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MARKET ANALYSIS – IMPORTANCE OF LONGER TIME HORIZONS

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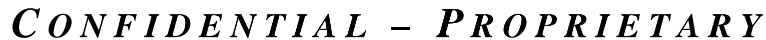

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Market Analysis

After a solid bull run in global equity markets that started in October 2002, investors have become nervous as the markets have cooled. This recent cooling period stems from a combination of inflation fears, as well as fear of future interest rate increases from the Fed. Investors are expecting the world economy to slow as the Fed considers raising the interest rate further due to its focus on taming inflation. However, the Fed has stated that it would wait for additional economic data points to dictate its next move, whether it is another increase in rates or a pause to watch for further developments in economic indicators. At this time, we believe the Fed is likely to raise interest rates at least one more time to 5.50%, with possibly another hike later in the year to 5.75%. These increases are likely to roil the market to some extent.

As a result of interest rate movement uncertainty, inflationary pressures, high commodities prices, softening housing markets, slowing US economy concerns, and profit recession for US companies, investors have become nervous, causing the markets to weaken. We believe investors will gravitate toward large cap companies that have the financial wherewithal to withstand a slowdown in economic growth as they have less need to access capital markets.

As for inflation concerns, the breakeven inflation rate - or the yield spread between TIPS (reflecting investors' expectations of long-term inflation) and nominal Treasuries - has come down from a high of 2.75% to below 2.6%. This implies that inflation is not much of a concern at this time for investors. Concerns have now shifted to the overall slowdown in the economy due to rising interest rates.

Despite the recent weakness stemming from these concerns, it should be noted that earnings growth is still expected to be in the 10% + range and valuations are at above historical median levels for forward P/Ex of 12 – about 14x next year's earnings. Moreover, the situation is quite different than in 2000 when valuations were too high (exceeding 40x P/E) and earnings rapidly decelerated into 2001 and 2002.

International and emerging markets have given up some of the gains in recent times – even more than domestic markets. This is because the international and emerging markets have each made significant gains relative to the US equity market over the past three years. Investors tend to be prone to profit taking at the slightest signs of market weakening. Investors believe that continued interest rate increases in the US will slow down the global economy, causing international and emerging market companies to experience a slowing of earnings growth as well. As a result, the inevitable sell-off in international equities - including emerging markets - has proven even more significant than the sell-off previously witnessed in the US.

In the past, a slowdown in US economy was tightly coupled with the rest of the world's economic growth rate. However, a case can be made that some structural changes in the international and emerging markets, as well as their current account situations (in conjunction with growing local demand for consumer goods and various services) suggest some decoupling of the economic growth rates compared to those of the US. Several of the emerging market countries had substantial current account deficits in contrast to today's current account surplus in these countries. Many experts, for some time, have been saying that the dollar is headed for a secular decline based on the growing US account deficit. To arrest the growth of this deficit, economic theory calls for a decline in the value of the dollar,

thus making a case for international investments – as the weaker dollar enhances the investment returns when translated back to the dollar for US based investors.

Beacon Pointe believes a fully diversified portfolio that has both equity and fixed income components, and is spread globally, will provide the means to meet investors risk/return objectives over the long-term. Short-term volatility is a concern and that is why in our research process we gravitate toward those managers that pay attention to downside risks, rather than significant excess return in strong markets. We believe our clients should stay invested at all times; it is extremely difficult to time entry and exits at optimal inflection points, and studies have repeatedly proven that market timing strategies do not work consistently over time. We always advise our clients to have a long-term view on the capital markets and to stay true to strategic asset allocation.

Please see Figure 1 below for an illustration of why market timing is difficult.

Why Market Timing Doesn't Work

1991	S&P 500 Appreciation	# Trading Days
Entire Year	26.3%	253
Jan 16–Feb 13	17.6	21
Last 7 Days	9.0	7
Rest of 1991	(1.5)	225

S&P 500: 1926–2001	Average Monthly Return
Full 912 Months	1.0%
Best 60 Months (7% of the time)	12.0
All Other Months (93% of the time)	0.2

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Source: Epoch Investment Partners

As seen above, it is prudent to stay invested at all times, as the bulk of market gains are achieved over intermittent, short time periods. Market timing strategies will invariably miss out on the strong runs achieved over a few trading days, leading to poor long-term results.

Beacon Pointe managers select companies based on their business fundamentals and make no effort to mirror the Index in terms of characteristics or weights. We believe our managers will perform well over the long-term as their portfolio holdings reflect valuations that match their business fundamentals over full market cycles. Underlying fundamentals do not change as rapidly as the stock market movements indicate.

Beacon Pointe conducted an extensive study of market returns beginning in 1926 as measured by the S&P 500. Our conclusion was that time horizon is key to benefiting from the stock market.

The following tables illustrate the range of outcomes and the likelihood of such outcomes. As can be seen, the longer the time horizon an investor employs, the more likely it is that they will post strong positive returns. This is essentially the key to profit from the stock markets – stay invested at all times and do not get emotionally involved when the markets go through difficult periods.

Table 1 below illustrates the returns for the period 01/01/1926 – 05/30/2006 and the number of observations of negative returns at different levels, as well as the likelihood of such occurrences.

Table 1

S&P 500 Returns (01/01/1926- 05/30/2006)

No. of Observations (% of Observations)	One Year	Three Years	Five Years	10 Years	20 Years
Total Observations	954	930	906	846	726
Negative Returns	250 (26.2%)	147 (15.8%)	114 (12.6%)	29 (3.4%)	0 (0%)
Greater Than -5%	186 (19.5%)	125 (13.4%)	103 (11.4%)	23 (2.7%)	0 (0%)
Greater Than -10%	127 (13.3%)	104 (11.2%)	82 (9.1%)	20 (2.4%)	0 (0%)
Greater Than -20%	56 (5.9%)	61 (6.6%)	56 (6.2%)	10 (1.2%)	0 (0%)
Greater Than -30%	26 (2.7%)	35 (3.8%)	45 (5.0%)	3 (0.4%)	0 (0%)

Source: Wilshire Associates Compass Database. Returns are cumulative and time periods are on a rolling basis.

From the above table and the returns shown in the Appendix A[1], we can derive the following conclusions:

- The longer the time horizon, the less likely one will suffer permanent loss of capital.
- Despite the severe drawdown during the depression, there was no 20-year period ever recorded to show negative returns.
- The 10-year negative returns observed were a result of the Great Depression, considered unlikely to repeat as lessons have been learned to avoid disastrous monetary and fiscal policies prevalent then. The S&P 500 returns post-Depression demonstrate this anomaly, as we will elaborate upon further in the pages to follow.

Table 2 on the next page illustrates the returns for the period 01/01/1926 – 05/30/2006 and the number of observations of returns greater than 100% at different levels, and the likelihood of such occurrences.

[1] Please contact your Beacon Pointe Consultant for an electronic copy of Appendices A and B.

Table 2

S&P 500 Returns (01/01/1926 - 05/30/2006)

No. of Observations (%% of Observations)	One Year	Three Years	Five Years	10 Years	20 Years
Total Observations	954	930	906	846	726
Greater Than 0%	704 (73.8%)	783 (84.2%)	792 (87.4%)	817 (96.6%)	726 (100%)
Greater Than 100%	2(0.2%)	95 (10.2%)	290(32.0%)	655 (77.4%)	715 (98.5%)
Greater Than 200%	0 (0%)	0 (0%)	31 (3.4%)	416 (49.2%)	685 (94.4%)
Greater Than 300%	0 (0%)	0 (0%)	2 (0.2%)	265 (31.3%)	641 (88.3%)
Greater Than 400%	0 (0%)	0 (0%)	0 (0%)	10 (10.9%)	539 (74.2%)
Greater Than 500%	0 (0%)	0 (0%)	0 (0%)	11 (1.3%)	511 (70.4%)
Greater Than 600%	0 (0%)	0 (0%)	0 (0%)	0 (0%)	483 (66.5%)

Source: Wilshire Associates Compass Database. Returns are cumulative and time periods are on a rolling basis.

Again, investors with long time horizons will be amply rewarded as shown above. From the above table and from Appendix A we derive the following conclusions:

- If your time horizon is 20 years or longer, staying invested in the market at all times can result in handsome returns.
- Even over the ten years, there is almost a 50% probability of tripling your assets nearly 50% of the time.
- Over the twenty year period, two-thirds of the time, one can grow his or her assets six times. This translates to an annualized return of over 10.2% as shown in the table below.

Table 3 below illustrates what the total return means in terms of annualized returns for the various time periods.

Table 3

Total	100%	200%	300%	400%	500%	600%
5-Year	14.9%	24.6%	32.0%	38.0%	43.1%	47.6%
10 Year	7.2%	11.6%	14.9%	17.5%	19.6%	21.5%
20 year	3.5%	5.6%	7.2%	8.4%	9.4%	10.2%
	Annualized Returns					

Earlier, we had mentioned that the Great Depression was unlikely to repeat as the Federal Reserve has learned to recognize such a situation and institute appropriate monetary and fiscal policies to prevent such an event happening in the future. The stock market returns, as reflected by the S&P 500 Index, show that beginning in 1942, the stock market has not shown negative returns for the 10-year period and beyond. This is shown in Table 4 on the next page.

Table 4

S&P 500 Post Depression Effect Returns (01/01/1943- 05/30/2006)

No. of Observations (%% of Observations)	One Year	Three Years	Five Years	10 Years	20 Years
Total Observations	750	726	702	642	522
Negative Returns	163 (21.7%)	68 (9.4%)	44 (6.3%)	0 (0%)	0 (0%)
Greater Than -5%	107 (14.3%)	51 (7.0%)	34 (4.8%)	0 (0%)	0 (0%)
Greater Than -10%	70 (9.3%)	37 (5.1%)	16 (2.3%)	0 (0%)	0 (0%)
Greater Than -20%	19 (5.9%)	19 (6.6%)	0 (0%)	0 (0%)	0 (0%)
Greater Than -30%	1 (0.1%)	8 (1.1%)	0 (0%)	0 (0%)	0 (0%)

Source: Wilshire Associates Compass Database. Returns are cumulative and time periods are on a rolling basis.

The following conclusions can be derived from Table 4 and Appendix B above:

- The odds of losing money over a three-year period are less than 10%.
- The odds of losing money over a five-year period are less than 5%.
- S&P 500 has not posted negative returns for the 10-year period and beyond.
- Most of the negative returns for the S&P 500 have been due to the 1972-1974 bear markets as well post tech bubble periods.

Table 5

S&P 500 Returns Post Depression Effect (01/01/1943- 05/30/2006)

No. of Observations (%% of Observations)	One Year	Three Years	Five Years	10 Years	20 Years
Total Observations	750	726	702	642	522
Greater Than 0%	587(78.2%)	658 (90.6%)	658 (93.7%)	642 (100%)	522 (100%)
Greater Than 100%	0 (0%)	61 (8.4%)	246 (35.0%)	539 (84.0%)	522 (100%)
Greater Than 200%	0 (0%)	0 (0%)	26 (3.7%)	379 (59.0%)	522(100%)
Greater Than 300%	0 (0%)	0 (0%)	0 (0%)	265 (38.3%)	491(94.1%)
Greater Than 400%	0 (0%)	0 (0%)	0 (0%)	10 (13.4%)	401(76.8%)
Greater Than 500%	0 (0%)	0 (0%)	0 (0%)	11 (1.7%)	376(72.0%)
Greater Than 600%	0 (0%)	0 (0%)	0 (0%)	0 (0%)	351(67.2%)

Source: Wilshire Associates Compass Database. Returns are cumulative and time periods are on a rolling basis.

The following conclusions can be derived from the table above and from Appendix B:

- The above table reveals that in the post depression period, the S&P 500 returns have been positive more than 90% of the time when the time horizon is greater than three years. This percentage increases to nearly 94% when the time horizon is five years and 100% for 10 years and longer.
- For the ten-year period, an investor could triple their assets nearly 60% of the time and if the time horizon is stretched to 20 years, it would happen 100% of the time.
- Astonishingly, an investor could multiply their assets by six times over a 20 year period nearly two-thirds of the time. This implies a compounded annual return of over 10% could be achieved 67% of the time. A longer time horizon is the key to capital appreciation.

- Typically, losing periods are followed by some of the strongest returns. Thus, it makes sense to stay in the market without attempting to time the market. As we mentioned earlier, the stock market's strongest returns typically occur intermittent, short time periods.

We continue to strongly advise our clients to stay the course and not get emotionally involved with the day-to-day fluctuations of the markets.

Market Analysis – Conclusions

- Beacon Pointe believes that our clients should ignore the day-to-day noise generated in the popular media regarding the volatility in the markets and strive to maintain a longer time horizon. Several studies including our internal research have shown it pays to have a long-term perspective as strong markets typically follow weak markets.

- Beacon Pointe believes returns in the post depression era could be what most investors can expect to earn over the long run. We believe over the 20-year time horizon, investors can expect low double digit returns using active managers and slightly below 10% if using an Index approach.

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