

Thoughts on the Market – February 2007

The worldwide equity markets weakened today. The global markets had experienced a significant period of strength. The US equity market, in fact, had experienced the second longest bull market run since 1910. However, it was time for some weakening to take place, and such declines are usually considered healthy as valuations are forced back to reasonable levels based upon company fundamentals.

All kinds of theories are typically presented to explain why the markets are weakening or correcting. Technically, corrections are defined as declines of 10% from the highs. To simplify our discussion, weakening and corrections will be used interchangeably, although we are far-off from the correction stage. The reality is, corrections are part of investing in the markets. It happens - and it happens swiftly and when least expected. The key is not to panic and give in to these temporary fears. However, we also have to be mindful of the risks involved.

The sell off in the US markets was triggered by the one of the largest single day declines in the Chinese equity market, as reflected by the nearly 9% drop in the China Shanghai Composite Index. However, this decline wiped out only the past six days trading gain. The Chinese markets have been on a tear since mid-2005, causing some government officials to be concerned, as they feared the evolution of a bubble. This led some officials to comment on the unreasonable valuation of the markets and stressed that steps would be taken to quell the markets. However, despite \$100 BB of market capitalization wiped off in one day in the Chinese markets, it must be emphasized that China, India, and many other emerging markets are not as dependent on the equity markets for economic growth as in the developed markets. Although we expect some slowdown in global growth due to world central banks tightening to moderate growth and subsequent inflation, we do not expect it to slow down to recessionary levels.

Several factors were responsible for the strength of the market synchronized global economic recovery - low cost of debt, rising real estate values, and an expansionary monetary policy by world central banks. In recent times, central banks have been tightening their monetary supply to slow down economic growth, fearing inflation. Despite a series of the world central banks tightening, the world was awash in plenty of liquidity as interest rates remained low compared to historic levels.

When markets rise for long periods, it encourages speculation in the markets as investors - nay, speculators - throw caution to the wind. This is evident in the US with the rise in buying stocks on margin to levels last seen in 1999 and 2000. Appetite for risk was very evident in the capital flows, as investors poured money into more volatile asset classes such as emerging markets and commodities. Much of the investments in emerging markets and commodities were initially supported by low valuations and solid growth exhibited by the natural resource countries in the emerging markets since 2002. The US and the developed international markets likewise were set on an upward trajectory since that time. Thus, a synchronized global bull market emerged from the ruins of a burst bubble that first began in March 2000.

However, bull markets and low volatility don't last forever. Reversion to the mean is one of the most powerful forces in the finance and investment world. Beacon Pointe released a whitepaper in April 2004 titled "Quality Matters". In this article, we made reference to low volatility prevailing in the markets and suggested that it was just a matter of time before it goes up. The recent pickup in volatility is a reflection of our views, albeit one that played out ten months later. We also suggested that in periods of higher volatility, quality does matter. At Beacon Pointe, we tend to gravitate toward managers that buy high quality companies at reasonable valuations. As such, we expect our managers to protect our clients on the downside as they have performed historically. Past performance during market declines leads us to believe that this will likely play itself out should markets continue to decline.

We cannot and will not predict how long and to what extent this correction will last. Beacon Pointe would like to stress periodic corrections are part and parcel of investing in the markets – be it equities, fixed income, commodities, or any other securities. This is necessary to get rid of speculation and excessive valuations not supported by fundamentals in certain market segments. As was highlighted in the paper "Quality Matters", large cap stocks have been trading at historic low valuations, both in absolute and in relative terms.

Research has shown it is futile to attempt to time the market as things have and will change before one anticipate the next move. For more on futility of market timing please refer to our whitepaper, "The Importance of Longer Time Horizons", released in June 2006. Incidentally, this paper was written when markets weakened over the summer of 2006. Our rationale for staying invested in a diversified pool of assets still remains and we are not advocating any major changes to asset allocation. Our clients should expect more volatility in small caps, emerging markets, and commodities and hopefully less in large cap stocks and in the developed world - especially the US - since these stocks have been underperformers for quite a few years. Again, this stems from our view that reversion to the mean is a powerful force in the investment world.

The long-term case for investing in a diversified pool of assets – be it equities, fixed income, or commodities - is still very much intact. If anything, the recent weakening in commodities markets might present us with another investment opportunity. Beacon Pointe's case for investment in commodities was released in November 2006, although at that time we cautioned clients that it was probably not prudent to step in at that time. Beacon Pointe is monitoring the global markets to identify the next set of opportunities and will come up with recommendations should things change from our current asset allocation strategy.