BEACON POINTE ADVISORS

BEACON POINTE RESEARCH

WHY QUALITY MATTERS
APRIL 2006

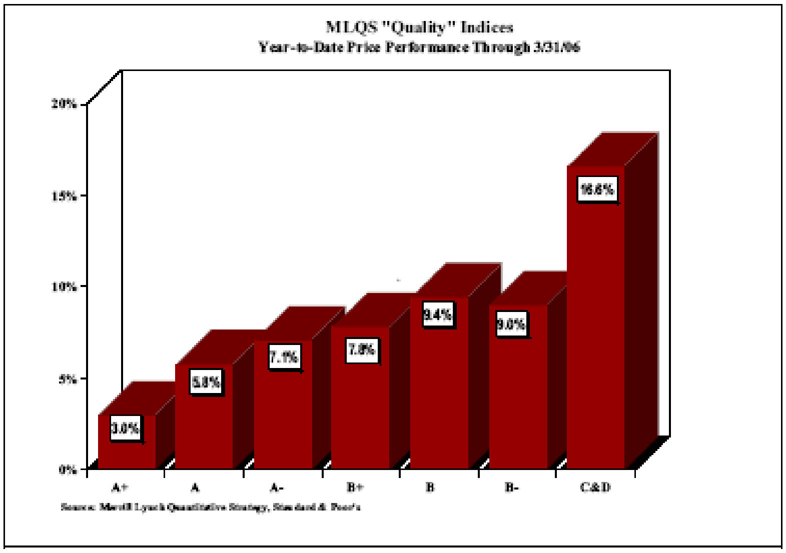
CONFIDENTIAL – PROPRIETARY

500 Newport Center Drive, Suite 125, Newport Beach, CA 92660
TEL 949.718.1600 FAX 949.718.0601 www.bpadvisors.com

Why Quality Matters

- In recent times, investors who believe in the importance of long term investing in quality companies may not have performed as well as those with riskier portfolios. During periods where investors have an increased appetite for risk, quality stocks tend to suffer, as seen in 2003. Thus far, 2006 has shown a theme of lower quality outperforming quality stocks, as illustrated in Figure 1.

Figure 1

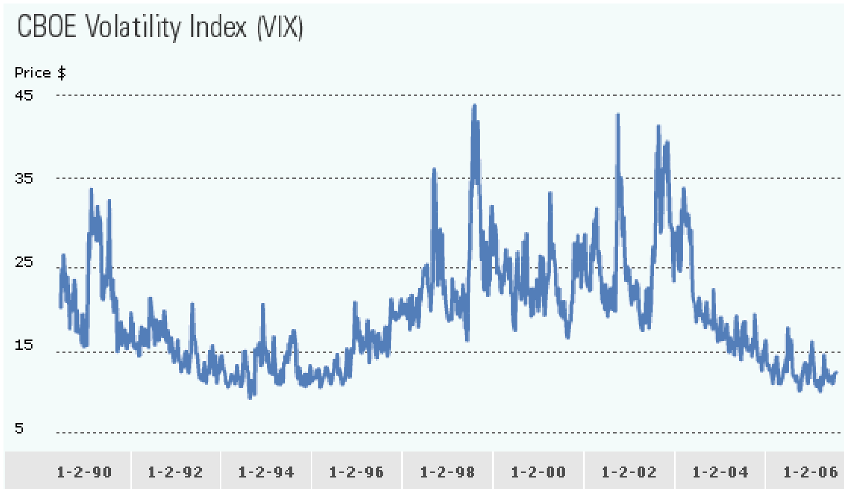


The quality ratings are assigned by S&P based on very objective, quantifiable measures. A+ rated stocks are the highest quality stocks while D rated stocks are the lowest quality stocks.

Source: Merrill Lynch – US Strategy April 2006

- Beacon Pointe would not gravitate towards lower quality investment managers. In the long run, higher quality portfolios with lower volatility perform better than a lower quality, higher volatility portfolios. Beacon Pointe believes that mean reversion is a powerful force in investing. The recent low volatility seen in the equity and fixed income markets (see Figure 2 on the next page) will not last and will eventually revert.

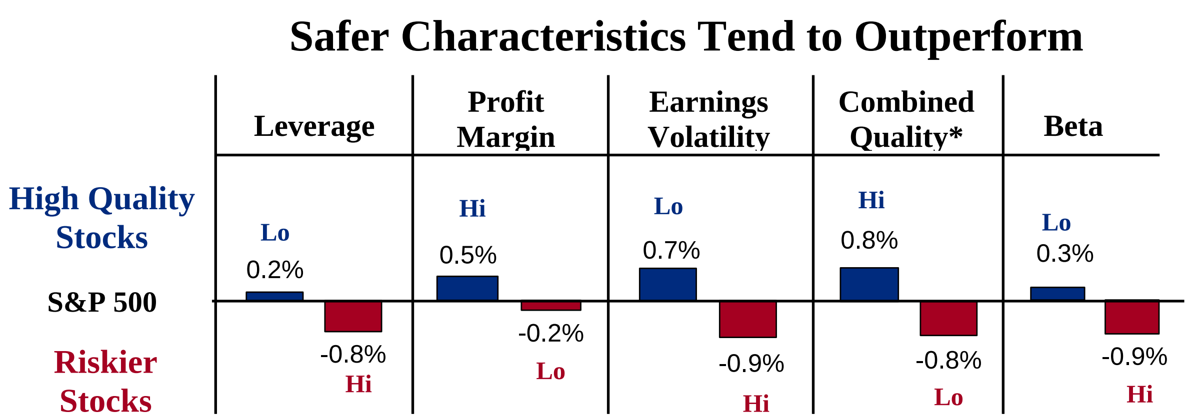
Figure 2



Source: Morningstar

- When volatility reverts to the mean, it is prudent to have a portfolio with safer, defensive characteristics, as evident in a study from Grantham, Mayo, and Otterloo (GMO) shown below in Figure 3. This is due to the fact that when volatility rises, stock prices tend to revert to their intrinsic value. GMO analyzed monthly data beginning in January 1965 and observed that despite capital market theory, which posits that higher returns can be achieved by taking on higher risk, risk and returns are negatively correlated. The numbers in Figure 3 below are the excess returns or negative performance relative to the S&P 500 returns for the various factors.

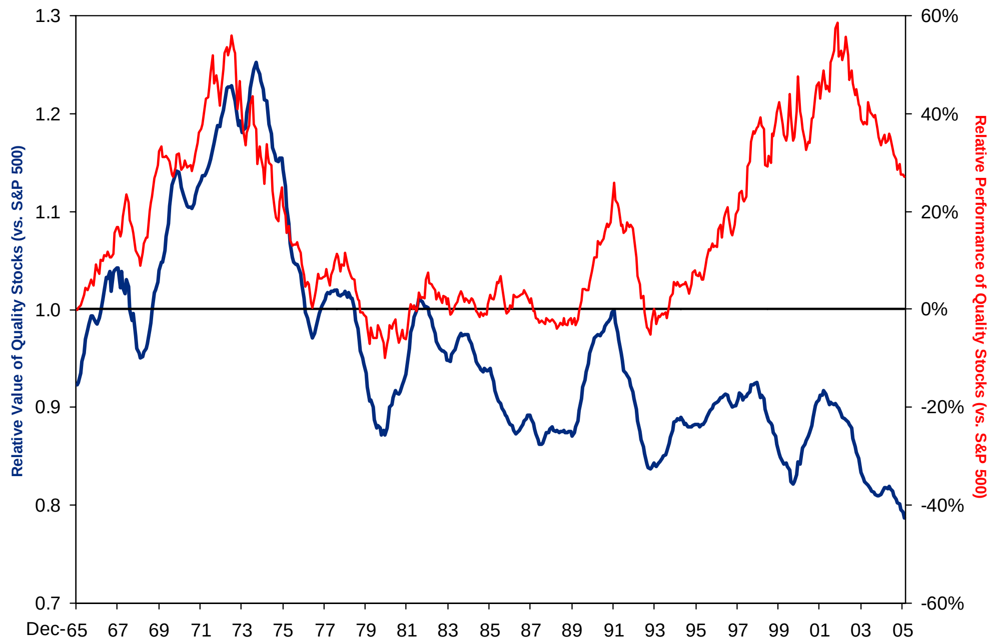
Figure 3



Source – GMO Presentation – The Wyle E Coyote Market, April 2006.

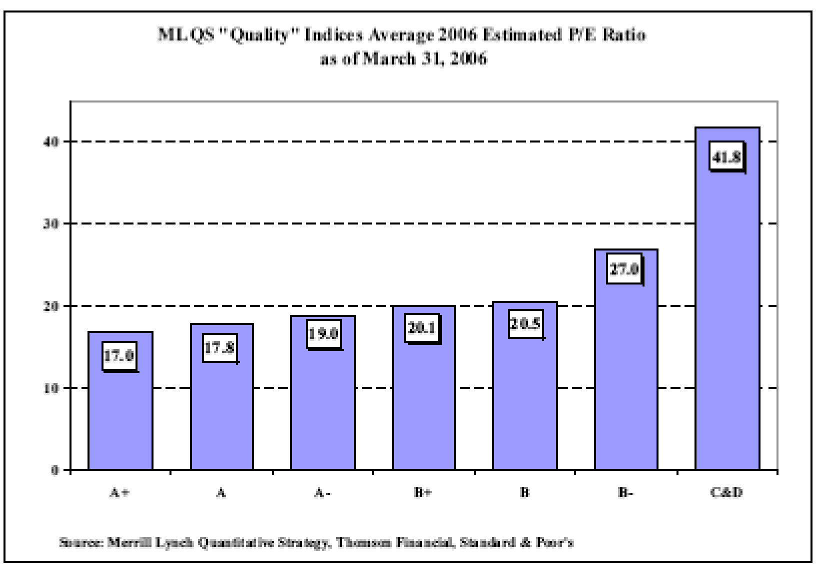
- Large cap quality names exhibit the above-mentioned safe characteristics and are available at one of the cheapest valuations in history. This low valuation is evident in Figure 4 on the next page. As can be seen in the figure, higher quality stocks are trading at about 40% discount to the S&P 500 valuation levels.

<u>Figure 4</u>



- The valuation discrepancy is also apparent in the price earnings multiple dispersion between low quality stocks and higher quality stocks. As shown in Figure 5 below, the lower quality stocks are more expensive than higher quality stocks.

<u>Figure 5</u>



Source: Merrill Lynch – US Strategy April 2006

- Another important element supporting higher quality large cap companies is that the recent fifteen interest rate increases, plus the likelihood of one or two more interest rate increases in the pipeline, will at some point in time slow down the economy. In a slower economy, investors gravitate towards large, quality companies that have lower valuations, higher dividends, and higher earnings stability.

- From a contrarian standpoint, Beacon Pointe is slightly concerned that the case for large, high quality companies is the conventional wisdom prevailing in the market. Historically, conventional wisdom is typically incorrect or too early. As such, Beacon Pointe is of the belief that a fully diversified portfolio that has exposure to all major asset classes is still the prudent course of choice for our clients.

- Beacon Pointe's investment philosophy leads us to managers that emphasize higher quality stocks in their portfolio. As such, when lower quality stocks lead the market, our managers tend to lag their peers. However, over a full market cycle that encompasses both a bull and bear market, Beacon Pointe managers will outperform their peers and typically place in the top quartile of their universe of peers.

- Please contact your Beacon Pointe consultant should you have any questions.