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The amazing Race

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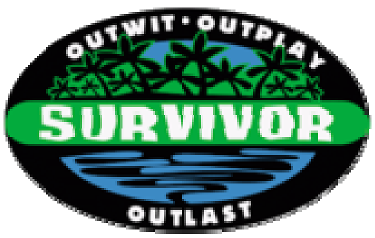
The Amazing Race

Despite their name, reality TV shows are scripted for maximum entertainment. But perhaps real life contains more excitement, extreme emotional swings, and entertainment (of the light or dark variety) than any writer or producer could ask for. The past 18 months, in particular, have taken us on a rollercoaster ride of fear, despair, hope, and elation. Starting with the Bear Stearns episode in March 2008, investors have witnessed the Wall Street editions of:

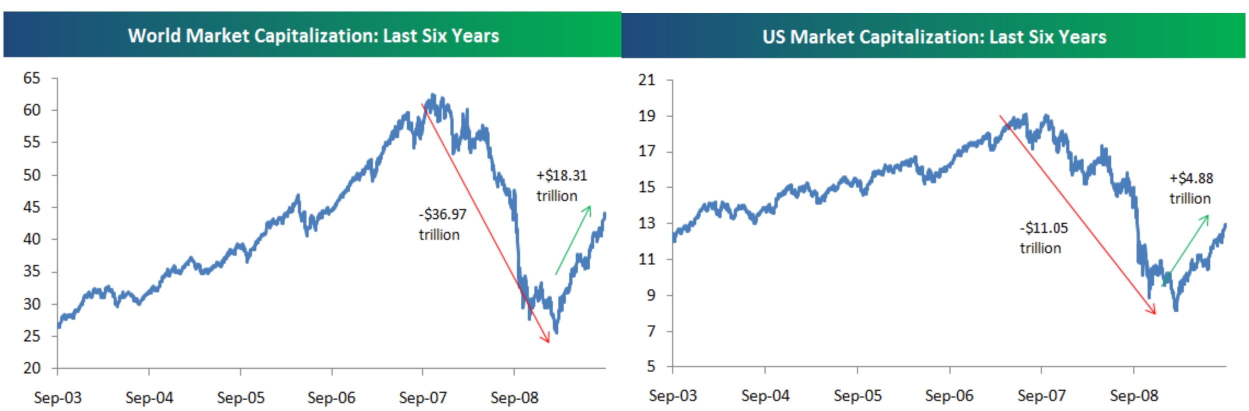


March 2008 to December 2008

January 2009 to March 9th, 2009

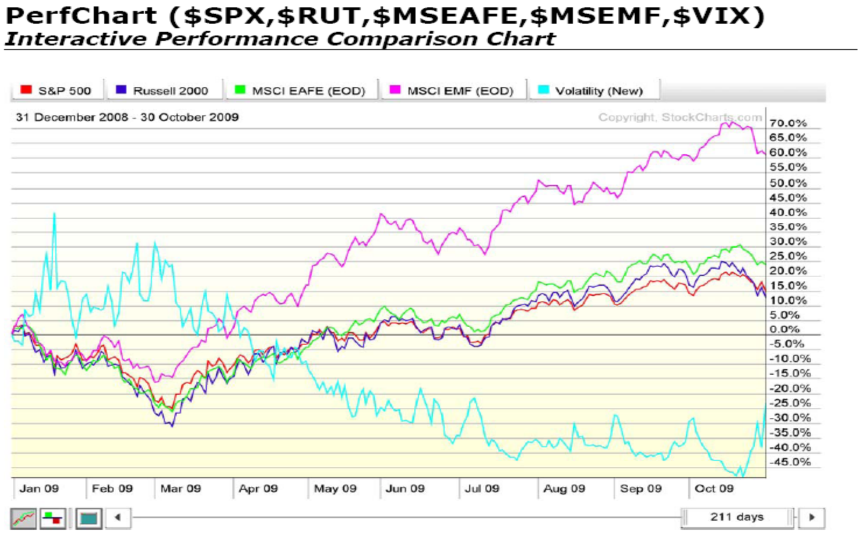
March 9th, 2009 to October 19th, 2009

Last year featured Bear Stearns, Lehman Brothers, AIG, and the government-sponsored enterprises in leading roles. Some were voted off, others were swallowed by stronger tribes, and still others were reorganized under the umbrella of government control. Few large financial institutions survived and a handful emerged more powerful than before the crisis. 2009 ushered in an accelerating wave of stock market losses, which culminated in the lows of March 9th. When it was all said and done, that bear market recorded larger declines than any other since the Great Depression. The economic news was universally bad and investors were ready to throw in the towel. What followed during the next seven months was nothing short of amazing. The rebound off the March 9 lows has been so swift and powerful, that it emboldened some to pronounce the beginning of the next secular bull market. Others vehemently argued that the 2009 rally is simply a bear market rally that has gone too far. Only time will give us the right answer. The fact is that the stock markets around the world have recovered $18 trillion of market capitalization since mid-March, but are still 30% below the peak reached in 2007.



Source: Bespoke Research Group

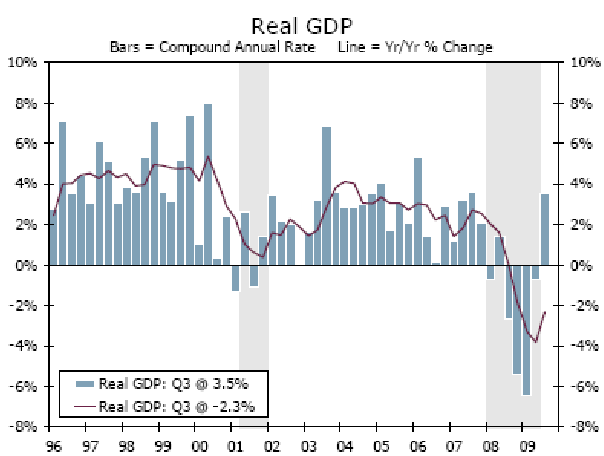
Closing the books on October brought back a more somber mood. It marked the first losing month for equities since February and gave credence to those market analysts who had been calling for a breather. Indeed, financial markets never move up or down in a straight line; perhaps the correction we are currently experiencing was overdue. After a gain of more than 60% over approximately 220 days, it is reasonable to expect that profit-taking and investor skepticism would lead to a partial retracement of the market advance.



Source: StockCharts.com

As shown in the chart above, both domestic and foreign markets have taken a step back; smaller market cap companies, which had led the rally, have paced the recent declines. In addition, volatility (light blue line in the chart) has returned, rising to levels not seen since the summer. The Chicago Board Option Exchange's Market Volatility Index (VIX), also known as the fear gauge, has spiked back to 32 from its low of 21 just a couple of weeks ago. We believe that volatility will remain elevated for an extended period as Mr. Market continues to seek a fundamentals confirmation in the form of consistently and sustainably improving economic measures. In addition, the end of the year brings tax-loss selling, window-dressing, and ETF trading that may have a material impact on daily volatility and market movements. As always, the short-term direction of the market is difficult to predict, but we wouldn't be surprised if VIX settled above its long-term average of 20.

On the economic front, the U.S. recession technically ended in June 2009. Third quarter real GDP grew at a 3.5% annualized rate, ending the streak of four consecutive quarters of GDP declines. This was a stronger-than-expected reading. It was driven to a large degree by consumer spending that got a boost from the government's "cash for clunkers" program. However, as long as unemployment continues to climb higher, consumer sentiment will be at risk. Going forward, therefore, consumer spending is less likely to provide a tailwind and GDP growth will depend more on exports, inventories, and government spending.



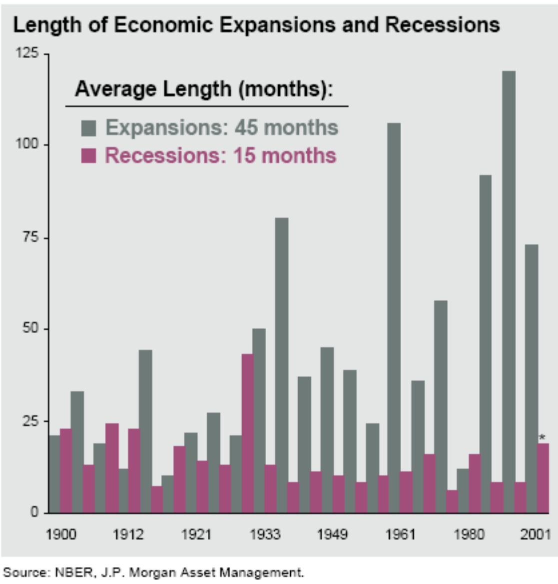
Source: Wells Fargo Economics Group

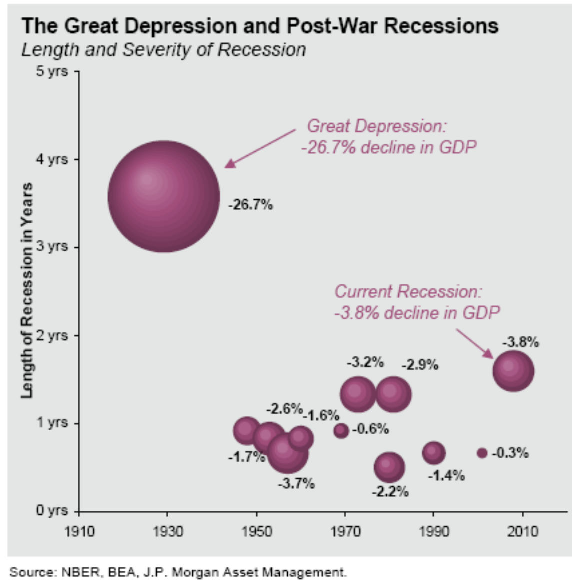
Table 1 Real GDP Peak-to-Trough

Business Cycle Peak to Trough	Duration of recession	Decline in GDP Peak to trough
Nov. 1948 - Oct. 1949	11 months	-1.69%
Jul.1953 - May 1954	10 months	-1.97%
Aug.1957 - Apr. 1958	8 months	-3.73%
Apr. 1960 - Feb. 1961	10 months	-1.58%
Dec. 1969 - Nov. 1970	11 months	-0.63%
Nov. 1973 - Mar 1975	16 months	-3.19%
Jan 1980 - Jul 1980	6 months	-2.23%
Jul 1981 - Nov 1982	16 months	-2.87%
Jul 1990 - Mar 1991	8 months	-1.36%
Mar 2001 - Nov 2001	8 months	0.05%
December 2007 - June 2009?	**18 months**	**-3.83%**

Source: Northern Trust

According to Asha Bangalore of Northern Trust, "this recession is the longest on record in the post-war period and the deepest also. Real GDP has declined 3.8% from the peak in the second quarter of 2008 to the trough in the second quarter of 2009. This is the largest peak-to-trough decline of real GDP in the post-war period." The following charts from J.P. Morgan compare this Great Recession to previous business cycles. As one of the longest and the second most severe decline in economic activity, it certainly made history. Its end was brought about, in large part, by an unprecedented global government stimulus effort, whose long-term implications are still unknown.



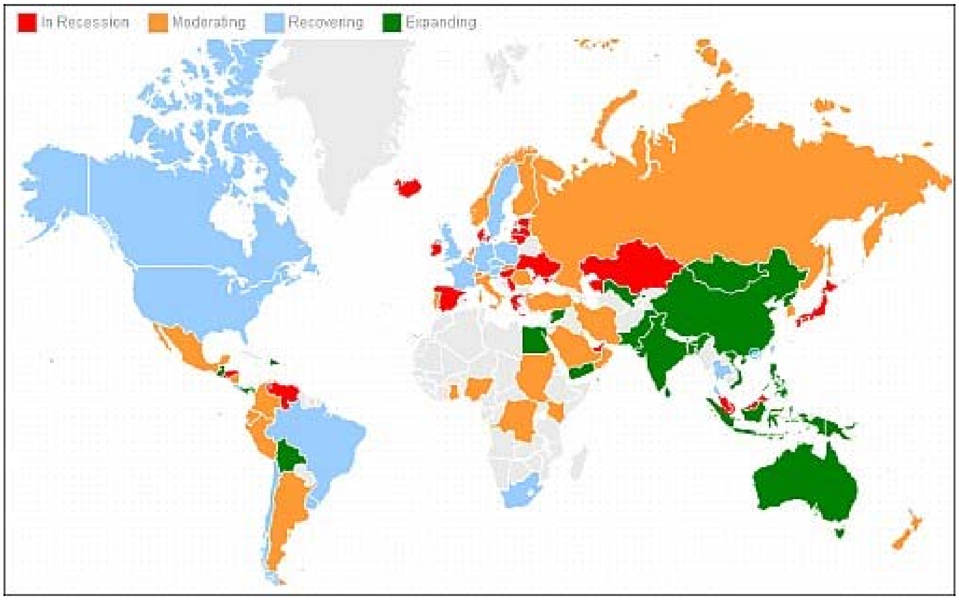


Source: J.P. Morgan

The process of recovery – now underway – will probably be, in the words of one economic analyst, "more muted than some hope, but less anemic than others fear". On one hand, the decline in commercial real estate values, unemployment approaching 10% (unofficial measures of unemployment, which include discouraged workers, are in the high teens), the sliding U.S. dollar, the implications of new regulation, and the ballooning budget deficit represent major headwinds and legitimate concerns going forward. There is still substantial work left to be done in reshaping the financial system and growing the U.S. economy without the benefit of government support.

On the other hand, news from the housing market has turned a corner, with many regions showing month-over-month increases in housing prices. Consumers have embraced prudence, saving more and spending within their means. Credit markets are also showing steady improvement – investment grade and high yield spreads are significantly below the panic levels of a year ago. The mergers and acquisitions market has come to life again, as companies with strong balance sheets take advantage of perceived strategic opportunities at attractive prices. And finally, some foreign economies have successfully restarted their growth engines, which should help stimulate demand in the U.S.

The following global map of economic health shows that, in addition to the U.S., most developed economies are in recovery mode, while some emerging markets, most notably China and India, are expanding. The noteworthy exceptions are Japan and Spain in the developed world, which are still in recession, and some important developing economies – such as Russia, Mexico, and South Korea – which are yet to enter the recovery phase.



Source: Investment Postcards from Cape Town, Dismal Scientist Economy.com

Third quarter corporate earnings are generally beating expectations on the strength of disciplined cost cutting. Weaker players have either exited the market or are being consolidated. Only a few businesses are able to report revenue growth. However, margin expansion and the improvement in the competitive environment will provide a boost to overall profits once final demand recovers and normalized economic conditions return. Moreover, the spirit of innovation and entrepreneurism remains engrained in the American business DNA and should drive aggregate profit growth going forward.

It is impossible to know in advance if the market will trade up, down, or sideways from here; there are simply too many moving parts and unknowns, not to mention the role played by unpredictable human emotions. PIMCO's Mohamed El-Erian characterized the current situation as "the point of maximum confusion in the multi-year transition of global economies, markets, and policymaking". From the perspective of equity investors, rising stock prices have pushed market valuations higher, but significant pockets of opportunities remain. Looking ahead, not all boats will rise, which makes fundamental research and security selection more important than ever. There will likely be significant differentiation between winners and losers, in terms of both operating and stock price performance. As a result, we also expect to see substantial performance gaps between passive and active strategies – the future environment should benefit active management over indexing.

This is precisely why Beacon Pointe's clients are not "invested in the market" as represented by various stock indices, but are entrusting their capital with a select group of investment managers that we believe will protect and grow that capital regardless of the market environment. These proven investors have the experience, discipline, independent thought, and conviction to construct concentrated portfolios of high-quality investments with limited downside risk, solid appreciation potential, and a requisite margin of safety. They typically invest in companies with leading market positions, pricing power, solid balance sheets, and consistent cash flow generation that ultimately translate into increased shareholder value. Many of these companies lagged the market during the recent rally, and as a result, now represent even more attractive opportunities for the long-term investor.

At the beginning of this letter, we likened the past 18 months to a series of reality TV shows. What will the next few years be like? We suggest that the script will read like “So You Think You Can Invest”. Much like in the eponymous dance competition, the winners will be those talented, persevering, and versatile investors that overcome challenges and perform well regardless of the frequent style changes from week to week (or quarter to quarter). The investment managers we talk to all agree that “the easy money has been made off the March lows”; the next two-to-three year will “star” managers with bona fide investment acumen. We at Beacon Pointe believe that our differentiated, intensive, and focused manager research process helps us identify those managers in a timely and efficient manner. Furthermore, our asset allocation, diversification, and manager selection recommendations are always customized according to each client’s specific investment objective and risk tolerance. We are confident that this strategy will serve our clients well going forward, as it has done so in the past.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.