BEACON POINTE

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BEACON'S POINT: CORRECTION OR CRISIS?

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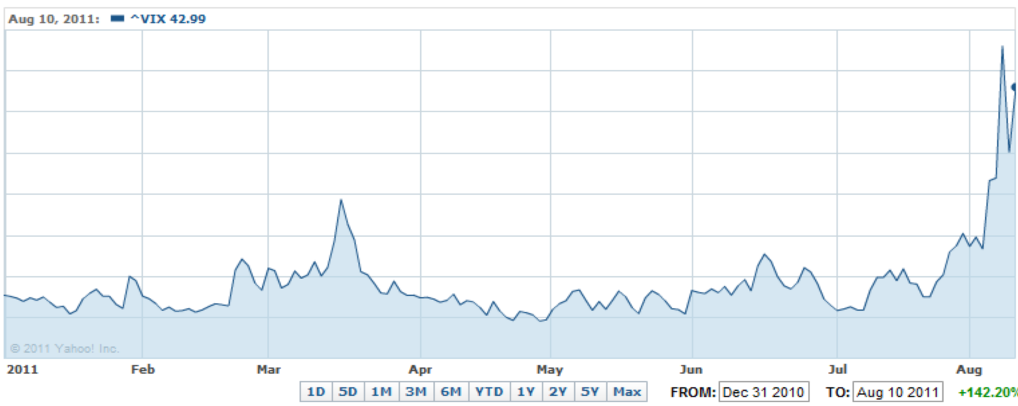
500 Newport Center Drive, Suite 125, Newport Beach, CA 92660
TEL 949.718.1600 FAX 949.718.0601 www.bpadvisors.com

Correction or Crisis?

Financial markets have been incredibly volatile over the past two weeks. One day brings a steep sell-off, then bargain-hunters enter the market and push prices higher, only to see the trend turn down again as concerns about global economic growth, the European sovereign debt crisis, or the U.S.' long-term fiscal health return to the front and center of investors' minds. The Dow Jones Industrial Average experienced moves of 400 points or more in either direction for four consecutive trading days. Gold prices reached new nominal record highs. The CBOE Volatility Index (VIX) spiked to 48 on August 8th and has more than doubled since the beginning of the year, as shown in the following chart:



Source: Yahoo Finance

The emotional pendulum has swiftly swung from greed (risk-on) to fear (risk-off). Although investors strive to act rationally, they are, after all, human beings bound by their emotions. It takes a strict discipline, unwavering conviction, and the insight coming from rich and varied experience to avoid making rash, imprudent decisions in the current environment. The S&P's one-day loss of 6.7% on August 8th was no doubt extreme, yet not unprecedented. Most of us remember late 2008, which contributed 7 of the 16 worst performing days for the S&P listed in the table below. Interestingly, the one-year return following most of these "Hall of Pain" days was strongly positive. On average, the index gained 21% over the subsequent 12-month period.

S&P 500 Index Returns During and After Worst Performing Days (1950-present)

Date	Return	Following 1-Year Return
10/19/1987	-20.47%	24.26%
10/15/2008	-9.03%	20.29%
12/01/2008	-8.93%	34.23%
09/29/2008	-8.81%	-3.93%
10/26/1987	-8.28%	24.03%
10/09/2008	-7.62%	17.10%
10/27/1997	-6.87%	22.27%
08/31/1998	-6.80%	38.31%
01/08/1988	-6.77%	15.31%
11/20/2008	-6.71%	45.51%
05/28/1962	-6.68%	25.89%
08/08/2011	-6.66%	?
09/26/1955	-6.62%	7.37%
10/13/1989	-6.12%	-10.08%
11/19/2008	-6.12%	37.59%
10/22/2008	-6.10%	20.59%
Average	**-8.04%**	**+21.25%**

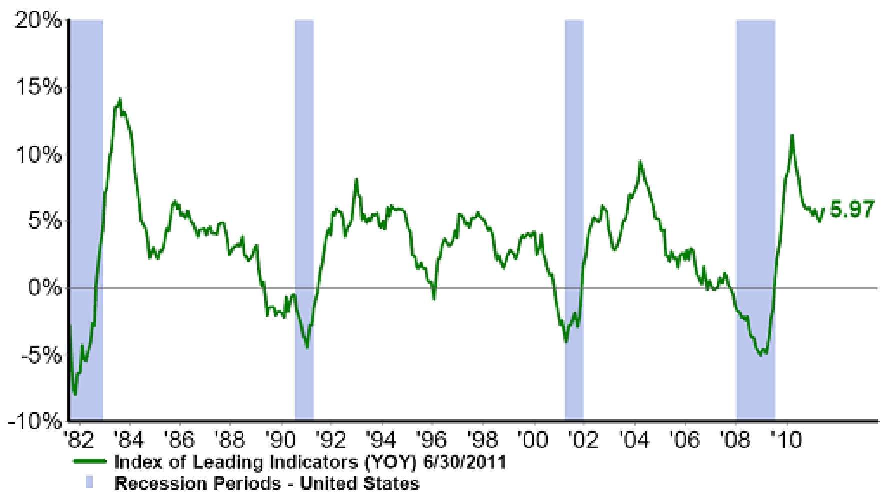
Source: BlackRock

Unquestionably, the re-pricing of risk across all asset classes is at least partially warranted by fundamental factors and persistently high macro-economic uncertainty. Across the Atlantic, the sovereign debt situation continues to unfold; most recently, rumors circulated that France's AAA credit rating was in jeopardy. Domestically, second quarter GDP growth came in below expectations and first quarter GDP growth was revised down. For the first half of the year, the U.S. economy grew at a positive but uninspiring 0.8% rate. Unemployment is still hovering at or above 9% and the housing market faces continuing challenges. Lastly, the S&P downgrade of U.S. Treasuries has intensified pressure on Washington to find a common ground on normally contentious issues such as entitlement programs and taxes in order to restore fiscal discipline and reduce the government's burgeoning deficits.

Besides these fundamental factors, there is also mounting evidence that high frequency traders, algorithm-based programs, and quantitative hedge funds have contributed to the abnormally-high volatility of the past two weeks. According to one source of market data, over 70% of the daily trading volume nowadays is generated by this group of market participants. While this pattern of extreme market swings is frustrating to observe and sometimes difficult to explain, it also creates a lot of opportunities for long-term, fundamentals-based, valuation-focused investors. Consider the following:

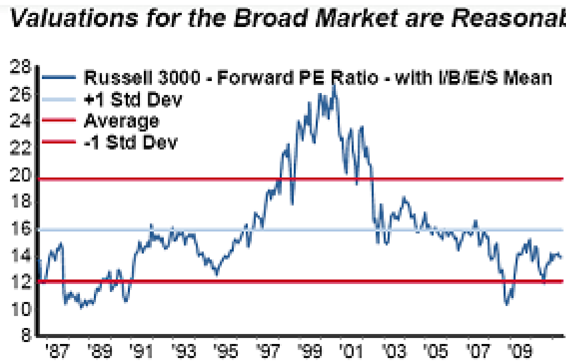
> *Warren Buffett, founder and chairman of Berkshire Hathaway, told Fortune magazine that he has been buying stocks in the current downturn and that he has not seen anything to suggest the economy is headed for another recession: "The lower things go, the more I buy." (Source: Wells Fargo Daily Advantage)*

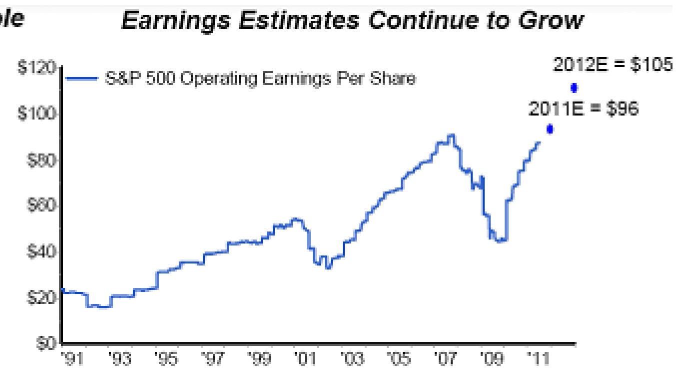
Moreover, Bloomberg reported that between August 3rd and August 9th, 66 corporate insiders at 50 companies bought their companies' shares, the most since the week ended March 9th, 2009 (the bear market trough). A few other important events have transpired recently which should provide support for asset prices going forward. The recent commitment by the Fed to keep short-term interest rates low through mid-2013 is a significant stimulus to the economy. Treasury rates across the curve have fallen, rather than spiked, as many had feared at the time of the S&P downgrade. Credit spreads are holding up well. Energy and other commodity prices are off their highs, providing some relief from inflationary and margin pressure. And finally, while the index of Leading Economic Indicators (LEI) has moderated in the last few months, it remains well into positive territory, indicating that conditions are still improving on a year-over year basis.



Source: Fidelity Investments and FactSet Research Systems

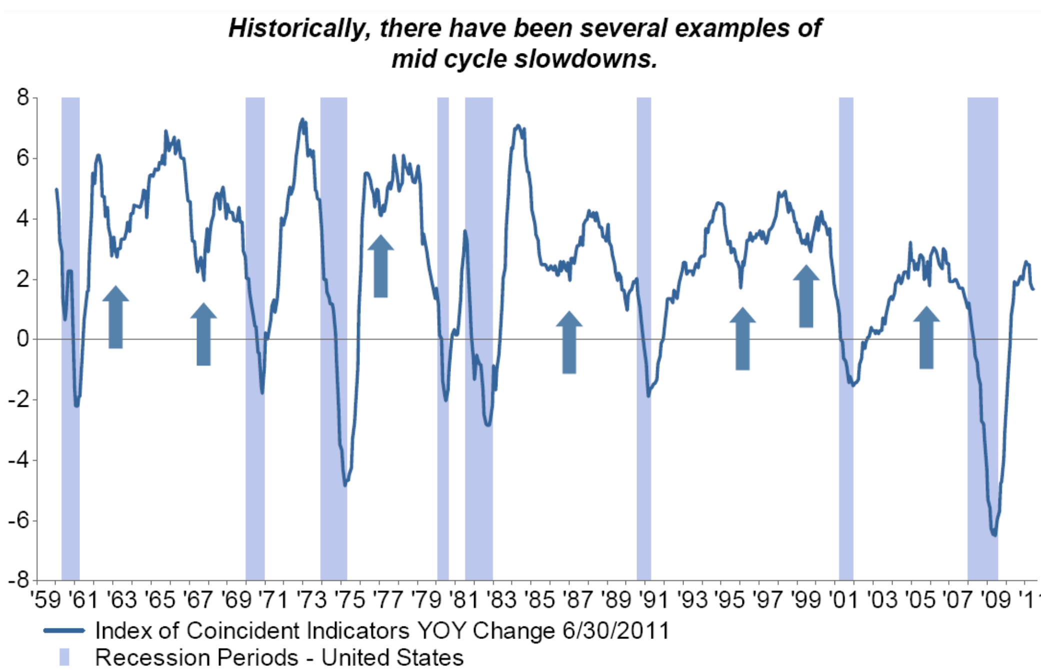
Several additional factors supportive of equities, particularly in the U.S., are highlighted in the graphs below. These include reasonable valuations (made even more attractive by the recent sell-off) and continuing growth in aggregate earnings.





Source: Fidelity Investments

At present, the U.S. economy is 25 month into the expansion phase of the current economic cycle. This is well below the 110-year average expansion duration of 45 months. Odds are that the current soft patch indicates a mid-cycle slowdown, rather than another recession. As shown below, this would be consistent with prior cycles. Russ Koesterich, Global Chief Investment Strategist at Blackrock, believes that "while it is hard to find a catalyst for a quick rebound, a combination of easy monetary policy, a healthy corporate sector, and declining commodity prices should be sufficient to keep the economy out of recession." At the same time, current equity prices suggest that markets are discounting a much more somber scenario.



Source: Fidelity Investments, FactSet Research Systems

Is the recent market volatility a simple correction or will it lead to a full-blown crisis? No one can predict what stocks, bonds, and other asset classes will do over the next few weeks, but we believe that what we are experiencing is a correction. Despite the sense of déjà vu, the set of problems we face today are different from the economic and market realities from three years ago, when the world was gripped by a liquidity freeze and a severe market meltdown. The level of leverage in the private system is significantly lower today; businesses have restored their balance sheets, are growing earnings and margins, and are engaging in M&A initiatives. That being said, we do expect volatility to remain elevated. Given this challenging environment, now more than ever it is important to maintain perspective, keep one's emotions in check, and continue executing on a sound long-term strategic plan. The venerable Peter Bernstein once said that you cannot manage returns, all you can do is manage risk. Beacon Pointe has always focused on risk management in its approach to asset allocation and manager selection. Our emphasis on diversification and capital preservation results in client portfolios that are well positioned to weather any further potential market turbulence and to ultimately grow over each client's investment time horizon.

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