BEACON POINTE

ADVISORS

# Beacon's Point: Handle With Care

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*Confidential – Proprietary*



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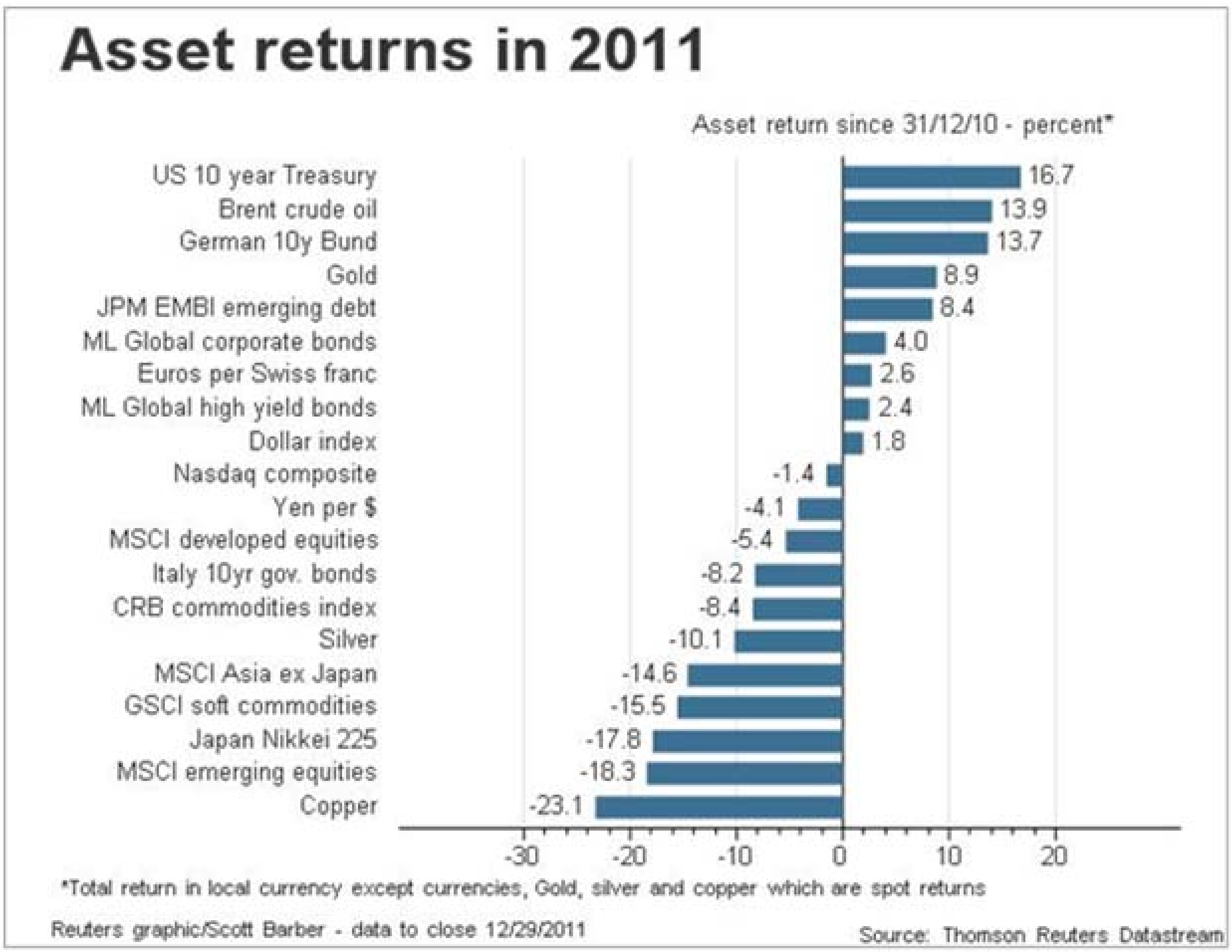
## Handle With Care

While we recognize that what most interests our clients and friends are Beacon Pointe's thoughts for the coming 12 months and beyond, it is important to take a look back at the developments and events of the past year as they provide context for our views regarding the future. Once we reflect, we will share some brief thoughts for 2012.

After all the ups and downs, the S&P 500 Index closed the year with a small gain (+2.1%, including dividends). Growth stocks generally outperformed Value stocks and Large Caps had a substantial lead over Small Caps. Non-U.S. equities fared poorly, losing between 12% (developed non-U.S. markets) and 18% (emerging markets). U.S. Treasuries had a record year, with the 10-year bond advancing almost 17%. Commodities produced mixed results - oil and gold prices were quite strong (up 14% and 9%, respectively), while industrial metals such as copper lost over 20% for the year.

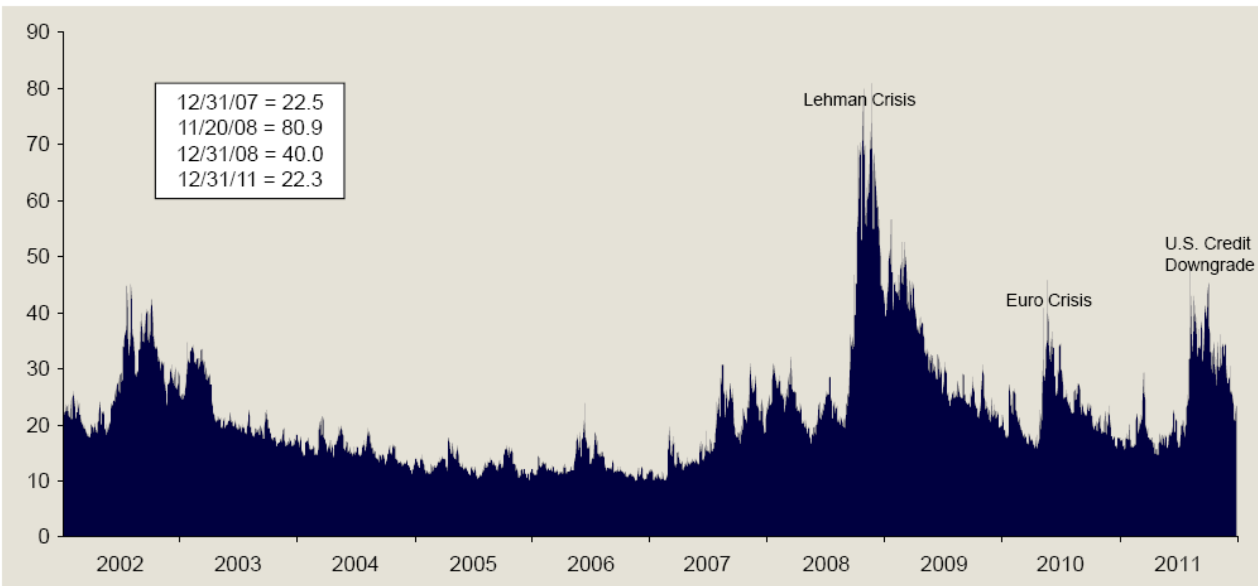



*Source: Thomson Reuters DataStream, Investment Postcards from Cape Town*

Beyond these numbers, the themes that defined 2011 included heightened volatility, geopolitical tensions, natural disasters, and fiscal challenges. Within the span of 12 months, markets swung back and forth between a feeling of confidence (a "risk-on" mentality) and a flight-to-safety (extreme risk aversion). After a positive first half of the year, the S&P 500 Index lost over 18% (excluding dividends) from late July through early October. This was followed by a 14% rebound over the fourth quarter of 2011 as buyers returned to the market and general investor sentiment improved. This summer's volatility spike, as shown in the following chart, was well below the levels of the 2008 Lehman Crisis, but was more long-lasting than the initial Euro Crisis episode that occurred in 2010.

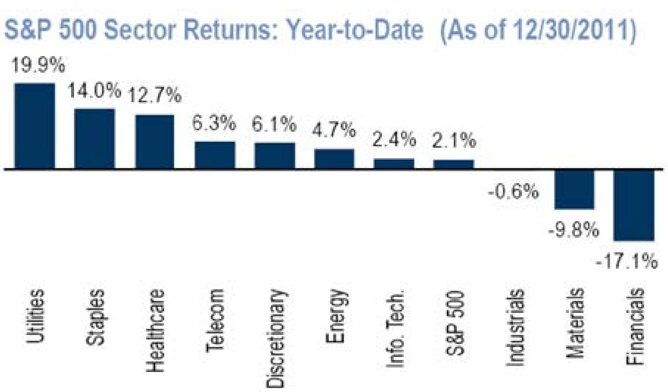
**Equity Volatility (VIX)**

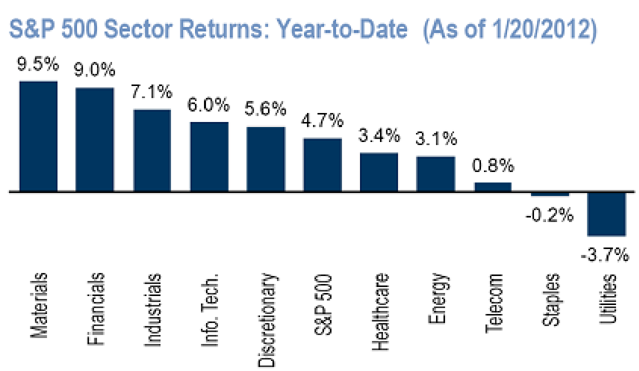
Responding to the European debt crisis and other global risks, projected market volatility spiked three times since 2008, then dropped to near normal levels as fear, uncertainty and doubt subsided.




*Source: ING Global Perspectives, Standard & Poor's, Chicago Board Options Exchange, FactSet*

Defensive sectors, such as Utilities, Consumer Staples, Health Care, and Telecommunication Services, held up well during 2011. Economically-sensitive and cyclical sectors underperformed -- Industrials, Materials, and Financial Services lost ground for the calendar year, as shown in the left-hand bar chart below. Since the start of 2012, however, sector leadership has once again reversed course. For the YTD 2012 period, the best performing sectors are last year's laggards (Materials, Financial Services, and Industrials), while defensive sectors have fallen to the bottom of the pack. 2012 sector returns are shown in the right-hand bar chart below.



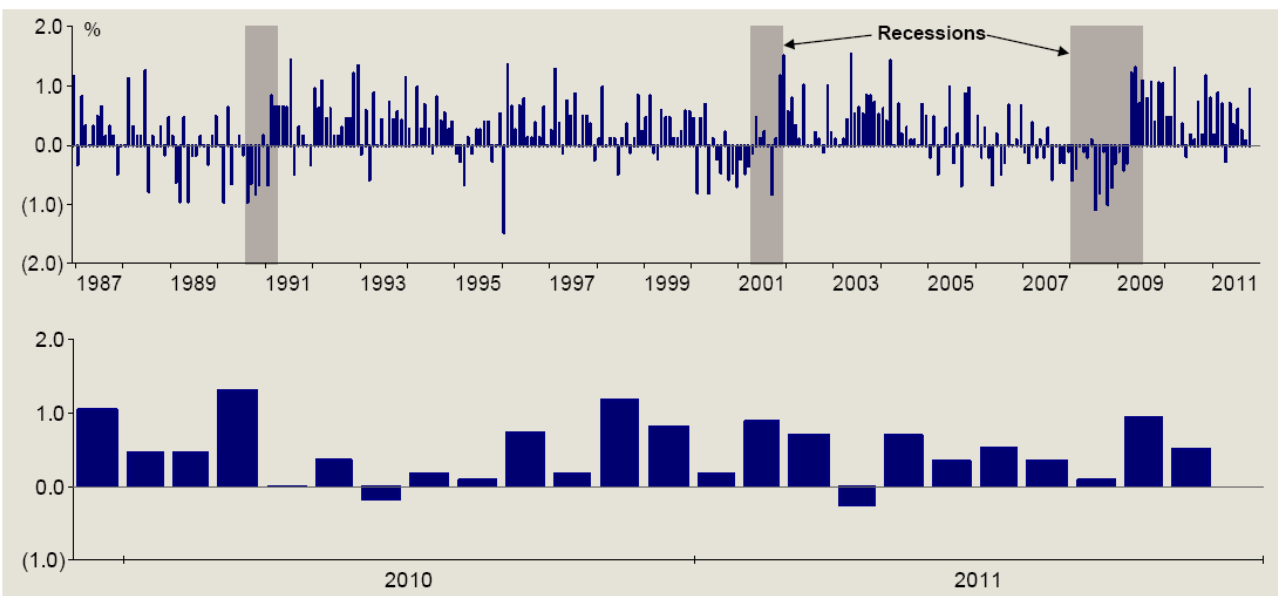

*Source: Goldman Sachs Asset Management*

For most of 2011, media attention was focused primarily on the natural disasters in Japan, the Arab Spring and regime changes in the MENA (Middle East/Northern Africa) region, the U.S. debt ceiling debate and subsequent credit downgrade, and the escalating sovereign debt crisis in Europe. There is no doubt that resolving these issues will require time, strong leadership, and compromises. Struggling to grow for years, Japan could ill-afford another setback of this magnitude. MENA continues to reshape itself, but its future is still highly uncertain. The state of the U.S. national balance sheet is likely to be the battleground on which the next Presidential Election campaign is won or lost. And Europe has finally come to the realization that the "can" has reached the end of the road. Another European recession is most likely already a reality, with a comprehensive austerity plan yet to be agreed upon and implemented. During a December summit, the member countries slowly and reluctantly started to move toward greater fiscal union and agreed on certain measures that provided relief to the liquidity-constrained market. However, much more needs to be accomplished in order to ease the European debt crisis.

One bright spot in the midst of all this appears to be the domestic economic front. U.S. GDP growth appears to have regained momentum towards the end of the year, surprising many forecasters who expected (or feared) a double-dip recession. The Index of Leading Economic Indicators remains in positive territory and has been for 26 of the last 28 months, as shown in the chart below.

## U.S. Leading Indicators

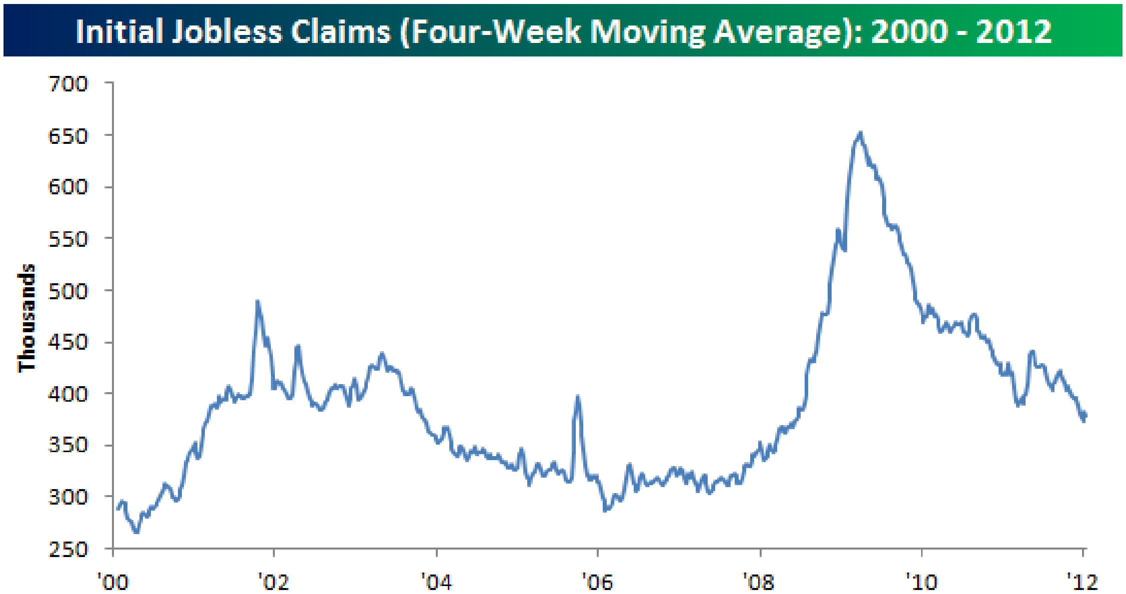
U.S. Leading Indicators have been consistently positive — in fact, for 26 of the last 28 months.




Source: Bloomberg, Factset
The Conference Board U.S. Leading Index consists of the weighted average of the following indices:
1. Average weekly hours, manufacturing 2. Average weekly initial jobless claims 3. Manufacturers' new orders, consumer
4. Vendor performance, slower deliveries 5. Manufacturers' new orders, capital 6. Building permits, new private housing units
7. Stock prices, 500 common stocks 8. Money Supply, M2 9. Interest Rate Spreads 10. Index of consumer expectations

*Source: ING Global Perspectives, Bloomberg, FactSet*

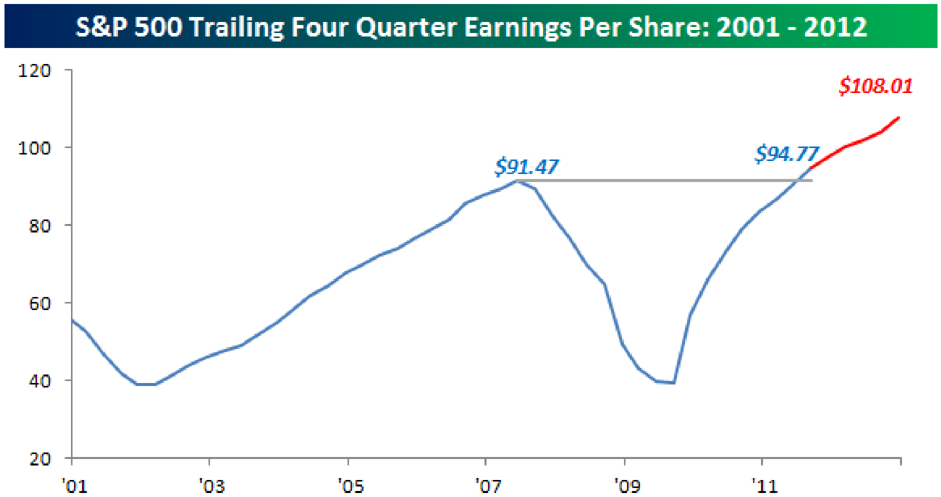
Furthermore, recent reports on Initial Claims for Unemployment are seen as evidence that the labor market is finally showing signs of improvement. According to InvesTech Research, and based on 50 years of data, Unemployment Claims usually start climbing 12 months or more prior to a recession, and then soar as the recession takes hold. The latest Unemployment Claims reading dropped to 352,000, the lowest level since 2008. As shown in the graph below, the four-week moving average has continued to drift down throughout the year. In addition, the unemployment rate recently dipped down to 8.5%. In summary, current job market trends seem to indicate an improving economy.




*Source: Bespoke Research*

Meanwhile, U.S. corporations are continuing to report solid results. Many are generating revenue growth, gaining market share, and reporting increasing profits. In addition, a shrinking share count, a result of share buybacks, is a further boost to earnings per share. Dividends are on the rise and, at currently modest payout ratios, have further room to grow. Finally, the yield on equities currently exceeds the yield on government bonds (using the 10-year Treasury as a proxy).

Commenting on the 3Q2011 earnings season, Bespoke Research stated that "*on a four quarter trailing basis, earnings for the S&P 500 are set to total $94.77, which would eclipse the old record of $91.47 set in Q2 2007. If you thought the market was volatile, the swings in earnings have been just as violent (which is partly responsible for why stocks have become so volatile). Since the prior record in earnings for the S&P 500 was set just over four years ago, the S&P 500 saw earnings drop by more than 55% in a little over two years. After bottoming out in Q3 2009, earnings have now rebounded by 139% in the course of two years. Based on current forecasts, earnings for the S&P 500 are expected to rise to $108.01 by the end of 2012. If, and this a pretty big if, analyst forecasts are correct, the S&P 500 is currently trading at a relatively meager 11.6 times next year's earnings*."




*Source: Bespoke Research*

Perhaps the biggest risk to the current forecast for earnings growth is in the area of profit margins. Presently, corporate America is operating at record margins. Further cost savings and productivity gains are likely limited from current levels. Historically, margins have been both cyclical and mean-reverting. In the future, downward pressure on margins could be driven by rising input prices, wage inflation (if the job market continues to improve), or the onset of a new capex spending cycle by corporate managements. A material change in any of these factors could lead to a revision of aggregate earnings expectations.

U.S. Treasuries benefited from the flight-to-safety during the second half of 2011 and, as mentioned previously, posted record returns, especially at the long end of the yield curve. During the year the yield on the 10-year Treasury fell below 2% and the yield on the 30-year Treasury fell below 3%. Investors -- retail as well as institutional -- continued to move money out of equities and into bonds. In fact, 2011 marked the fifth consecutive year in which mutual fund flows have favored bonds over stocks. Given the discrepancy in performance between the two asset classes over the last decade, that is probably not surprising. However, the shift has left many investors materially underexposed to equities. Going forward, a bond-heavy portfolio is unlikely to match the returns of the last 10 years, given the current low level of interest rates.

**Mutual Fund Flows**

| *millions USD* | 2011 | 2010 | 2009 | 2008 | 2007 |
|---|---|---|---|---|---|
| Asset Class Flows | | | | | |
| **Total Equity** | (157,246) | (28,765) | (9,056) | (234,387) | 90,816 |
| Domestic | (162,600) | (87,739) | (39,666) | (151,749) | (47,791) |
| Foreign | 5,354 | 58,975 | 30,613 | (82,635) | 138,609 |
| **Hybrid** | 38,682 | 23,522 | 22,764 | (18,414) | 24,162 |
| **Total Bond** | 149,695 | 246,000 | 376,137 | 27,593 | 108,768 |
| Taxable | 158,708 | 234,817 | 307,052 | 19,773 | 97,895 |
| Municipal | (9,016) | 11,183 | 69,086 | 7,820 | 10,874 |
| **Total** | 31,130 | 240,756 | 389,847 | (225,209) | 223,749 |
| AUM | | | | | |
| **Money Market** | 2,694,825 | 2,814,001 | 3,302,793 | 3,840,054 | 3,122,000 |

*Source: ING Global Perspectives, ICI (Investment Company Institute)*

In their latest earnings announcement, Nike executives stated that "Uncertainty is the new normal." To a large extent, this is always true in the world of investing. But it rings especially true as we look ahead at 2012 and beyond. Investors need to consider the many unknowns, including: how forceful and effective will the policy response be in the EuroZone; when will the U.S. start making progress toward reducing its fiscal deficit; how well will China manage its precarious growth/inflation balance; what will transpire in geopolitical hot-spots around the world (Iran, North Korea, Russia, MENA, etc.); and, of course, how sustainable will corporate profit growth prove to be. Notwithstanding the high level of uncertainty, there are several encouraging developments taking place, particularly in the U.S. Three recurring themes in our discussions with investment managers are the resurgence of domestic manufacturing, the potential for U.S. energy independence, and an eventual improvement in housing and consumer sentiment. Although still in the early innings, each of these has the potential to drive growth in the coming years and restore America's economic health. On balance, the current environment poses both risks and opportunities and, therefore, investors would be well-served by the old adage "handle with care".

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