

BEACON POINTE

ADVISORS

BEACON'S POINT: A BROKEN RECORD

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A Broken Record

While the digital revolution has rendered the gramophone obsolete, some of us are old enough to remember the sound of a broken record. Vinyl is vulnerable to scratches, causing the needle to stay in the same groove and play it over and over. This same image can be used to describe the now ubiquitous risk-on/risk-off environment, affectionately referred to as "RORO" by some market observers. The concerns and issues on the minds of economists, investors, politicians, and the media today are not much different from what they were last month, last quarter, or last year. Broad markets frequently switch their appetite for risk on and off, depending on the latest facts and rumors, but appear unable to break out of the RORO groove and move on to another tune.

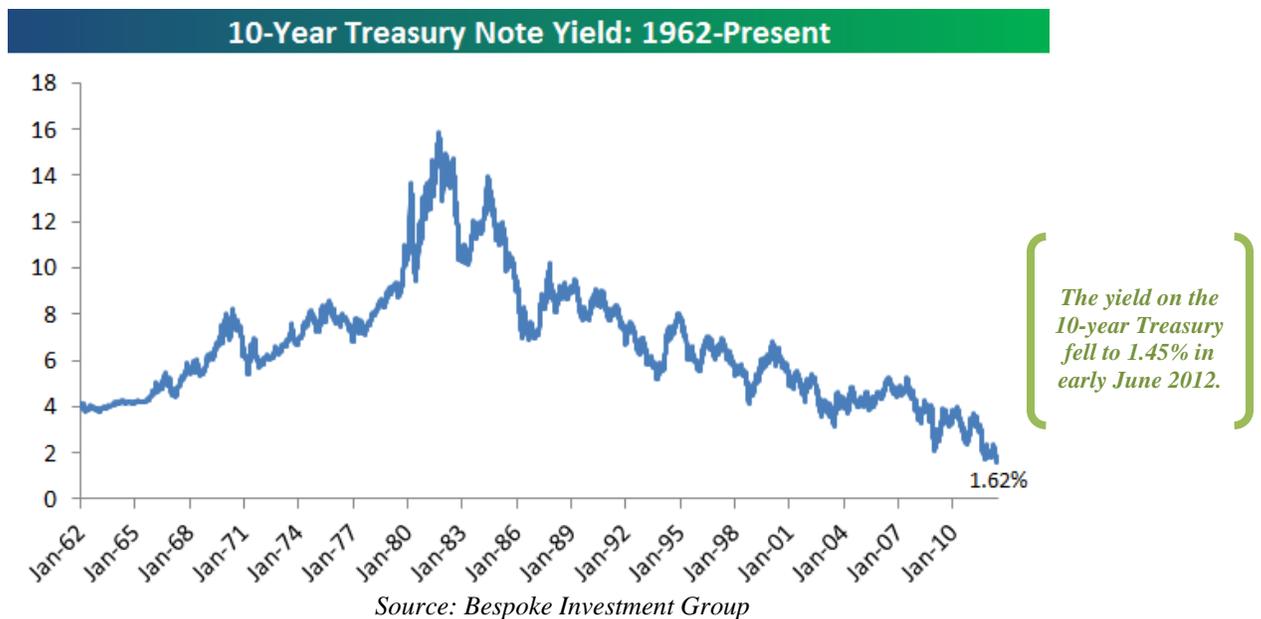


Image Source: Bloomberg Businessweek

Europe remains the main source of uncertainty, but questions around a slowdown in emerging markets, the upcoming elections in the U.S., and unresolved fiscal deficits are also adding fuel to the fire:

- On the old continent, every summit of European leaders is seen as a chance to agree on a robust plan to deal with the crisis. However, while the European Central Bank (ECB) has successfully addressed short-term liquidity pressures, the underlying solvency problems continue to loom large as the different members of the union struggle towards a compromise. A Greek exit from the Euro is no longer just a remote possibility. Spain and Italy have come under increased pressure. Some austerity measures are already being implemented in Europe with more to come, creating further growth headwinds for the European and global economy. News out of Germany, France, and the peripheral countries dominate media headlines on a daily basis, even if we have heard it all before. Unless there are clear signs of progress towards a solution, market volatility is likely to persist.
- In the developing world, inflation appears to be under control, allowing central banks in China, Brazil, and other countries to reverse some of their tightening policies. In the meantime, however, emerging markets growth has clearly slowed. Industrial production numbers out of China are weakening, leading many to worry about a possible "hard landing", although Chinese leaders seem to have enough tools at their disposal to successfully navigate the maze of inflationary and growth dynamics. It remains to be seen how the developing world, and China in particular, will manage its economic, political, and social challenges.

- On the home front, the Fed recently extended Operation Twist (selling short-term Treasuries and using the proceeds to buy long-term Treasuries) through the end of the year; worries about the looming "fiscal cliff" have intensified; and both political parties are busy working on their election campaigns as November nears. A potential third round of quantitative easing (QE3), if instituted, could jump-start a market advance. At the same time, the uncertainty around regulation, taxation, and inflation persists. Some days bring marginally more positive economic news, leading to risk asset gains; other days bring disappointments and broad market selloffs. It is a complex environment with many moving variables and possible scenarios. Policies implemented by the Federal Reserve and the U.S. government have boosted asset prices and depressed interest rates. Even as government bond yields -- represented by the 10-year Treasury in the chart below -- appeared to be at historic lows, offering negative real yields, they managed to fall further, from 2.38% (on March 19th) to 1.45% (on June 1st). This phenomenon indicates that U.S. government bonds are now seen not so much as an investment, but as an insurance policy against systemic risk.



With the gramophone needle stuck on this refrain, we turn the spotlight on one distinctive aspect of Beacon Pointe's research philosophy -- our focus on identifying undiscovered talent. Many of the firm's clients and friends have heard our team talk about "proven but unknown" investment managers. What we mean by that is firms that have the track record (a minimum of 5 years of GIPS-compliant and verified composite results), but not the asset level or market presence of their better-known peers. Studies have shown that smaller firms have an edge over larger ones because they:

- Are able to remain nimble,
- Have a boutique, independent culture,
- Are more focused on asset management than asset gathering,
- Maintain an advantageous ownership and compensation structure, and
- Are led by more stable, disciplined, and accountable teams.

These "proven but unknown" firms are not the only managers we recommend, but based on our research and past experience, we believe they can be an important part of clients' portfolios and contribute significantly to achieving clients' stated return and risk objectives. Boutique firms, in general, tend to be

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less concerned with benchmark composition and relative returns. Instead they have an absolute return mindset and pay a lot of attention to downside risk and the protection of their clients' capital. As a result, their portfolios are likely to look different from any index (exhibiting high active share). And because they are less constrained by statistical constructs such as tracking error or style boxes, they have the flexibility and will to do the right thing from a long-term risk/return perspective.

A musical analogy applies to this situation as well. Formed in 1976 in Dublin, U2 was virtually unknown until the mid-1980s. The same four band members, who met in high school, have created and performed all of U2's lyrics and music for the past 36 years. Not every song topped the charts and not every concert sold out, but U2's entire body of work is unmatched in rock music. The band has recorded 12 studio albums, sold 150 million records worldwide, and performed live in countless stadiums. During U2's latest world tour, on a warm October night in Pasadena, almost 100,000 people were in attendance, setting a new record. Those who were at the Rose Bowl would agree that U2 put on a great show, but it was decidedly different from seeing the band perform in an Irish pub in the 1980s. The early concerts took place at much smaller venues, yet for the band's early and true fans (especially those with front row seats), they were an unforgettable experience. Naturally, given U2's success since then, it is close to impossible to get front row seats today.

It is never too late to become a U2 fan. But unlike in music, in investment management you cannot simply download all past albums from iTunes. For this reason, we include "proven but unknown" managers in our initial research pool. Scouting the large universe of investment managers, we work hard to discover exceptional skill and talent before it is widely recognized. We are not looking for one-hit wonders, but for great investors that will generate strong results over many years and market cycles. There is a risk, of course -- that of being an early adopter. But if we have the patience, follow our strict due diligence process, and successfully identify these rare opportunities, the benefits the managers provide to our clients can be substantial: excellent client service, the ability to customize portfolios (if necessary), open communication lines with the Portfolio Manager and other key decision makers, and a thorough understanding of how each investment idea is generated, researched, purchased, monitored, and sold.

Because of the risks inherent in utilizing smaller investment firms, Beacon Pointe's due diligence process takes at a minimum several quarters from start to finish (from idea generation to final recommendation) and sometimes we may be in talks with a firm for years before we start working with it. We are very deliberate in the research we do, honest in the debates we have internally, and mindful of the impact our recommendations have on client portfolios. As a result, when Beacon Pointe recommend a "proven but unknown" manager to our clients, we do so with high conviction and a long-term commitment. These managers are intensely focused on quality and a margin-of-safety when building portfolios. Such an approach is especially well-suited for the current investing environment, given the prevailing uncertainty and potential systemic risks. Beacon Pointe is confident that we have positioned our clients prudently, weighing in both risks and opportunities presented by financial markets today.

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