BEACON POINTE
ADVISORS

BEACON POINTE RESEARCH WHITE PAPER

ACTIVE EQUITY MANAGEMENT
NOVEMBER 2006

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Active Equity Investment Management

As of the third quarter-end 2006, active equity managers have underperformed their respective passive indices, index funds, and ETFs. Although this phenomenon has occurred across the broad investment styles (growth, value, and core), and market capitalizations (small, mid, and large), the underperformance relative to the indices has been most significant among value managers

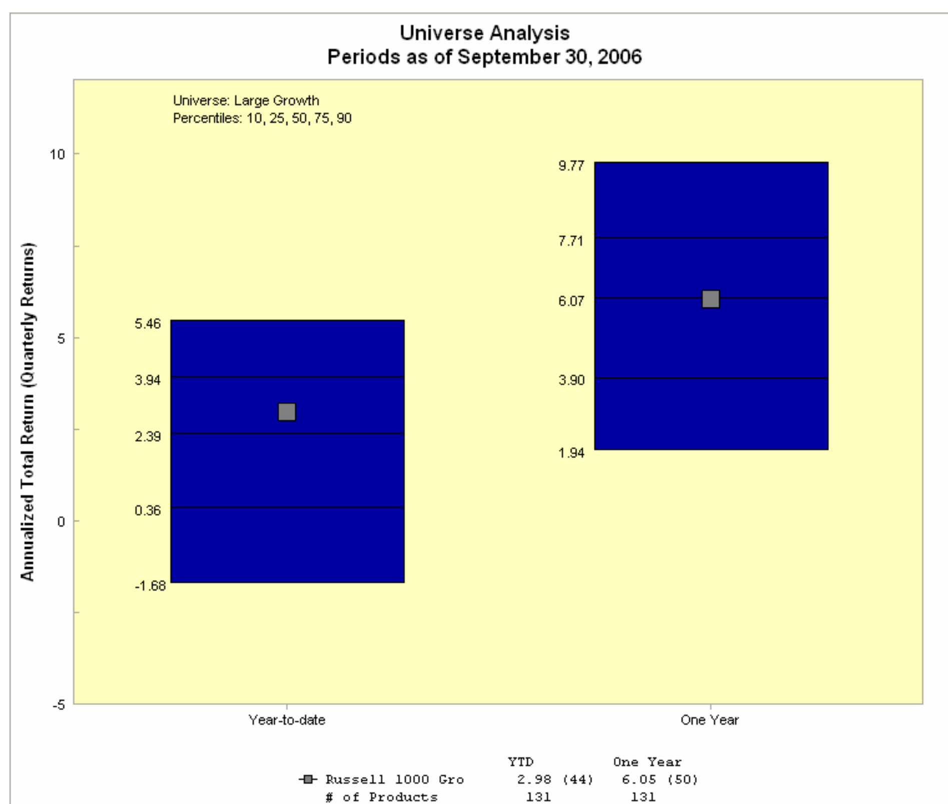
Listed below are performance comparisons of active equity investment managers relative to the appropriate style benchmark for the year-to-date (as of September 29, 2006) and the past 1-year periods. Exhibits 1, 2, and 6 also present the peer universe analytics to illustrate how the indices have performed relative to the peer performance quartiles.

For the large cap growth universe, the Russell 1000 Growth index has outperformed the median manager for the period January 1, 2006 through September 29, 2006 (2.98% vs. 2.39%). The index also outperformed 56% of active large cap growth investment portfolios year-to-date.

Exhibit 1

Large Cap Growth

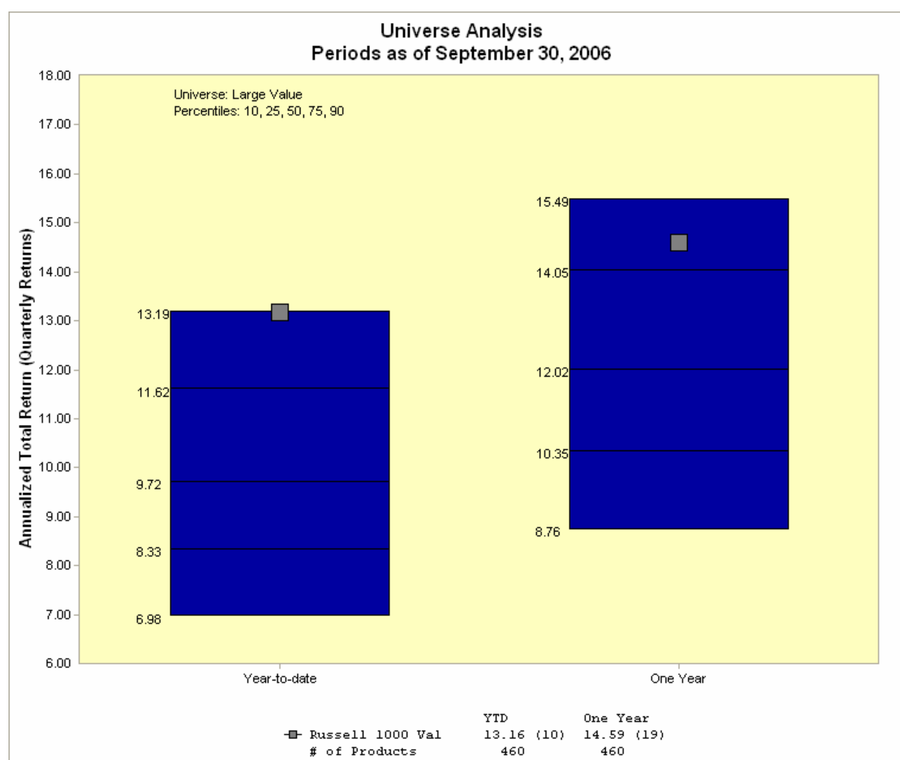
	Year-To-Date	**1-Year**
Russell 1000 Growth Return	2.98%	6.05%
Median Manager Return	2.39%	6.07%
Russell 1000 Growth Rank	44th percentile	50th percentile



Active Equity Investment Management

Exhibit 2

Large Cap Value		
	Year-To-Date	**1-Year**
Russell 1000 Value Return	13.16%	14.59%
Median Manager Return	9.72%	12.02%
Russell 1000 Value Rank	10th percentile	19th percentile



For the large cap value universe, the recent outperformance of the Russell 1000 Value index relative to the median large value manager was even more significant for the year-to-date period (13.16% vs. 9.72%). For the past 1-year period, the benchmark outperformed the median large value manager by 2.57%.

Not only did the Russell 1000 Value index outperform the median large value manager, it also outperformed the top quartile manager within the universe for both periods. For the year-to-date period, the index outperformed 90% of large value managers. For the past 1-year period, the index outperformed 81% of the large value managers.

For the other investment styles, we have provided a summary of the performance and peer universe ranking of the index. As evidenced, the indices have performed extremely well relative to active management through the past 3-4 quarters. The most difficult area to outperform the benchmark

Active Equity Investment Management

during this recent time period has been the area of small cap value (please refer to Exhibit 6). The Russell 2000 Value index has outperformed 94% of small cap value managers year-to-date.

Exhibit 3

Midcap Growth		
	Year-To-Date	**1-Year**
Russell Mid Growth Return	3.47%	7.04%
Median Manager Return	1.57%	5.08%
Russell Mid Growth Rank	39th percentile	24th percentile

Exhibit 4

Midcap Value		
	Year-To-Date	**1-Year**
Russell Mid Value Return	10.79%	12.28%
Median Manager Return	8.36%	9.13%
Russell Mid Value Rank	31st percentile	26th percentile

Exhibit 5

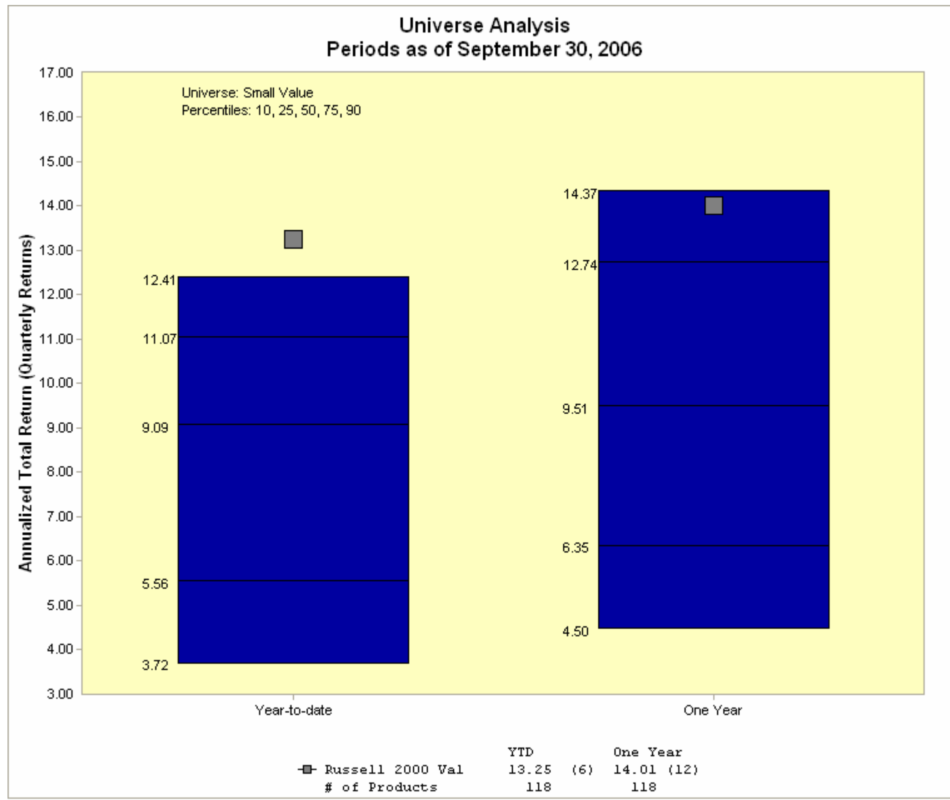
Small Cap Growth		
	Year-To-Date	**1-Year**
Russell Mid Value Return	4.22%	5.89%
Median Manager Return	3.08%	5.73%
Russell Mid Value Rank	37th percentile	48th percentile

Exhibit 6

Small Cap Value		
	Year-To-Date	**1-Year**
Russell Mid Value Return	13.25%	14.01%
Median Manager Return	9.09%	9.51%
Russell Mid Value Rank	6th percentile	12th percentile

Active Equity Investment Management

Exhibit 6-continued



Within each investment style peer universe, the median active equity manager has underperformed the respective style benchmark for the year-to-date period. This phenomenon also holds true in each case for the 1-year period, with Large Cap Growth as the only exception.

The first sentence in a client letter, issued by one of the investment managers whom Beacon Pointe closely follows, says it all: *"To put it bluntly, active domestic equity managers' returns in 2006 have sucked."*

What Happened—Why Did Active Management Perform So Poorly?

It is insightful to see what factors caused indices to perform well while active managers have had a hard time thus far trying to beat the passive benchmarks. Evidence suggests several factors have contributed to the indices having a strong year, including fund flows, low quality stocks performing well, and above average performance from stocks with poor growth prospects and the cheapest valuation. All of this has resulted in high quality stocks trading at one of the cheapest relative valuations in recent history.

According to research conducted by Dalton, Greiner, Hartman, Maher & Co., LLC, for a investment management firm based in New York City, of the $34 billion going into mutual funds (as of November 2006), ETFs received approximately $28 billion of the $34 billion in flows. In comparison, active managers faced one of the largest outflows since 1989, which was an aftermath of the 1987 debacle.

As a result, over 80% of the funds flowing to the ETFs that replicate the various indices reflected enhanced performance, as the ETF managers were compelled to buy more of the stocks populated in the indices. At the same time, active managers who took positions different from that of the indices, faced redemptions, hurting their relative performance as they were forced to sell into weakness. This exacerbated an already difficult position for active investment managers.

In addition, active managers, especially those recommended by BPA, typically buy high quality companies with solid balance sheets. As an example, in 2006, companies in the automotive sector were one of the best performing groups. This is significant as in prior years, the automotive sector has significantly underperformed. Most of our managers typically avoid these companies, as they are very cyclical and highly leveraged. Many auto parts companies had even filed for bankruptcies.

In the last couple of years, it appears that global investors have been complacent concerning risk aversion. It is evident that the higher beta asset classes which are more volatile, such as emerging markets and high yield, have performed very well. Surprisingly, the correlations of these asset classes with the S&P have increased in recent times. An analysis of the underlying companies in the S&P Index would indicate that the lowest quality stocks have shown higher correlations with riskier asset classes. These companies generated the highest alpha over the past couple of years despite having poor return on equity, poor growth prospects, and highly leveraged balance sheets.

All of this has contributed to the lofty returns of the indices, while leaving active managers, who typically own higher quality stocks, on the wayside. However, mean reversion is a powerful tool in the investment world. We believe it is a matter of time before index returns fall below the recent highs relative to active managers. Our studies indicate that over the long-term, on a rolling 3-year or 5-year basis, active managers have shown the ability to outperform the indices.

Beacon Pointe expects that investment managers who invest in fundamentally strong companies will generate returns in synch with the long-term economic drivers of the stocks and expect to outperform their respective market benchmarks. As such, Beacon Pointe continues to advocate the use of active managers and would advise against investing in ETFs. Many investors forget that when investors flee ETFs and chase active managers' increasingly strong returns, the downward spiral will exacerbate as more and more investors unwind their ETF positions.

What is Important Then?

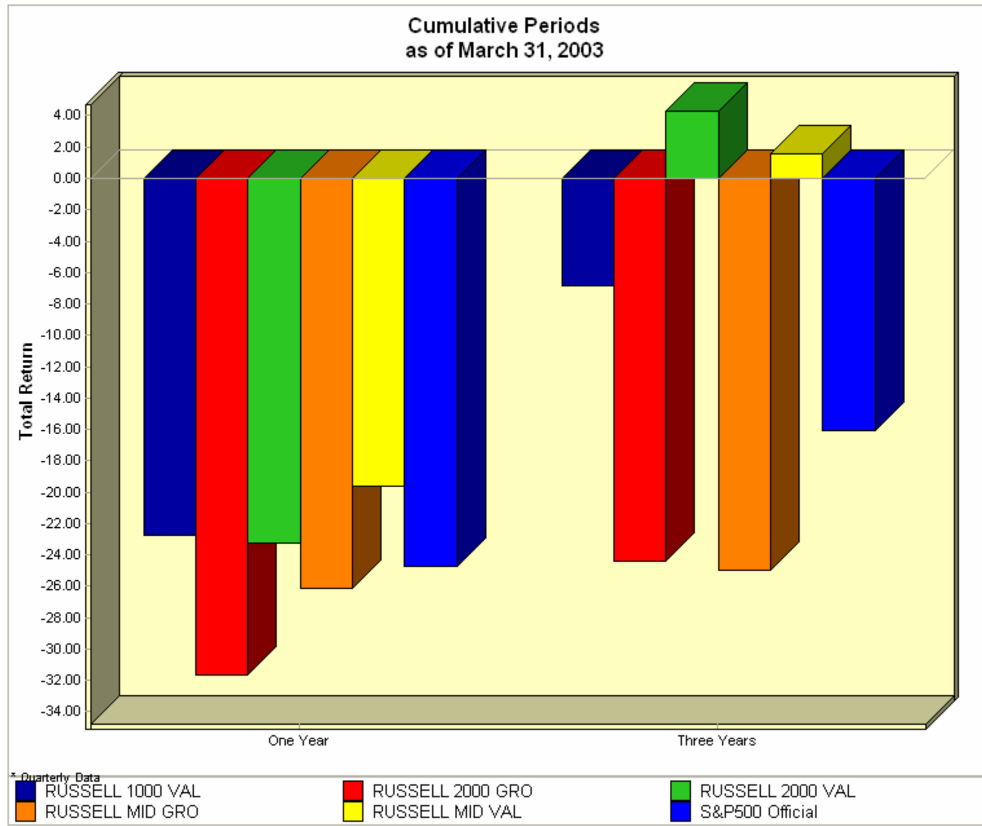
The capital markets, in recent periods, have performed very well in absolute terms. We are in the 2nd longest bull run in stock market history. The exhibit below shows the past 1- and 3-year returns for the major investment indices (as of September 29, 2006).

Exhibit 7

Index	Last 1-Year	Last 3-Years
S&P 500 Index	10.81%	12.30%
Russell 1000 Growth	6.05%	8.37%
Russell 1000 Value	14.59%	17.23%
Russell 2000 Growth	5.88%	11.82%
Russell 2000 Value	14.01%	19.04%
Russell Midcap Growth	7.03%	14.53%
Russell Midcap Value	12.28%	21.17%

It is no wonder why investors have swarmed into ETFs and index funds based on the recent performance of the U.S. stock markets. Yet, if you flip back time just a few years, you will see how dramatically different these returns looked. As of March 31, 2003, the major indices had the following performance:

Exhibit 8



What is Important Then?

Exhibit 8-continued

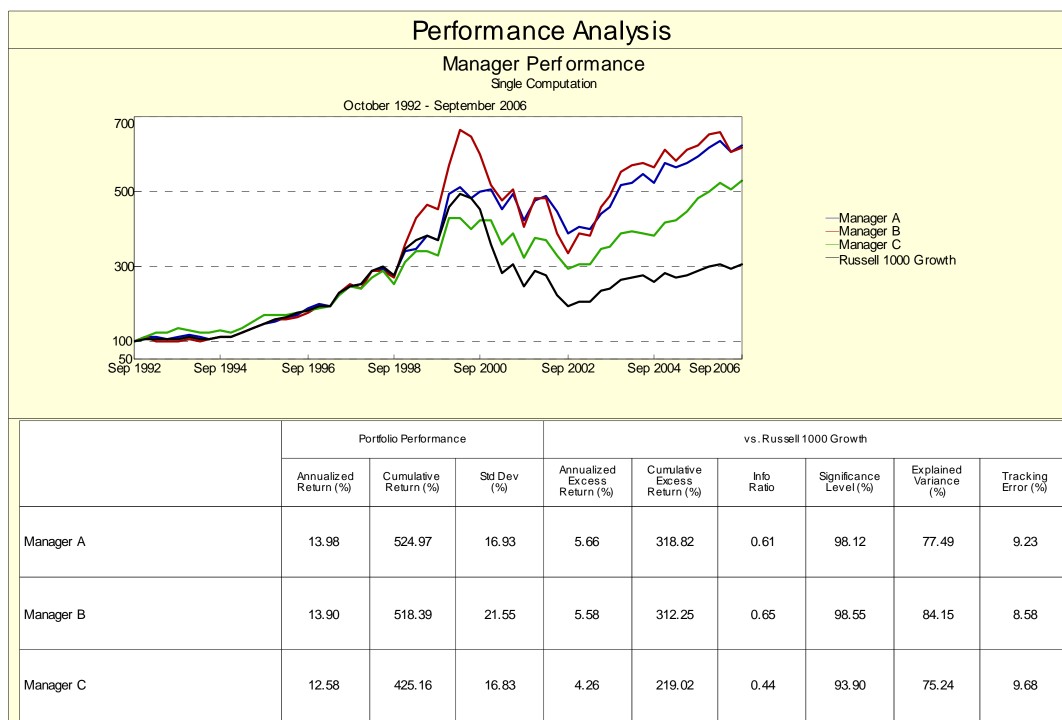
Index	1-Year	3-Years
S&P 500 Index	-24.75%	-16.08%
Russell 1000 Growth	-26.77%	-25.64%
Russell 1000 Value	-22.79%	-6.86%
Russell 2000 Growth	-31.63%	-24.42%
Russell 2000 Value	-23.27%	4.27%
Russell Midcap Growth	-26.12%	-24.98%
Russell Midcap Value	-19.66%	1.53%

Although investing in the passive indices or ETFs seem like a home-run today, investing in the market may result in striking out. The key to compounding wealth is the ability to not give it away in bad periods.

Beacon Pointe believes that performance consistency is the best method to building wealth. Investors, however, must not get caught up with short-term performance. We believe this is the worst outlook to have. The exhibit below (Exhibit 9) plots three of Beacon Pointe's large cap growth recommended investment managers relative to the Russell 1000 Growth in a "Growth of $100" chart.

As you can see, each of the investment managers, despite underperforming the Russell 1000 Growth Index in specific time periods, have outperformed over the long-term. Manager A, from 1992 through 2006, has grown from $100 to $624. Manager B has grown to $618 and Manager C has grown to $525. The Russell 1000 Growth Index, for this period, grew from $100 to $306.

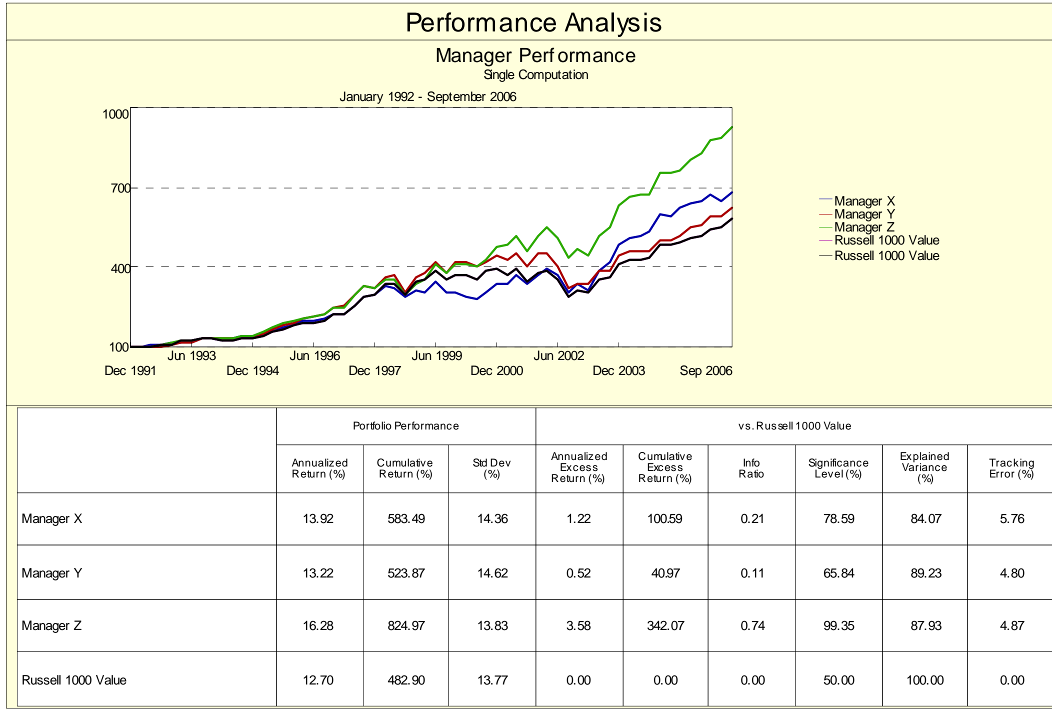
Exhibit 9



	Portfolio Performance			vs. Russell 1000 Growth					
	Annualized Return (%)	Cumulative Return (%)	Std Dev (%)	Annualized Excess Return (%)	Cumulative Excess Return (%)	Info Ratio	Significance Level (%)	Explained Variance (%)	Tracking Error (%)
Manager A	13.98	524.97	16.93	5.66	318.82	0.61	98.12	77.49	9.23
Manager B	13.90	518.39	21.55	5.58	312.25	0.65	98.55	84.15	8.58
Manager C	12.58	425.16	16.83	4.26	219.02	0.44	93.90	75.24	9.68

What is Important Then?

Exhibit 10



	Portfolio Performance			vs. Russell 1000 Value					
	Annualized Return (%)	Cumulative Return (%)	Std Dev (%)	Annualized Excess Return (%)	Cumulative Excess Return (%)	Info Ratio	Significance Level (%)	Explained Variance (%)	Tracking Error (%)
Manager X	13.92	583.49	14.36	1.22	100.59	0.21	78.59	84.07	5.76
Manager Y	13.22	523.87	14.62	0.52	40.97	0.11	65.84	89.23	4.80
Manager Z	16.28	824.97	13.83	3.58	342.07	0.74	99.35	87.93	4.87
Russell 1000 Value	12.70	482.90	13.77	0.00	0.00	0.00	50.00	100.00	0.00

The exhibit above presents the same long-term outperformance of Beacon Pointe's focus list of large cap value managers relative to the Russell 1000 Value index. Manager X has grown from $100 to $683. Manager Y has grown to $623. Manager Z has grown to $924. The Russell 1000 Value Index, however, has only grown from $100 to $582 from1992 through 2006.

Over the long-term, Beacon Pointe's recommended active investment managers have outperformed the passive indices and benchmarks.

Focus on Rolling Performance

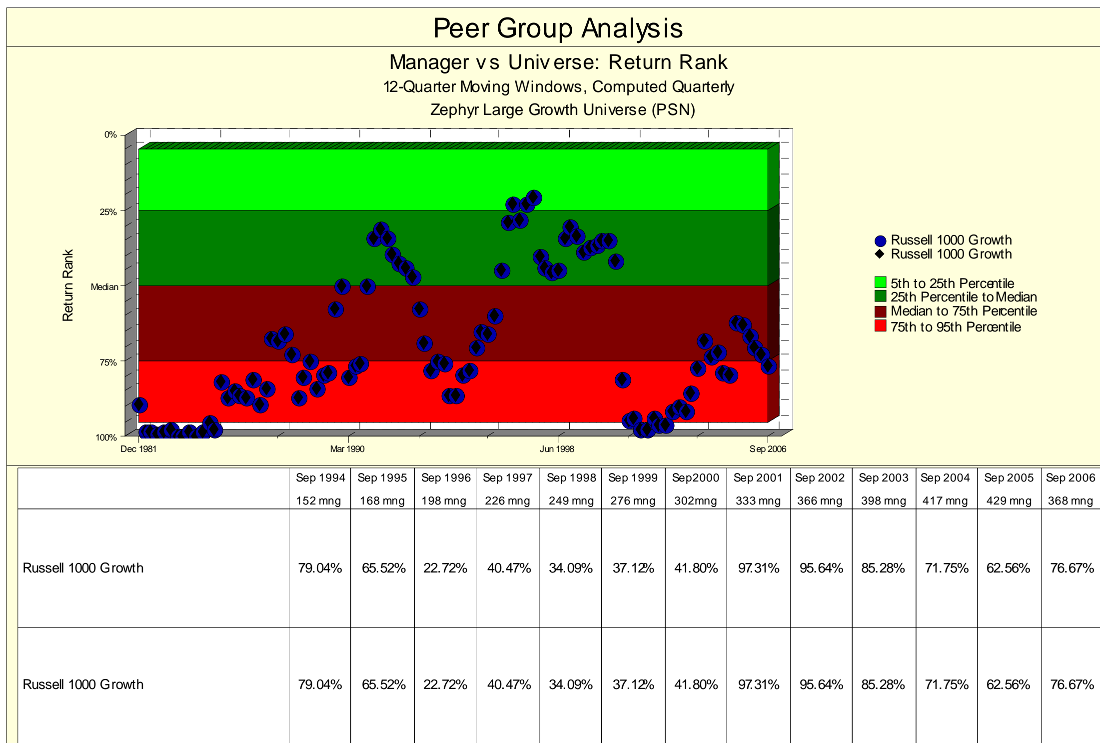
Beacon Pointe's quantitative analysis evaluates investment managers and funds over rolling 3- and 5-year periods. As mentioned, we believe that managers perform well consistently over rolling time periods to eliminate chasing performance. The exhibits below demonstrate how the passive indices have performed over rolling periods.

Over rolling 3-years, the Russell 1000 Growth index consistently underperforms the median large cap growth manager.

Exhibit 11 demonstrates the importance of analyzing performance over rolling periods to time. As one can see, the Russell 1000 Growth index, performed extremely well in the late 90s due to the run-up of technology and the dot-com names. However, if an investor continued to remain invested in the index, performance dropped to the bottom quartile—even to the bottom 97th percentile of the universe. When invested in an index fund, there is no way to avoid the poor performance of a falling market.

The following exhibits identify the same phenomenon—over rolling 3-and 5-year periods, passive benchmarks have performed at or below the median manager within specific investment styles.

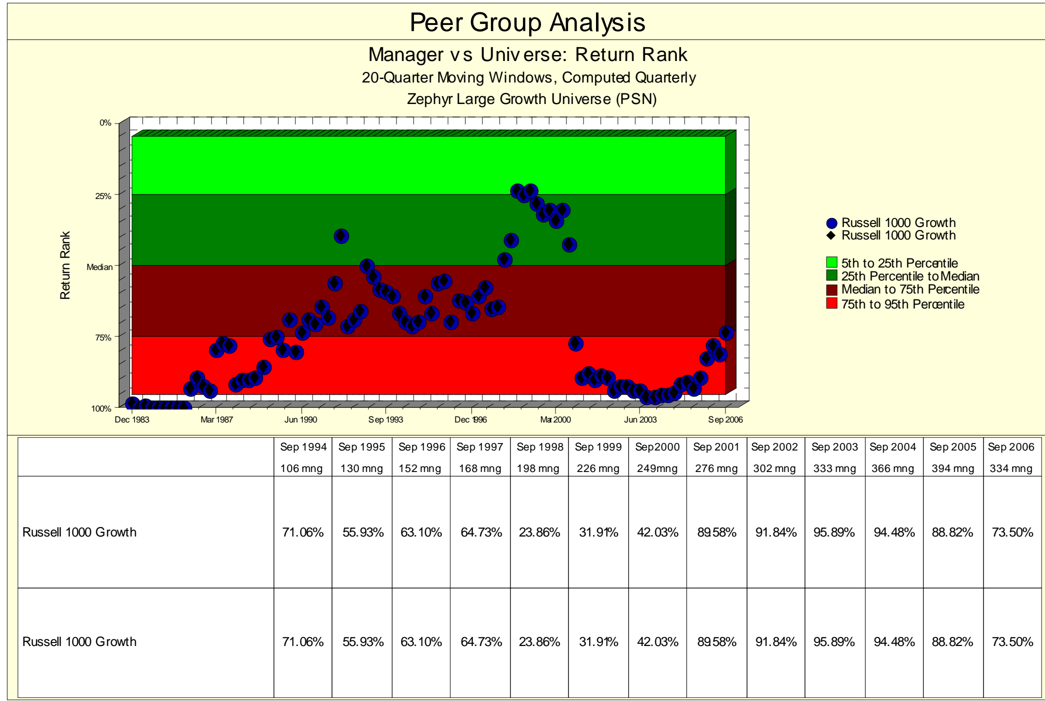
Exhibit 11 (Large Growth: Rolling 3-Year)



	Sep 1994 152 mng	Sep 1995 168 mng	Sep 1996 198 mng	Sep 1997 226 mng	Sep 1998 249 mng	Sep 1999 276 mng	Sep2000 302mng	Sep 2001 333 mng	Sep 2002 366 mng	Sep 2003 398 mng	Sep 2004 417 mng	Sep 2005 429 mng	Sep 2006 368 mng
Russell 1000 Growth	79.04%	65.52%	22.72%	40.47%	34.09%	37.12%	41.80%	97.31%	95.64%	85.28%	71.75%	62.56%	76.67%
Russell 1000 Growth	79.04%	65.52%	22.72%	40.47%	34.09%	37.12%	41.80%	97.31%	95.64%	85.28%	71.75%	62.56%	76.67%

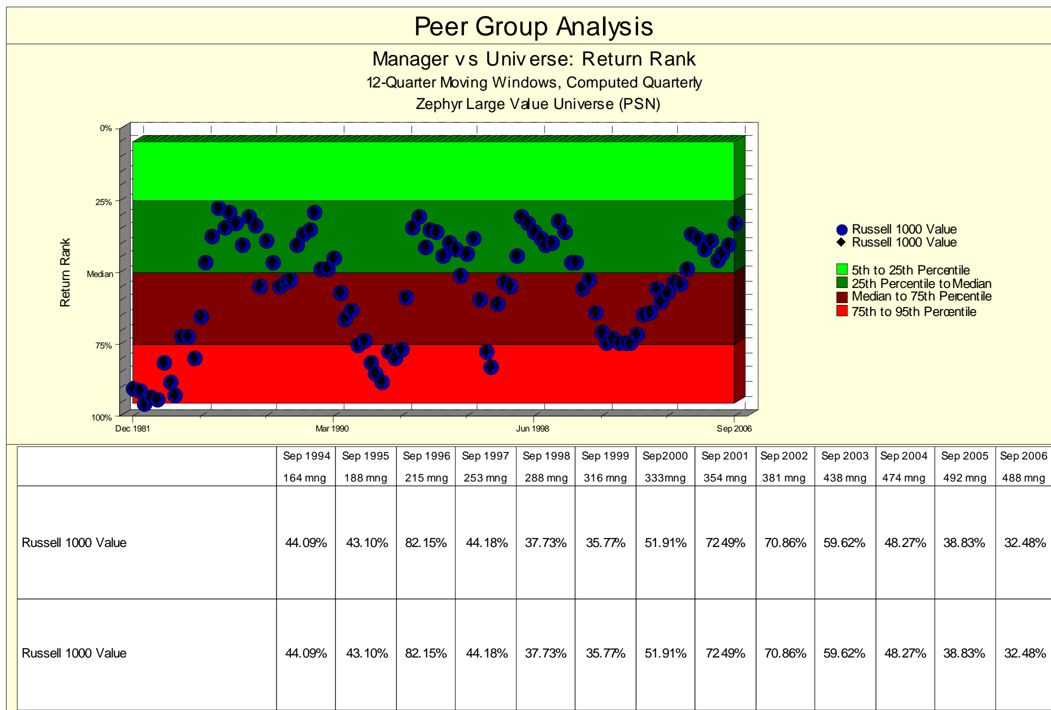
Focus on Rolling Performance

Exhibit 12 (Large Growth: Rolling 5-Year)



	Sep 1994 106 mng	Sep 1995 130 mng	Sep 1996 152 mng	Sep 1997 168 mng	Sep 1998 198 mng	Sep 1999 226 mng	Sep2000 249mng	Sep 2001 276 mng	Sep 2002 302 mng	Sep 2003 333 mng	Sep 2004 366 mng	Sep 2005 394 mng	Sep 2006 334 mng
Russell 1000 Growth	71.06%	55.93%	63.10%	64.73%	23.86%	31.91%	42.03%	89.58%	91.84%	95.89%	94.48%	88.82%	73.50%
Russell 1000 Growth	71.06%	55.93%	63.10%	64.73%	23.86%	31.91%	42.03%	89.58%	91.84%	95.89%	94.48%	88.82%	73.50%

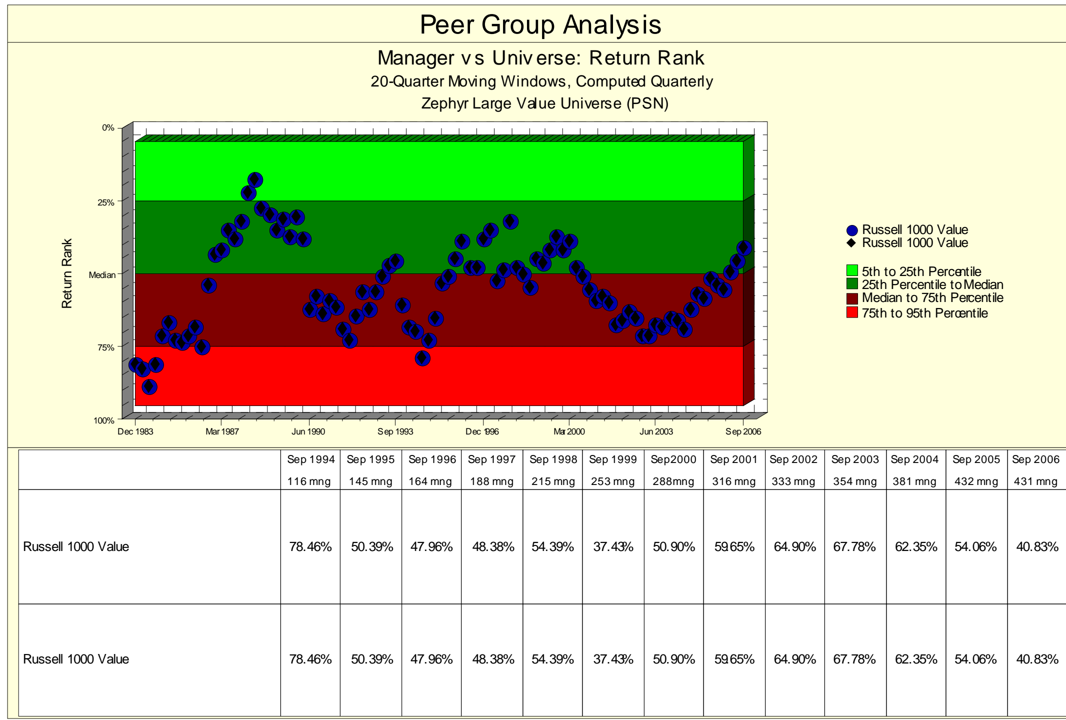
Exhibit 13 (Large Value: Rolling 3-Year)



	Sep 1994 164 mng	Sep 1995 188 mng	Sep 1996 215 mng	Sep 1997 253 mng	Sep 1998 288 mng	Sep 1999 316 mng	Sep2000 333mng	Sep 2001 354 mng	Sep 2002 381 mng	Sep 2003 438 mng	Sep 2004 474 mng	Sep 2005 492 mng	Sep 2006 488 mng
Russell 1000 Value	44.09%	43.10%	82.15%	44.18%	37.73%	35.77%	51.91%	72.49%	70.86%	59.62%	48.27%	38.83%	32.48%
Russell 1000 Value	44.09%	43.10%	82.15%	44.18%	37.73%	35.77%	51.91%	72.49%	70.86%	59.62%	48.27%	38.83%	32.48%

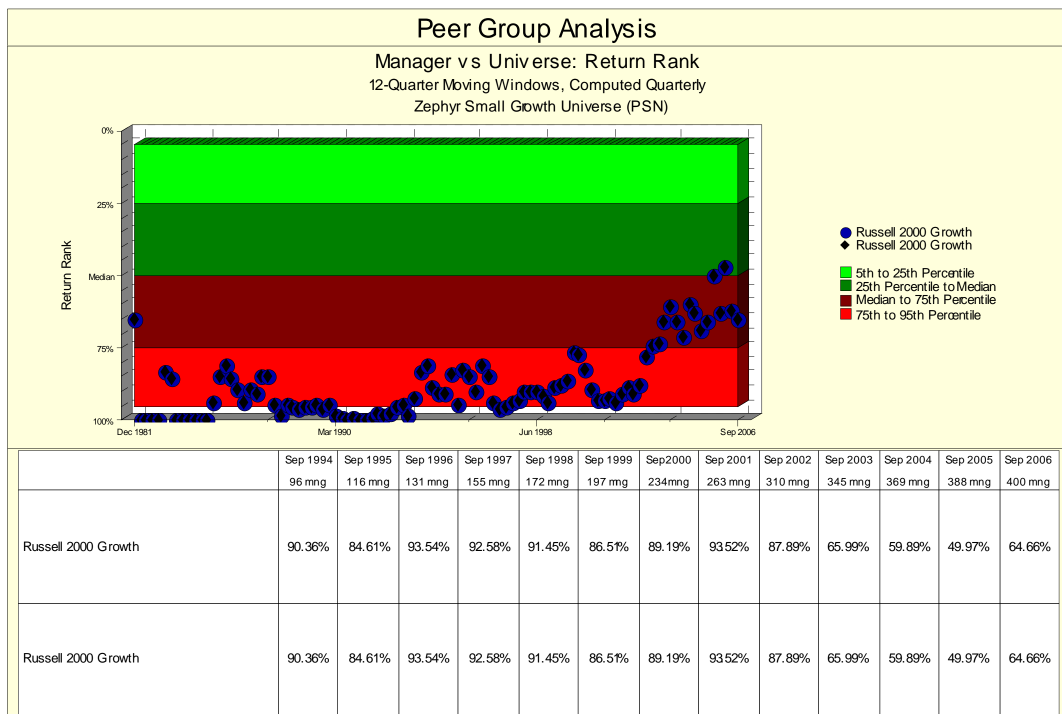
Focus on Rolling Performance

Exhibit 14 (Large Value: Rolling 5-Year)



	Sep 1994 116 mng	Sep 1995 145 mng	Sep 1996 164 mng	Sep 1997 188 mng	Sep 1998 215 mng	Sep 1999 253 mng	Sep2000 288mng	Sep 2001 316 mng	Sep 2002 333 mng	Sep 2003 354 mng	Sep 2004 381 mng	Sep 2005 432 mng	Sep 2006 431 mng
Russell 1000 Value	78.46%	50.39%	47.96%	48.38%	54.39%	37.43%	50.90%	59.65%	64.90%	67.78%	62.35%	54.06%	40.83%
Russell 1000 Value	78.46%	50.39%	47.96%	48.38%	54.39%	37.43%	50.90%	59.65%	64.90%	67.78%	62.35%	54.06%	40.83%

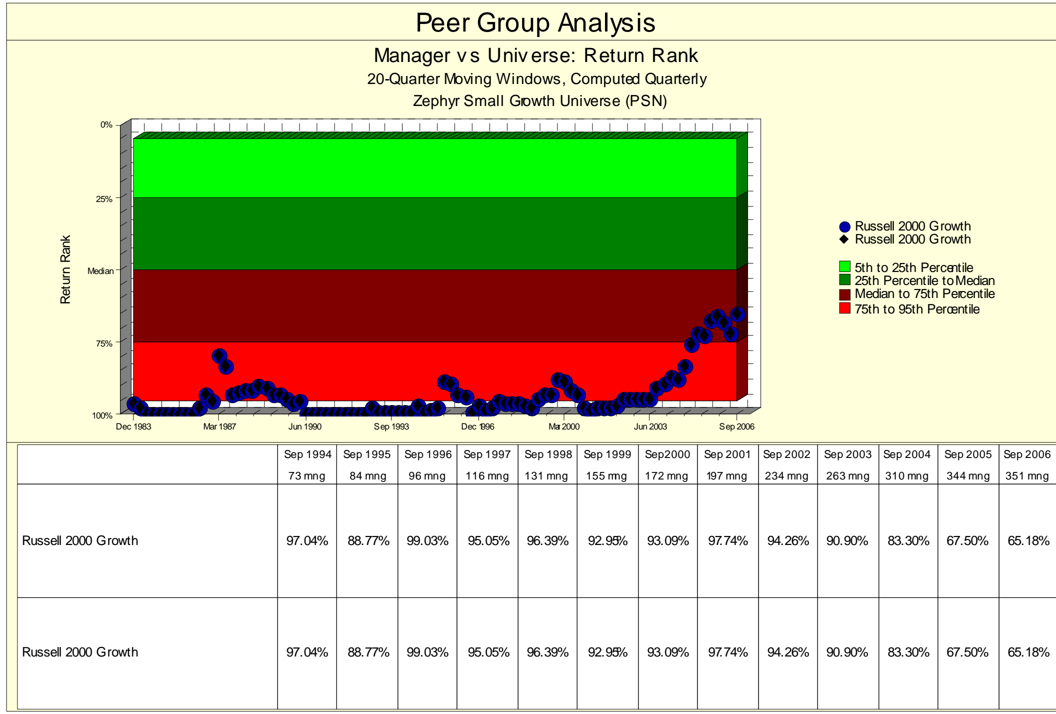
Exhibit 15 (Small Growth: Rolling 3-Year)



	Sep 1994 96 mng	Sep 1995 116 mng	Sep 1996 131 mng	Sep 1997 155 mng	Sep 1998 172 mng	Sep 1999 197 mng	Sep2000 234mng	Sep 2001 263 mng	Sep 2002 310 mng	Sep 2003 345 mng	Sep 2004 369 mng	Sep 2005 388 mng	Sep 2006 400 mng
Russell 2000 Growth	90.36%	84.61%	93.54%	92.58%	91.45%	86.51%	89.19%	93.52%	87.89%	65.99%	59.89%	49.97%	64.66%
Russell 2000 Growth	90.36%	84.61%	93.54%	92.58%	91.45%	86.51%	89.19%	93.52%	87.89%	65.99%	59.89%	49.97%	64.66%

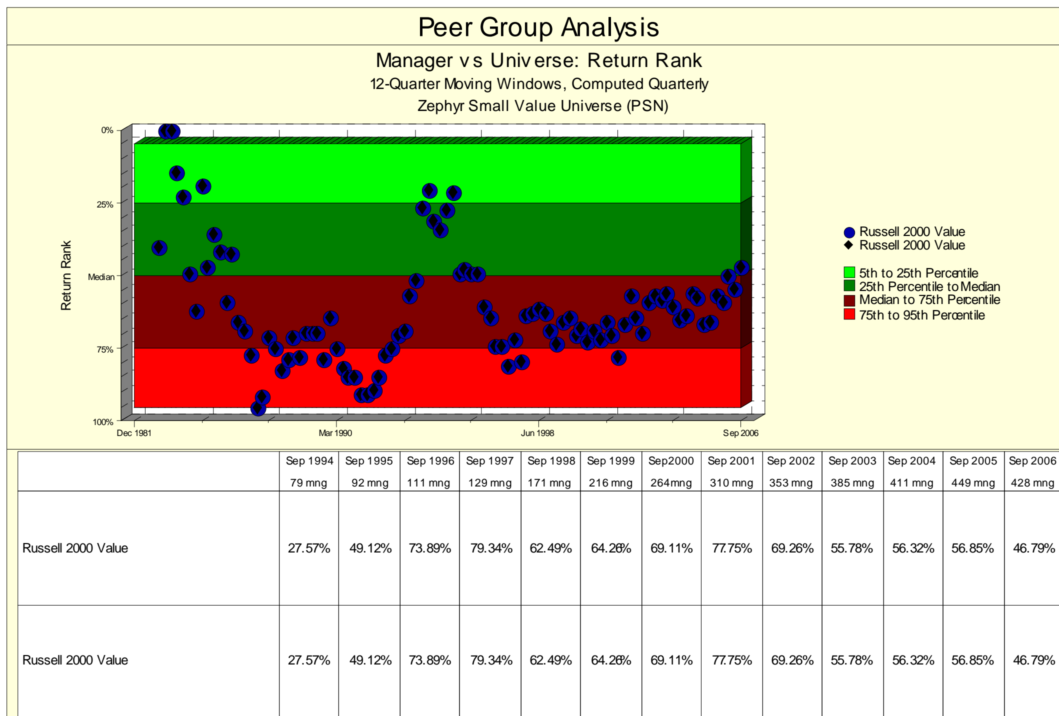
Focus on Rolling Performance

Exhibit 16 (Small Growth: Rolling 5-Year)



	Sep 1994 73 mng	Sep 1995 84 mng	Sep 1996 96 mng	Sep 1997 116 mng	Sep 1998 131 mng	Sep 1999 155 mng	Sep2000 172 mng	Sep 2001 197 mng	Sep 2002 234 mng	Sep 2003 263 mng	Sep 2004 310 mng	Sep 2005 344 mng	Sep 2006 351 mng
Russell 2000 Growth	97.04%	88.77%	99.03%	95.05%	96.39%	92.95%	93.09%	97.74%	94.26%	90.90%	83.30%	67.50%	65.18%
Russell 2000 Growth	97.04%	88.77%	99.03%	95.05%	96.39%	92.95%	93.09%	97.74%	94.26%	90.90%	83.30%	67.50%	65.18%

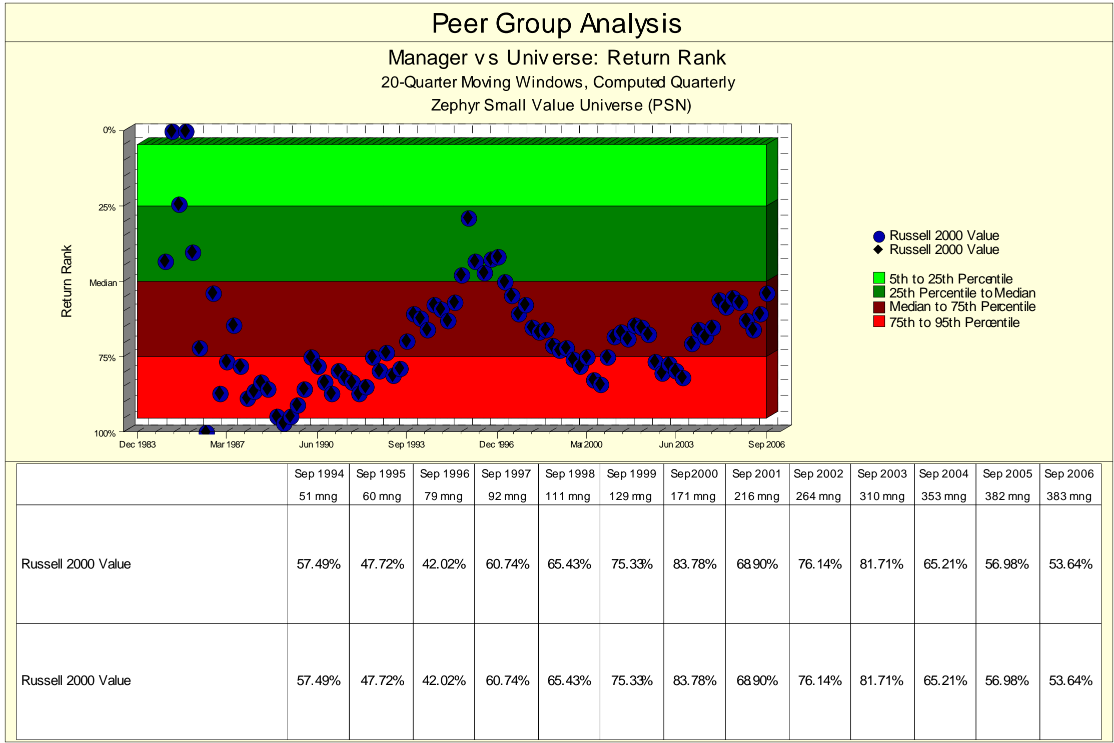
Exhibit 17 (Small Value: Rolling 3-Year)



	Sep 1994 79 mng	Sep 1995 92 mng	Sep 1996 111 mng	Sep 1997 129 mng	Sep 1998 171 mng	Sep 1999 216 mng	Sep2000 264mng	Sep 2001 310 mng	Sep 2002 353 mng	Sep 2003 385 mng	Sep 2004 411 mng	Sep 2005 449 mng	Sep 2006 428 mng
Russell 2000 Value	27.57%	49.12%	73.89%	79.34%	62.49%	64.26%	69.11%	77.75%	69.26%	55.78%	56.32%	56.85%	46.79%
Russell 2000 Value	27.57%	49.12%	73.89%	79.34%	62.49%	64.26%	69.11%	77.75%	69.26%	55.78%	56.32%	56.85%	46.79%

Focus on Rolling Performance

Exhibit 18 (Small Value: Rolling 5-Year)



	Sep 1994 51 mng	Sep 1995 60 mng	Sep 1996 79 mng	Sep 1997 92 mng	Sep 1998 111 mng	Sep 1999 129 mng	Sep2000 171 mng	Sep 2001 216 mng	Sep 2002 264 mng	Sep 2003 310 mng	Sep 2004 353 mng	Sep 2005 382 mng	Sep 2006 383 mng
Russell 2000 Value	57.49%	47.72%	42.02%	60.74%	65.43%	75.33%	83.78%	68.90%	76.14%	81.71%	65.21%	56.98%	53.64%
Russell 2000 Value	57.49%	47.72%	42.02%	60.74%	65.43%	75.33%	83.78%	68.90%	76.14%	81.71%	65.21%	56.98%	53.64%

Summary

Over the past year, the passive indices and ETFs have performed extremely well relative to active equity investment management. We have seen a number of indices not only outperform the median active manager within a specific investment style, but also rank in the top quartile within the universe.

Beacon Pointe, however, believes that active investment management can outperform the passive benchmarks over the long-term. Beacon Pointe's cumulative performance (Exhibits 9-10) as well as its performance analysis over rolling time periods (Exhibits 11-18), support our firm's philosophy of active management. Although there are short periods of time when passive investing does outperform active management, it is often difficult to avoid the ensuing poor relative performance that normally follows.

Beacon Pointe's investment managers have traditionally had an upside capture ratio of .80%-.90 demonstrating that when the markets are up $1, Beacon Pointe's recommended investment managers have historically been up $0.80-$0.90. However, our recommended managers have historically had an downside capture ratio of 0.7 or lower—meaning that when the markets are down $1, our recommended managers have historically had a downside capture ratio of $0.70 or lower. The ability to protect principal on the downside is indeed significant and is one of the largest factors to long-term absolute performance.

As the capital markets possibly move into a slowing economy, Beacon Pointe believes that fundamental, bottom-up stock pickers will outperform in a possibly flat or lower return market environment.

Please feel free to call your Beacon Pointe consultant should you have any questions (949 718-1600).