IN THE WORLD (USD BN)



Source: IMF WEO and Morgan Stanley Research among American consumers). But we highlight this scenario as a very plausible development that carries risks investors haven't seen since way back in 1998.

Betting against the American consumer hasn't worked since the 1930s, but by most measures, we're pretty stretched. We are (collectively, that is) spending more than we earn (see Graph 7—Personal Savings Rate) and our debt/income ratio continues to set records (see Graph 8). Housing affordability has fallen to a 14-year low at the same time real estate represents 39% of household net worth, an all-time high.

Betting against the dollar has also been a fool's pursuit this year, but we'd like to draw a distinction between relative value and absolute value. The dollar's relative strength against most major currencies reflects myriad forces, including interest rate differentials and economic growth (both higher in the US than abroad). But the dollar (or any fiat currency for that matter) as an absolute store of value is a different (uglier) picture (see Graph 9, page 6). The dollar has lost more than 92% of its value since 1792, or even since 1930, for that matter. The message here is, beware inflation (or, alternatively, don't trust your government).

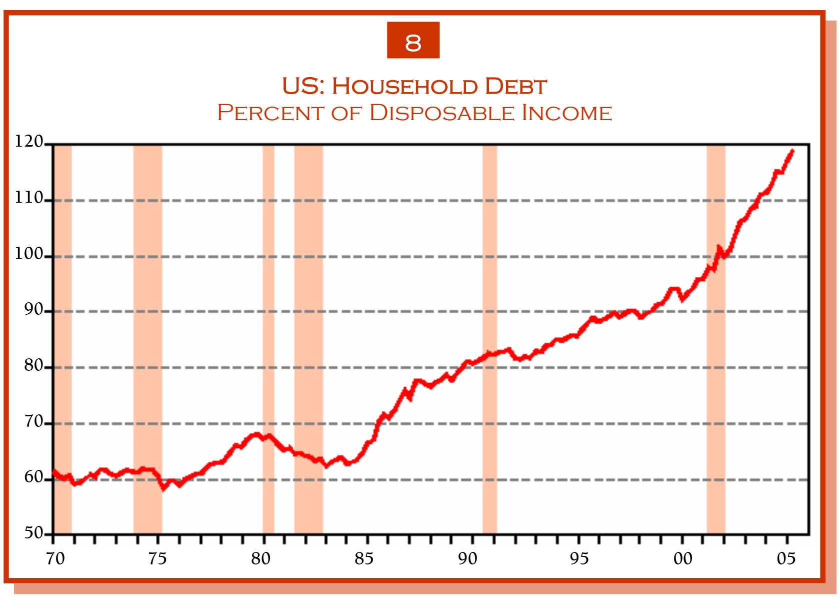


Source: U.S. Department of Commerce: Bureau of Economic Analysis

Cardiff, the coastal capitol of Wales, is a small city, only about 300,000 people, but in 1900, it was easily the largest port in the British Empire. Coal was the reason, as the local Welsh mines produced the finest coal in the world. The largest users of coal were the world's navies, each with its own global network of coaling stations, each demanding Cardiff coal to stockpile. It is no exaggeration to say that the global economy in 1900 ran on coal, most of which was dug out by Welsh miners and passed through the port of Cardiff.

From behind his desk, having seen no action since Taku in 1859, Jacky Fisher grew impatient with the naval bureaucracy. Upon his appointment as Third Sea Lord in 1892, he walked around the Admiralty with a placard around his neck announcing, "I have no work to do." That said, it was Fisher who masterminded the concept of both a torpedo boat destroyer and a flotilla defense of small surface ships and submarines both to defend against attacks and command the narrow sea lanes around Britain.

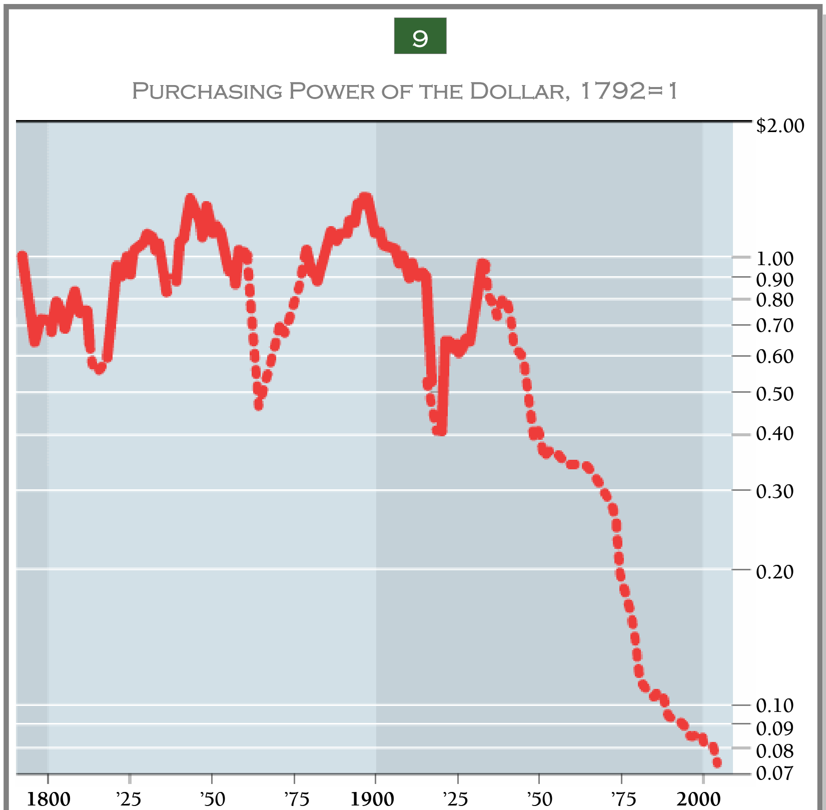
In 1904, Fisher became First Sea Lord, and proceeded to scrap the entire fleet, calling his ships "a miser's hoard of useless junk." His revolutionary concept was to create a new core of the navy comprised of all big-gun ships, bigger than had ever been imagined. The result was the *Dreadnought*-class of battleships which, when intro-



Source: FRB Flow of Funds, Bureau of Economic Analysis *Graph courtesy Merrill Lynch* duced in 1906, made all other naval ships obsolete, as it was faster and more powerful than anything afloat.

A few years earlier, Marcus Samuel, the founder of Shell Oil, had pressed the British navy to switch from coal to oil. This notion met with derision for very sound strategic reasons. The source of coal was secure, as it was mined within the country, whereas oil had to be obtained from abroad. The infrastructure of coaling stations around the world was already established, as was the engine technology in ships geared to burning coal. Coal was also inert and would limit the damage caused by an explosion. No, the British navy was not about to entertain the silly notion of abandoning Cardiff coal for foreign oil.

The British navy was not receptive to this idea, but Jacky Fisher was. His mantra was "faster and bigger," hence the controversial Dreadnought design. He realized that oil would offer distinct advantages to the navy, not withstanding how successful Britannia already ruled the waves. Oil contains twice the thermal content of coal, meaning boilers could be smaller and ships could travel twice as far with greater speed. Refueling could occur at sea via tankers and pipes, a procedure impossible with coal.



Source: Chart by American Institute for Economic Research, from the Wholesale Price Index complied by the Bureau of Labor Statistics

Fisher found a like-minded nonconformist in Winston Churchill, to whom he extolled the virtues of an oil-powered navy. Upon becoming First Lord of the Admiralty in 1912, Churchill rocked the naval establishment by siding with Fisher and ordered all ships to convert to oil. To secure supplies, since he was loathe to be dependent on Samuel's oil company, Churchill created the Anglo-Persian Oil Company, majority owned by the British government, as the sole supplier of oil to the navy. Anglo-Persian Oil evolved into British Petroleum, and its creation marked the beginning of the now century-old race to secure Middle Eastern oil.

Investors have benefited these past few years from the surge of liquidity provided by central banks. Liquidity lessened many risks, and investors were amply rewarded for taking risk. Why change?

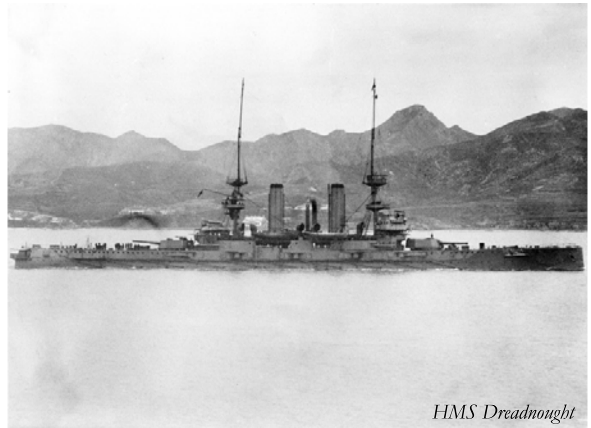
Of course, that was the very question asked by the British naval establishment when confronted with converting from coal. Fundamental changes never occur until they are forced upon us. Following World War One, every navy in the world converted to oil when its advantages were seen in the British Navy. Investors vowed to become less dependent on equities following the brutal bear market, although the subsequent two-year rally may have engendered more complacency than action.

We can see a fundamentally different world than that of the past few decades. A world in which portfolio returns are not measured solely against benchmarks or other investors, but against the individual objectives of each investor, be they an absolute or real return, capital preservation or measured versus specific liabilities. Investment strategy in this context must look different than previous approaches.

Perhaps this shift will be forced upon us; forced, because, as George Eliot wrote so perceptively in *Silas Marner*, *"The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given* *event has not happened is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent."*

Or perhaps an eccentric like Jacky Fisher will persuade us to challenge our assumptions and see the world in a very different way. For Britain, the conversion to oil was just in time. Less than two years later, the Great War began, and supremacy of the seas by the Royal Navy prevented a German victory.

At the outbreak of war in August 1914, Churchill recalled the retired Jacky Fisher to be First Sea Lord again. The following year, over Fisher's strenuous objections, Churchill authorized the disastrous campaign in the Dardanelles. Half a million British and Commonwealth troops were landed at the Gallipoli peninsula with plans to take Constantinople. 44,000 died trying, 100,000 were wounded, and British confidence in their invincibility was destroyed forever. Jacky Fisher resigned in protest over Churchill's plan. Not listening to Jacky Fisher was Churchill's greatest mistake in his life. Investors would do well to remember



HMS Dreadnought

how difficult it is to change, and how important it is to challenge convention. Conversion or convention? The man who transformed the British navy from the age of sail to steam, from coal-fired to oil-burning, from wood to steel, bears remembrance when confronting that question.

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