BEACON POINTE

ADVISORS

Beacon's Point: The Royal Road to Riches

February 4, 2011

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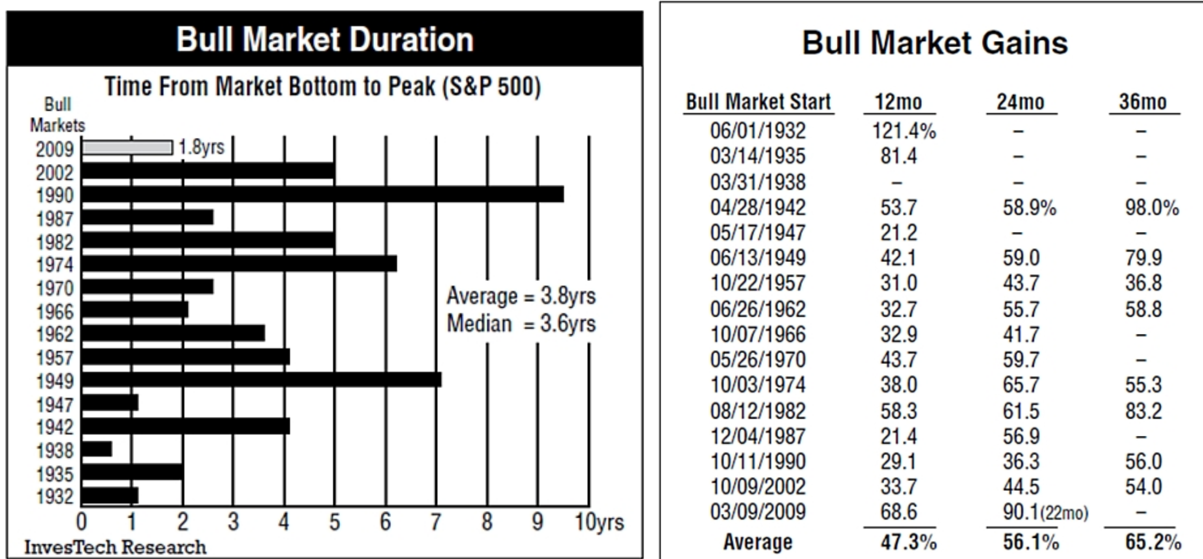
The Royal Road to Riches

Human beings, including those in the investor tribe, tend to have short memories. For the past two years financial markets have marched upwards in a seemingly uninterrupted fashion, making it quite easy to forget the lessons of 2008. As shown in the InvesTech Research charts below, the current bull cycle is still young by historical standards (1.8 years vs. the average of 3.8 years), but its 90% gain over 22 months has outpaced any of its predecessors since the Great Depression.



Bull Market Gains

Bull Market Start	12mo	24mo	36mo
06/01/1932	121.4%	–	–
03/14/1935	81.4	–	–
03/31/1938	–	–	–
04/28/1942	53.7	58.9%	98.0%
05/17/1947	21.2	–	–
06/13/1949	42.1	59.0	79.9
10/22/1957	31.0	43.7	36.8
06/26/1962	32.7	55.7	58.8
10/07/1966	32.9	41.7	–
05/26/1970	43.7	59.7	–
10/03/1974	38.0	65.7	55.3
08/12/1982	58.3	61.5	83.2
12/04/1987	21.4	56.9	–
10/11/1990	29.1	36.3	56.0
10/09/2002	33.7	44.5	54.0
03/09/2009	68.6	90.1(22mo)	–
Average	**47.3%**	**56.1%**	**65.2%**

Source: InvesTech Research

What will the next two month or two years look like? As always, Beacon Pointe does not claim to have a crystal ball for the future and leaves the forecasting business to the media pundits and celebrity-seekers. However, we feel it is important to remind ourselves that, over the long term, capital preservation is as important as capital appreciation. Although the mathematical equation of compounding or linking periodic returns is well-known, it is perhaps worth revisiting again. We consider the last three calendar years and compare the performance patterns of three different equity managers (these are actual, not simulated results) and the S&P 500 Index.

	2008	2009	2010	**CummulativeThree Years**
Manager A	-11%	20%	9%	**17%**
Manager B	-27%	31%	11%	**7%**
Manager C	-42%	31%	13%	**-13%**
S&P 500 Index	**-37%**	**26%**	**15%**	**-8%**

Equal investments of $100 in each of the four options at the beginning of the three-year period would result in very different ending values. Manager A turned the initial investment into $117. It added value by limiting its loss in 2008, which meant it had less to make up in the subsequent years. As a result, even though Manager A's returns in 2009 and 2010 lagged the broad market index, it finished well ahead of the benchmark and solidly into positive territory. Manager B outperformed in 2008 and kept pace with the market in 2009, but lagged in 2010. Again though, by virtue of losing less in the down market, Manager B realized positive

cumulative three-year returns and increased the value of the initial investment to $107. On the other hand, Manager C and the S&P 500 Index recorded substantial losses during 2008 and ended that year with $58 and $63 dollars, respectively. That put them at a significant disadvantage, as they had a long climb ahead just to get back to even. In fact, the ending portfolio values of Manager C ($87) and the Index ($92) are still underwater, despite solid positive performance in 2009 and 2010.

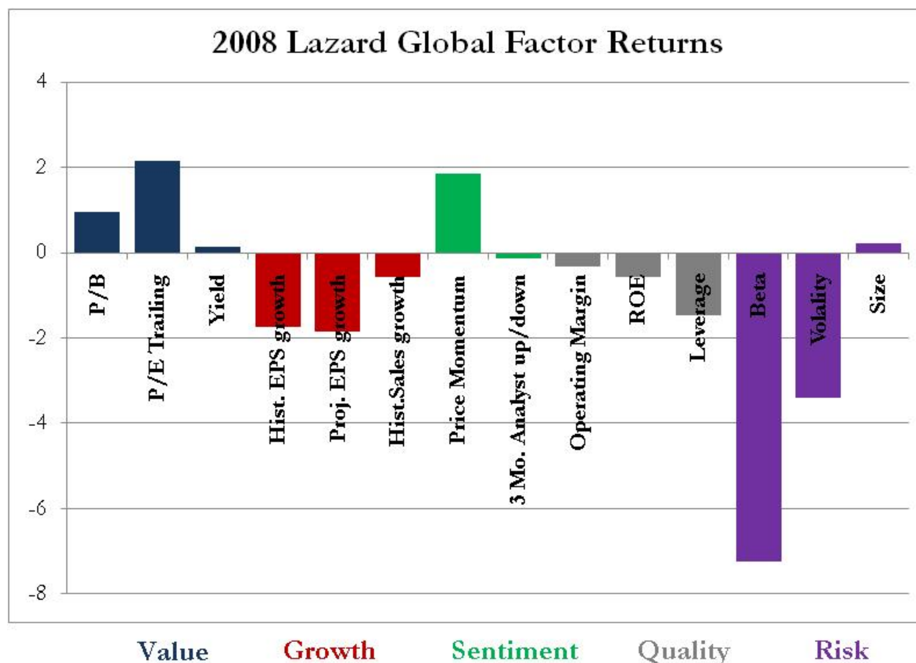
The mathematical reality of capital destruction means that:

- If you lose **10%**, you need to make **11%** to get back to even;
- If you lose **25%,** you need to make **33%** to get back to even;
- If you lose **33%**, you need to make **50%** to get back to even; and
- If you lose **50%**, you need to make **100%** to get back to even.

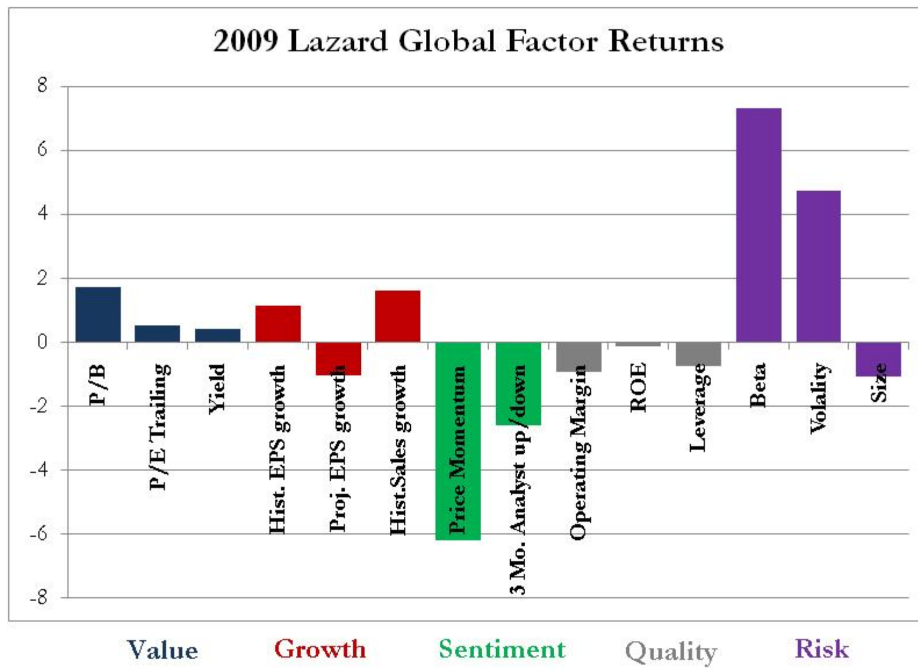
Beacon Pointe's investment philosophy and research process seek to identify money managers that emphasize downside protection and the preservation of client capital. They construct concentrated portfolios of carefully selected high-quality investments based on their independent research, thorough evaluation of the fundamentals, and a disciplined valuation framework. These strategies tend to perform much better than the broad market indexes during bear markets such as 2000-2002 and 2008 as well as in "normal" markets (those driven by fundamentals). However, they usually lag in narrow markets (i.e. driven by a single sector, such as technology or energy) or during low-quality market rallies.

Let us examine the primary drivers of market performance during the past three calendar years:

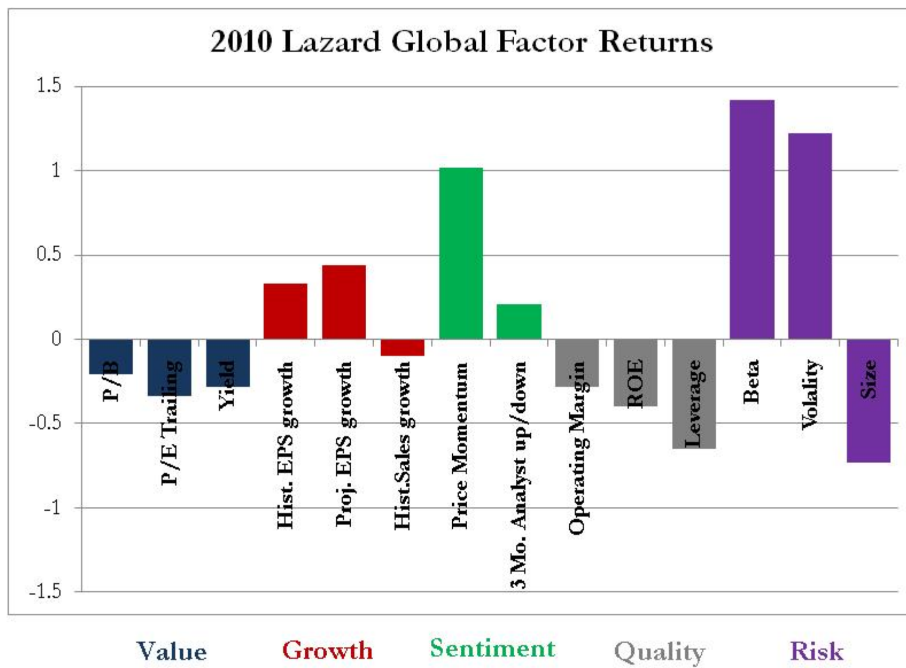
- 2008 was dominated by risk-aversion. Accordingly, high beta, high volatility, high leverage, and high growth investments led markets to the downside.



- 2009 brought about a reversal of fortunes. High beta and high volatility grabbed the headlines again, but this time they propelled the markets higher.



- 2010 saw a continuation of the high-beta, high-volatility rally, but two other factors joined the party – price momentum and high growth.



(The three graphs above are courtesy of Lazard Asset Management. The following footnote provides an explanation of the methodology used for calculating factor returns.)

Notes

1 Factor performance is based on a universe of developed market stocks with a market capitalization of $200mm or greater (approximately 6,000 companies). Global factor returns reflect the return differential, computed monthly, for an equal weighted composite of stocks ranked in the top and bottom 20% (quintile) for each measure shown. For example, each month the aggregate return for stocks ranking in the top 20% in terms of operating margins is subtracted from the aggregate return for stocks ranking in the bottom 20%. The difference is the return displayed. The monthly differences are averaged for longer time periods.

The calculation for P/B, P/E and leverage reflect the performance difference between the lowest quintile less the highest quintile. For all other measures, the difference reflects the difference between the highest quintile less the lowest quintile. P/B is calculated as current market price divided by book value. P/E is calculated as current market price divided 1 year trailing earnings. Yield is calculated as most recent dividend by current market price. Historic EPS Growth is calculated as a 5 year trailing earnings per share growth. Projected EPS growth is calculated as IBES analyst forecasted 3-5 year growth in earnings per share. Historic Sales Growth is calculated on a 5 year trailing growth in sales revenue. Price momentum is calculated as the 12 month change in USD price. 3 MO Analyst Up/Down is calculated as the change in the average EPS estimate over the past three months. Operating margin is calculated as net operating income divided by total revenue. ROE is calculated as the net income divided by shareholder's equity. Leverage is calculated as outstanding debt divided by shareholder's equity. Beta is calculated against local market indices for periods up to 36 months. Volatility is calculated on a trailing 270 day average of USD based price returns. Size is market capitalization as calculated according to MSCI.

Source: Lazard Asset Management

Needless to say, this has been a difficult terrain for investment managers to navigate. A changing market environment, however, would **not** cause our managers to deviate from their fundamental philosophies or investment styles. They remain committed to the strategies and processes that have generated their strong historical performance track records and continue to manage portfolios with the clients' goals in mind and with a view toward the long run. Similarly, Beacon Pointe is steadfast in its conviction that a strategic approach, proper diversification, diligent manager selection, and a long-term investment horizon afford our clients the best opportunities to achieve their goals with the minimal amount of risk possible. We concur with the venerable Richard Bernstein, who said that *"Compounding is the royal road to riches. Compounding is the safe road, the sure road, and fortunately anybody can do it. To compound successfully you need the following: perseverance in order to keep you firmly on the savings path. You need intelligence in order to understand what you are doing and why. You need knowledge of the mathematical tables in order to comprehend the amazing rewards that will come to you if you faithfully follow the compounding road. And, of course, you need time, time to allow the power of compounding to work for you. Remember, compounding only works through time."*

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