BEACON POINTE
ADVISORS

# Beacon's Point: And The Beat Goes On...

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*Confidential – Proprietary*



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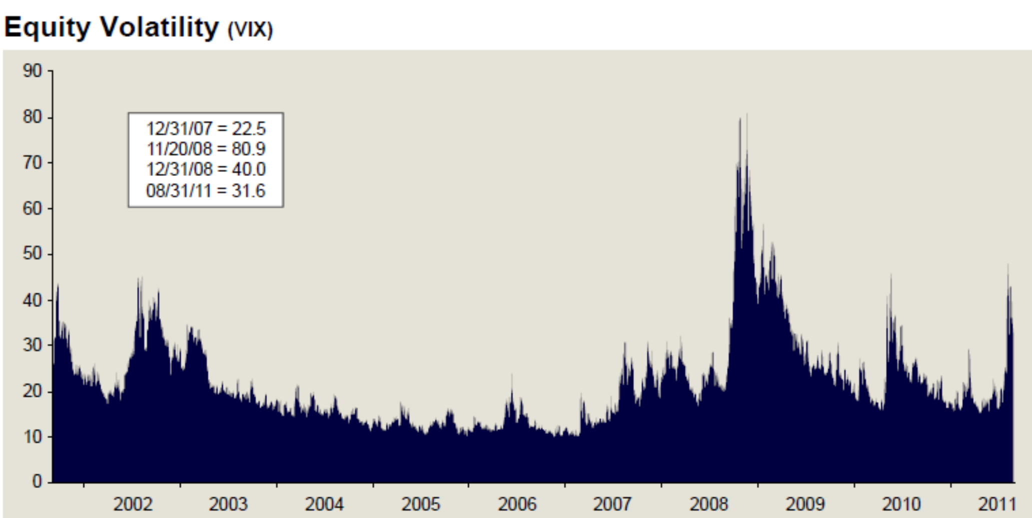
## And The Beat Goes On...

Financial markets are sending a strong signal to the world's political and economic leaders that their policies and initiatives are not working. The exact diagnosis and recommended course of treatment are open for debate. While Beacon Pointe's team has limited medical expertise, we believe that the global economy is similar to the human heart. There are billions of individual cells in this vital organ, each with its own beat, together responsible for pumping blood throughout the blood vessels by repeated, rhythmic contractions. When one or more of these cells is starved for oxygen, the heart's normal beat (72 beats per minute, on average) is disrupted, causing a person to experience pain. Many times, the passage of time or a single aspirin can relieve the pain. However, in extreme cases muscle cells die from a lack of oxygen, resulting in arrhythmia, or even cardiac arrest. Often times, a defibrillator is needed to restore the heart's normal sinus rhythm.

Much like the heart, the global economy is one big muscular system pumping wealth and value among the populace. A few rogue cells can interrupt its efficient functioning and progress. Equity markets, through their discounting mechanism, frequently serve as an early warning system for economic arrhythmia and the potential need for a defibrillator. At present, the message is clear – markets have lost confidence in Washington, DC; leverage is still too high at the government and individual level; European banks are on the brink of insolvency; businesses will not fully commit to hiring, capital spending, and growth until they see some resolution to the prevailing tax and regulatory uncertainty. Volatility (measured by the CBOE VIX Index) has once again spiked, as economic doubts and fears became widespread. As shown below, the so-called "fear gauge" reached 48 on August 8th, 2011 and has remained elevated ever since.

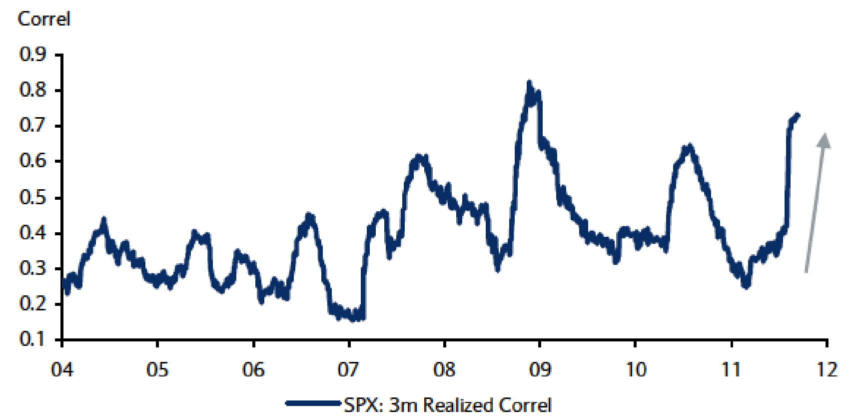



**The VIX Index closed at 41 on September 23rd, 2011.**

*Source: ING Global Perspectives*

With one week left in the seasonally weak third quarter, it is all but certain that the S&P 500 Index will end September down for the YTD period and flat on a trailing one-year basis. From its near-term high of 1,364 (reached on April 29th, 2011), the S&P 500 has lost almost 17%. Macroeconomic concerns have been the dominant force in media headlines and on investor minds. As a result, correlations among stocks (that measure the extent to which stocks move together, regardless of company-specific fundamentals) have reached extreme levels, as shown in the graph on the following page.

**In previous periods when macroeconomic factors dominated individual stock movements, it lasted two months before conditions began to normalize; we are about one month into a similar period of extreme correlation**

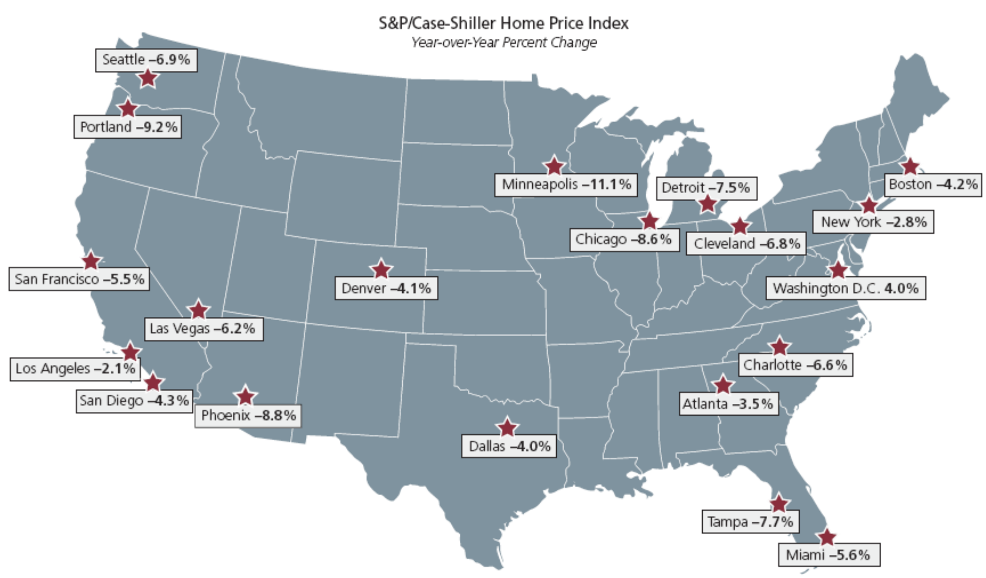



*Source: Barclays Capital*

The sell-off started in late July, intensified in August, and has persisted throughout September. The debt ceiling stalemate and an unprecedented U.S. credit rating downgrade by Standard& Poor's gave rise to a risk-off sentiment, while a round of disappointing economic data suggested slowing economic growth. Second quarter GDP advanced just 1% on a year-over-year basis and the first quarter reading was revised down to 0.4%. Unemployment remains above 9% and U.S. housing prices are still falling. As shown in the map below, Minneapolis, MN (-11.1%), Portland, OR (-9.2%), Phoenix, AZ (-8.8%) and Chicago, IL (-8.6%) recorded the most significant declines. Washington, DC (+4.0%) and – surprise! – Los Angeles, CA (-2.1%) were the best performers in the 20-city S&P Case-Shiller Home Price Composite Index.

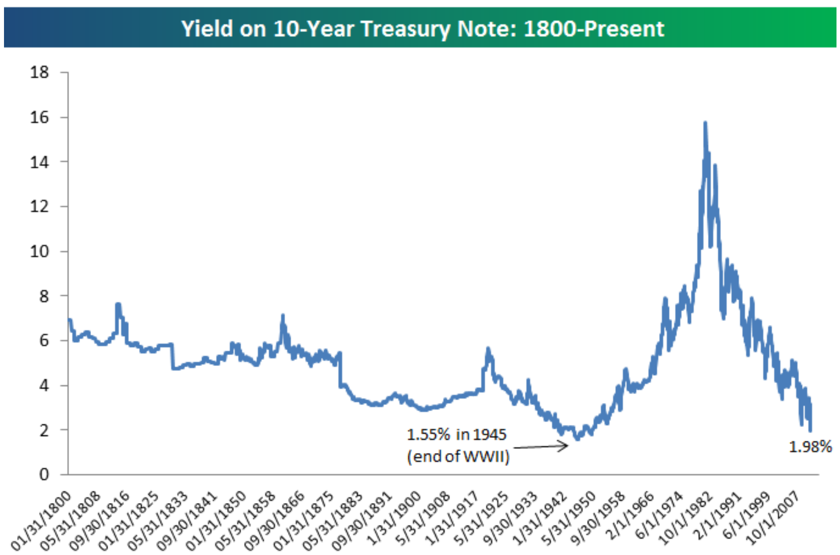
**U.S. Housing Remains a Drag on the Recovery**

The housing market continues to be a drag on U.S. growth, both directly, via weak residential investment, and indirectly, as a drain on household confidence. Given the massive oversupply of homes on the market and the number of homeowners underwater on their mortgages, the housing sector may have years to go before fully recovering.




*Source: Oppenheimer Capital*

That being said, core fundamentals for manufacturing, retail sales, personal consumption, and corporate profits remain positive. Furthermore, global trade, spurred by the emerging middle class, could prove to be just the catalyst needed to restart the world's growth engine. Finally, interest rates are at historic lows. In August, the Federal Reserve announced its intent to keep short-term rates low through mid-2013. Last week, as expected, the Fed launched "Operation Twist", the latest in a series of efforts to promote sustainable economic growth. In essence, the Fed plans to partially shift its existing Treasuries portfolio out of short-term maturities and into longer-dated bonds. Fixed income securities rallied on the news, with the 10-year Treasury yield falling below 1.75% for the first time since the end of World War II.




**The 10-year Treasury yield fell further to 1.72% on September 22nd, 2011.**

*Source: Bespoke Investment Group*

A few contrarian indicators point to an oversold condition, implying that markets may be bottoming out. Mutual fund flows this year decidedly favor bonds over stocks. Broadly speaking, investors regard the world as insecure and seek the safety of fixed income instruments.

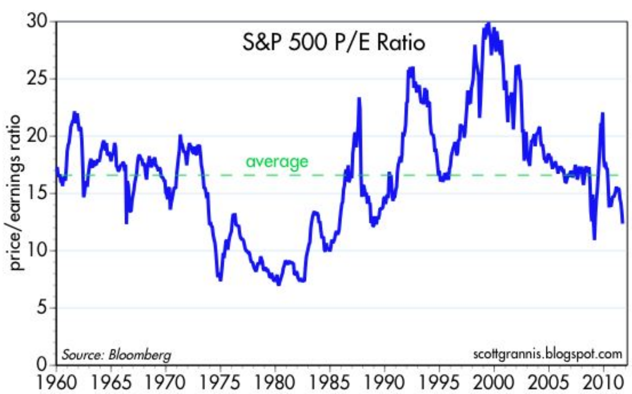
**Mutual Fund Flows**

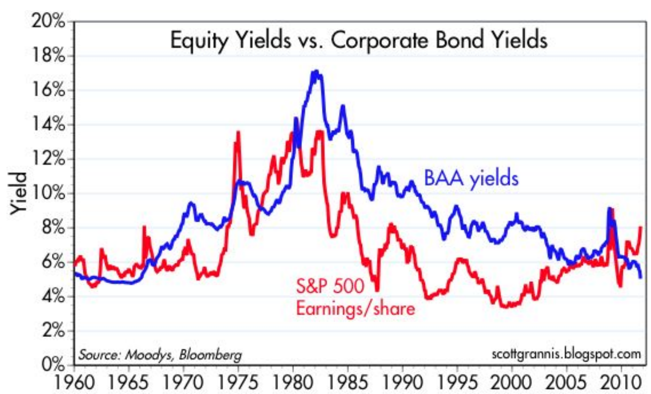
| *millions USD* | YTD 2011 | 2010 | 2009 | 2008 | 2007 |
|---|---|---|---|---|---|
| Asset Class Flows | | | | | |
| Total Equity | (116,652) | (28,765) | (9,056) | (234,387) | 90,816 |
| Domestic | (73,569) | (87,739) | (39,666) | (151,749) | (47,791) |
| Foreign | 15,242 | 58,975 | 30,613 | (82,635) | 138,609 |
| Hybrid | 26,763 | 23,522 | 22,764 | (18,414) | 24,162 |
| Total Bond | 73,747 | 246,000 | 376,137 | 27,593 | 108,768 |
| Taxable | 97,854 | 234,817 | 307,052 | 19,773 | 97,895 |
| Municipal | (24,113) | 11,183 | 69,086 | 7,820 | 10,874 |
| Total | 42,179 | 240,756 | 389,847 | (225,209) | 223,749 |
| AUM | | | | | |
| Money Market | 2,637,002 | 2,814,001 | 3,302,793 | 3,840,054 | 3,122,000 |
| Change YTD | (176,999) | | | | |

*Source: ING Global Perspectives*

With risk appetite virtually non-existent, investors are pulling money out of domestic stocks and moving into fixed income and money market funds. According to Bloomberg, more than $75 billion have been withdrawn from U.S. equity funds since April, 2011. This is a larger amount than the five-month total withdrawal following the collapse of Lehman Brothers in 2008. Other sources report that investors currently have $3.17 trillion sitting in money-market funds. In addition, Barron's Mike Stanoli notes that short interest relative to market capitalization "has exceeded any level going back to 2009".

And then there is the issue of valuations. Beacon Pointe's research team just returned from a trip through the middle of the country that included investment manager site visits in St. Louis, Kansas City, Louisville, and Columbus. The Portfolio Managers and Research Analysts we spoke with were closely monitoring macro-economic events and undeniably concerned about the increasing risks to global growth. At the same time, their bottom-up fundamental research-intensive approach is currently leading them to more numerous attractive opportunities than at any other time since March 2009. The following charts and analysis by Mr. Scott Grannis, investment blogger and former Chief Economist of Western Asset Management Company, reinforce the valuation case for equities.




> *This week's market swoon improved equity market valuations that were already attractive. The 12-month trailing P/E of the S&P 500, according to Bloomberg, is now around 12.5, well below its 50-year average of 16.6. On an earnings basis, equities are now yielding around 8%, much higher than the 5% yield on BAA corporate bonds, according to Moody's. The only logical explanation for why valuations are so attractive is that the market fully expects a significant deterioration in corporate earnings in the years to come.*

*Source: Scott Grannis, Bloomberg, and Moody's*

As stated at the beginning of this letter, some of the cells that comprise the global economic heart are not functioning properly. Financial markets are flashing a warning signal: things need to change in order to prevent a more serious condition. The onus is on the U.S. and European leaders to make real progress toward problem resolution on all fronts: political, fiscal, monetary, regulatory, and social. Absent such progress, the world's economy - especially in the developed camp - risks cardiac arrest. The defibrillator will then have to be pulled out of storage to shock the system back into sinus rhythm. Beacon Pointe believes that the steps necessary to prevent this scenario will be undertaken and a crisis will be averted. In the meantime, the investment managers we recommend to our clients are working tirelessly to uncover investment opportunities that will help anchor portfolios through turbulent times and achieve client objectives over the long run.

The current environment of heightened uncertainty presents investors with both perils and opportunities. We have highlighted some of challenges in this and prior market letters. However, once the uncertainty on both sides of the Atlantic begins to clear up, markets could propel forward, considering the amount of cash on the sidelines and on corporate balance sheets. This type of down-and-up market generally favors those with a focus on security selection, a strong research effort, and unwavering valuation discipline. These are the managers Beacon Pointe has always recommended for client portfolios and, we believe, they will continue to make good decisions that position your portfolios well for preserving and growing capital in the future.

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