BEACON POINTE
ADVISORS

Beacon's Point: Keep Calm and Carry On

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Confidential – Proprietary

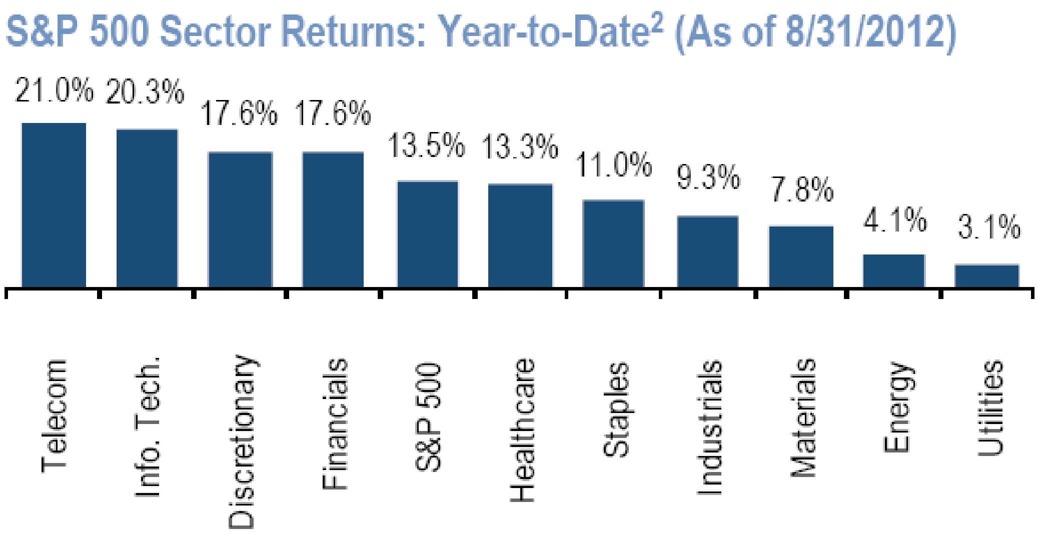
24 Corporate Plaza Drive, Suite 150, Newport Beach, CA 92660
TEL 949.718.1600 FAX 949.718.0601 www.bpadvisors.com

Keep Calm and Carry On

With August now in the books, it is time to take stock of what transpired over the summer months and where we are today in terms of market fundamentals and economic health. For the most part, risk assets have shown a positive bias, while economic news – both in the U.S. and internationally – has been mixed. Important ECB (European Central Bank) and FOMC (Federal Open Market Committee) meetings as well as the next round of corporate earnings announcements and key economic data should provide more clarity and will likely determine the tone and direction of global markets for the balance of the year.

U.S. equities posted solid results in July and August, bringing the year-to-date return of the S&P 500 Index back into double-digit territory (+15.6% on a total return basis since January 1st). In fact, the S&P currently trades at a multi-year high, just 8% below its all-time high set on October 9th, 2007. As is typical for this time of the year, recent trading volumes have been quite low, but should pick up as we head into the fall season.

Assessing the details behind the index' year-to-date return reveals some interesting divergences. In terms of economic sectors, the best performing group (telecommunication services, +21%) outperformed the worst performing group (utilities, +3%) by 1,800 basis points, as shown in the chart below. Information technology, consumer discretionary, and financial services stocks were also relative outperformers, while industrials, materials, and energy lagged the broad market.



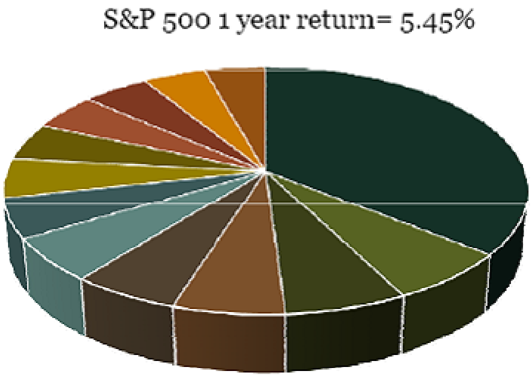
Source: Goldman Sachs Weekly Market Monitor

Drilling down to the individual stock level produces even more interesting insights. The "Apple effect", discussed in our last "Beacon's Point", continues to be a major driver of performance within the S&P 500 Index. Add 12 more mega cap names to the mix and you have accounted for 100% of the index' trailing one-year return (data as of June 30, 2012 shown in the table and pie chart on the following page). This means that the remaining 487 constituents of the S&P 500 Index contributed virtually zero. Such narrow leadership within the 500-stock index is an exception rather than the norm. A U.S. equity portfolio that did not include Apple, Philip Morris, Microsoft, Wal-Mart, AT&T, et al, would have been very challenged to outperform the S&P benchmark.

Flight to Certainty

Narrow list of 13 "quality" stocks account for all of S&P 500's 1 year return

Components of S&P 500 Return for 1 year ended 6/30/12



Company Name	Total Return	Contribution To S&P Return	% of S&P Return
Apple	73.98 %	1.94 %	35.82 %
Philip Morris	36.00	0.36	6.63
Microsoft	20.87	0.35	6.52
Exxon Mobil	7.82	0.32	5.93
Wal-Mart	34.80	0.31	5.74
AT&T	20.26	0.31	5.67
IBM	15.91	0.29	5.28
Wells Fargo	21.90	0.28	5.11
Intel	24.34	0.26	4.88
Home Depot	50.29	0.26	4.83
Pfizer	16.32	0.26	4.75
Verizon	25.85	0.24	4.50
General Electric	14.56	0.24	4.34
Total		5.45 %	100.00 %

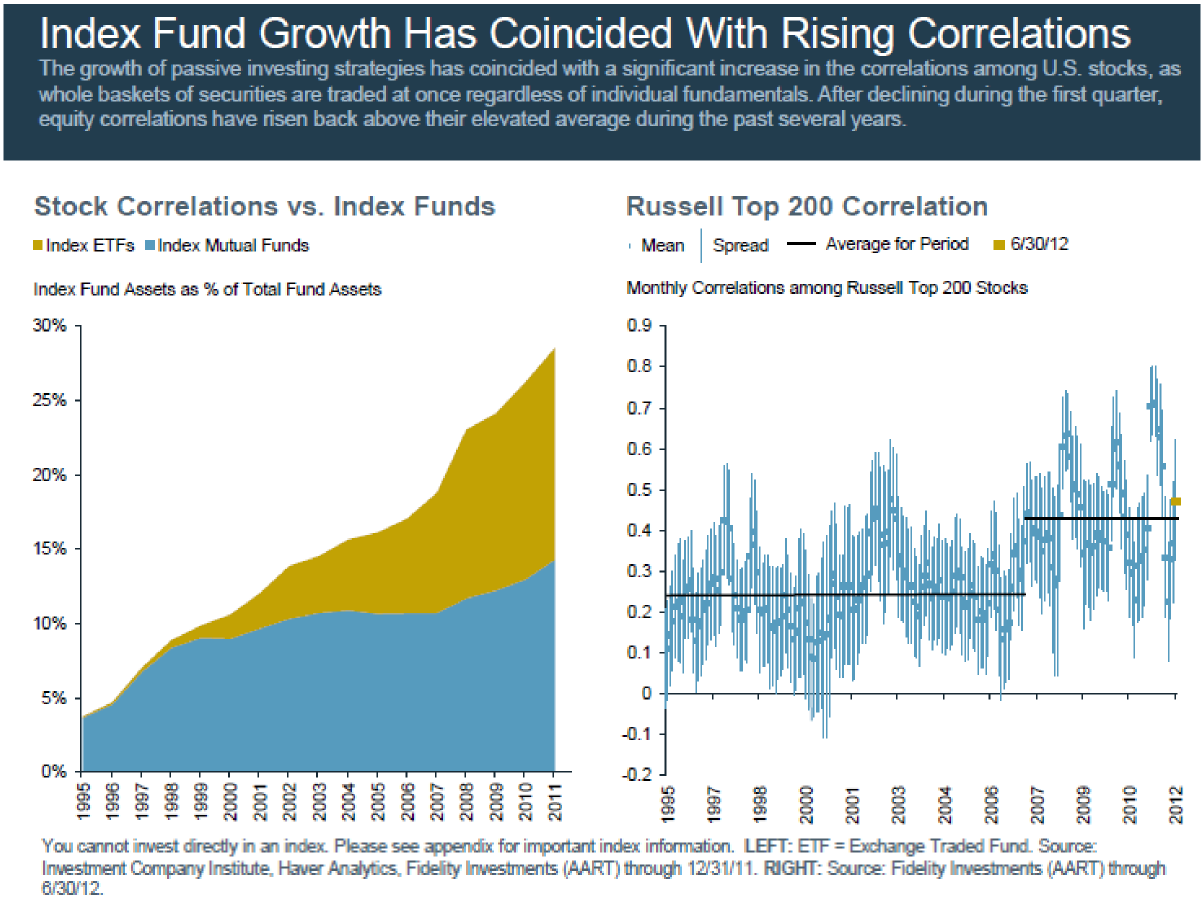
Source: Factset; iShares S&P 500 Index Fund

Source: Southeastern Asset Management, FactSet

The various fixed income sectors have also posted differentiated returns. Intermediate government instruments gained a little less than 2% for the year-to-date period, compared to a 7.5% gain for corporate bonds and a 10% gain for high yield bonds of similar maturities. The yield on the 10-year Treasury rebounded from a low of 1.39% earlier in the year to its current level of 1.66%, a significant move. Furthermore, VIX – the CBOE Volatility Index – has fallen back below 15, concurrently with the strong performance of risk assets.

Broadly speaking, investors remain skeptical of the rally. According to Morningstar, U.S. equity funds are on pace to see their sixth consecutive year of outflows, a very telling sign of where market sentiment stands today. True to recent form, the majority of fund inflows in 2012 are directed toward bond funds, despite the historically low level of interest rates. But interestingly, through the first half of the year, while investors pulled $50 billion out of actively managed U.S. stock funds, they added $41 billion to passive vehicles (index funds and exchange-traded funds) in the domestic equity asset class.

Following several years of market share gains, aggregate assets invested in passive strategies now account for almost 30% of all fund assets, as shown in the left-hand chart by Fidelity, provided on the following page. As a result of more and more trades involving entire baskets of stocks, correlations among stocks are well above their long-term averages. Higher correlations generally serve as a headwind for active fundamental investors. This condition, along with the narrow index leadership discussed earlier, are the most likely reasons why so many active investment managers are struggling to keep up with their benchmarks.

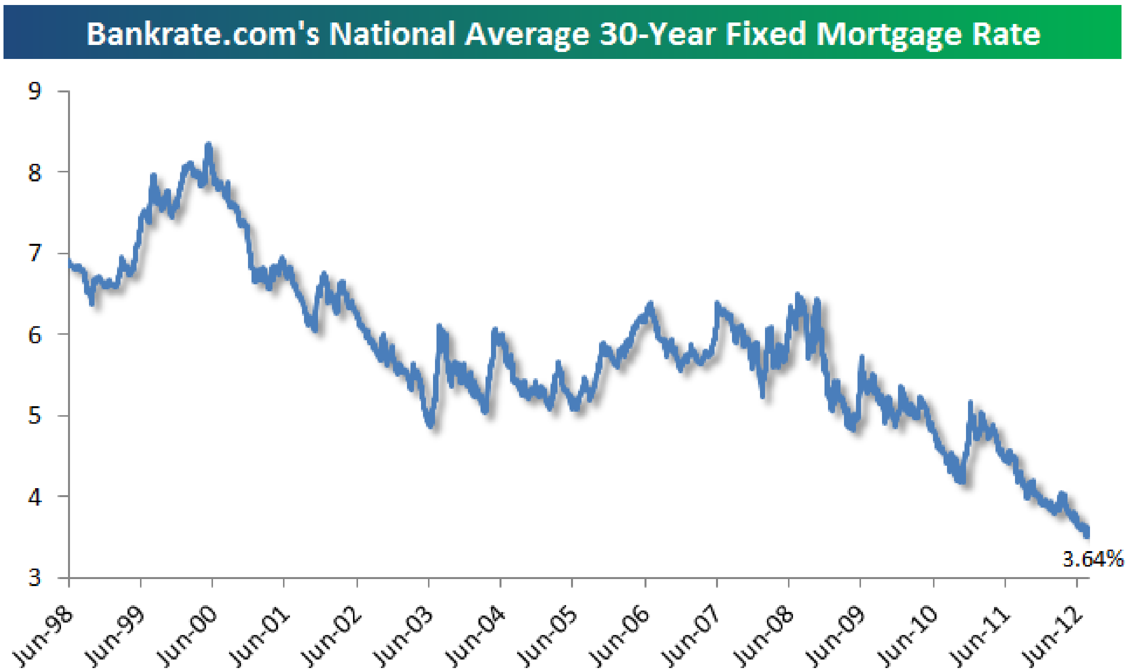


Source: Fidelity Investments

What is the macro-economic backdrop for this market action? Central banks around the world maintain their accommodative stance. During his Jackson Hole speech last week, Fed Chairman Ben Bernanke seemed to suggest that additional quantitative easing may be undertaken "if economic conditions warrant". China, Japan, Brazil, and the U.K are also easing. Finally, Mario Draghi just announced an aggressive new plan for the European Central Bank to buy the short-term bonds of troubled EuroZone countries. Any new information that is deemed a disappointment relative to current expectations for further easing will likely cause a market pullback, although its duration and magnitude are unknown.

Real GDP growth in the U.S. for 2Q 2012 was 1.7% (revised up from the initially reported 1.5%). This is a rather pedestrian pace for a recovery from a severe recession. U.S. manufacturing, which had been going strong, once again slipped into contraction mode due to economic uncertainties in the EuroZone and China. Nevertheless, the U.S. Index of Leading Economic Indicators was in positive territory in July, potentially signaling healthier growth in the second half of the year. Inflation pressures, based on official government measures such as Core CPI, remain subdued. That being said, both gasoline and food prices are on the rise, which for consumers certainly feels like inflation.

Meanwhile, there is increasing evidence of a U.S. housing market recovery. Over the last few months, builder confidence improved materially and housing starts and permits are on the rise. On a year-over-year basis, the pending home sales index rose a robust 12% according to the latest data, while the Case-Shiller price index finally turned positive. Existing home prices are approaching their early 2003 levels. Housing affordability remains very high, given the historically low mortgage rates, as shown in the following graph:



Source: Bespoke Investment Group

This nascent recovery in housing should have a positive impact on consumer sentiment. However, current sentiment is weak, dragged down by the future expectations component. Such weakness has not yet translated into consumer spending, judging by the latest retail sales figures, but it certainly bears watching. As a reminder, consumer spending accounts for 70% of U.S. GDP. Naturally, when it comes to sentiment, employment remains a significant headwind. In fact, within the Conference Board's consumer sentiment index, one of the worst readings was "jobs availability outlook". The rate of unemployment remains above 8%. The rate of "under-employment" is significantly higher. Mr. Bernanke recently characterized the state of the labor market as a "grave concern" and indicated that the Federal Reserve is monitoring employment trends very closely.

Finally, the election factor should not be underestimated. What happens between now and November, as well as into the next electoral term will have important implications for businesses, individuals, and the nation as a whole. The level of uncertainty related to the "fiscal cliff" continues to increase as we approach the January 1st, 2013 deadline, when a series of tax increases and spending cuts are to automatically come into effect. The Congressional Budget Office estimates that the U.S. economy will contract by 2% next year and unemployment could once again exceed 9% in 2014 if nothing is done to address the "fiscal cliff" issue. In addition, business owners are hesitant to make decisions, hire new employees, or spend on capex because they do not know what health care costs, taxes, or regulations will be next year. Corporate profits have been strong, but rather than putting their cash to work, most businesses are piling it up on their balance sheets. This "wait-and-see" approach has undoubtedly held back the pace of jobs growth and economic recovery.

Outside the world of investments and economics, the undisputed highlight of the summer was the XXXth Olympiad, starring many incredible athletes and inspiring human beings. Team U.S.A. was outstanding and provided countless unforgettable moments. The city of London hosted the Games with grace, dignity, and efficiency. British culture and pageantry took center stage over the two-week period, but we were also reminded of the spirit and resiliency of that nation. A favorite British-ism – "Keep Calm and Carry On" – originated in a 1939 war poster intended to raise public morale in case of invasion by enemy forces. The message has grown in popularity in the past decade and many feel it is especially relevant in the post-2008 world. As we watch the market pendulum swing from risk-off to risk-on and back again, as Europe struggles to prevent a wide-spread crisis, as the U.S. faces its own political, fiscal, and growth challenges, and as emerging economies seek to manage a precarious balance, “Keep Calm and Carry On” (with a thoughtful and prudent investment strategy) appears to be very sound advice, indeed.

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