BEACON POINTE

ADVISORS

BEACON'S POINT: AN OVERWEIGHT TO PATIENCE

JANUARY 16, 2013

CONFIDENTIAL – PROPRIETARY

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

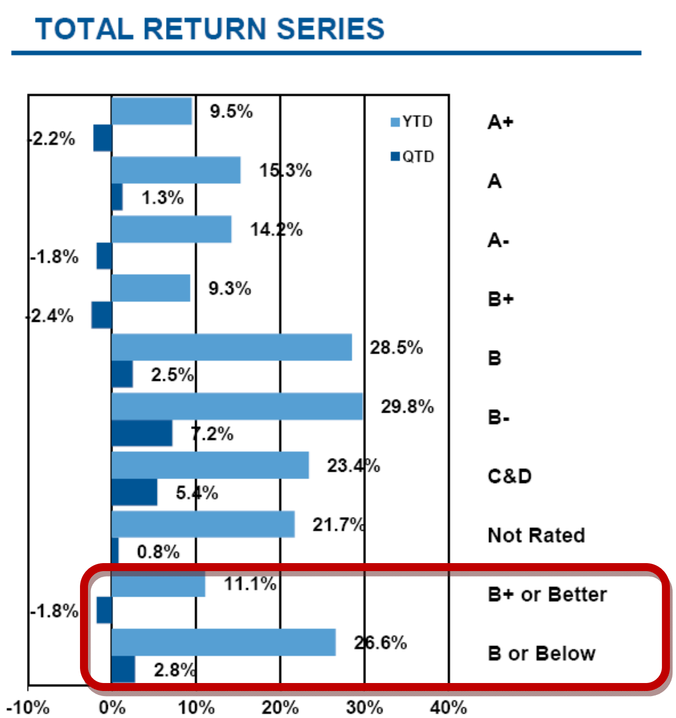
An Overweight to Patience

The start of 2013 was marked by a 13th hour fiscal cliff deal in Congress that averted an immediate crisis but left plenty of long-term challenges unresolved. In a way, the current (relative) quiet is nothing more than an intermission before Act II of the fiscal drama plays out in approximately two months' time. In this issue of Beacon's Point, we will comment briefly on 2012 performance themes, summarize the terms of the agreement reached on January 1st, discuss the market's reaction to these latest developments, highlight several key issues that will need to be addressed in the coming months, and revisit the importance of patience in executing an investment strategy and plan.

2012 Performance Themes

Over the 12-month period, the S&P 500 Index advanced 16% on a total return basis (including dividends). Two minor corrections -- in April-May and October-November -- reminded investors that the macro environment remained highly uncertain, causing equity markets to swing from one extreme in sentiment (confidence and risk appetite) to another (fear and risk aversion). Despite this persistent uncertainty, equity markets ended the year with strong gains. We have identified several factors or themes that drove investment returns in equities during 2012:

- High-quality stocks underperformed low-quality stocks: one way to dissect the annual performance of the S&P 500 Index is by quality ranking. The following chart shows that high quality stocks (ranked B+ or better) significantly trailed low quality stocks (ranked B or below) during 2012. Accordingly, portfolios that emphasize the highest quality segment of the equity universe have been challenged to keep up with the broad benchmarks.



Source: Atlanta Capital Investment Management

- Companies with low-to-no debt underperformed highly leveraged companies: focusing the analysis on the ratio of debt-to-capital leads to a similar conclusion. Beacon Pointe's attribution work in Morningstar Direct revealed that the most leveraged companies in the S&P 500 Index (the highest quintile based on debt-to-capital ratios) posted annual returns that were almost double the returns of the least leveraged companies in the index (the lowest quintile based on debt-to-capital ratios).

- Companies with high earnings visibility underperformed those with low earning visibility: this relationship was true across market cap segments and investment styles, as shown in the data table below. Undoubtedly, a major macroeconomic influence on equity markets in 2012 was the Federal Reserve's program of Quantitative Easing. An announcement or even just the anticipation of another round of QE generally helps push the prices of risky assets -- and especially stocks -- higher. This was the case in September 2012, when QE3 was announced, providing a boost for more cyclical companies (that generally have lower earnings visibility). As a result, companies with stable, consistent, and visible earnings underperformed.

YEAR TO DATE *as of December 31, 2012*

Index	High Earnings Stability	Low Earnings Stability	% Difference
S&P 500	11.0	26.6	(15.5)
Russell 1000 Growth	8.7	27.0	(18.2)
Russell 1000 Value	14.5	22.3	(7.8)
Russell 2000 Growth	12.2	15.2	(3.0)
Russell 2000 Value	8.7	20.3	(11.6)

Source: Atlanta Capital Investment Management

- Financials and REITs were very strong: from a sector performance perspective, the standout of 2012 was financial services. Bank of America, for example, saw its share price double last year. The REIT industry, which is a subset of the financial services sector in the S&P 500 Index, was one of the top performing groups in the index. A portfolio with limited exposure to the financial sector and/or the REITs industry would have been challenged to outperform.

We saw similar performance themes in 2006, when lower quality stocks and highly leveraged companies led market performance. Interestingly, the trend completely reversed in the following years. Such leadership changes are not unusual. Although solid fundamentals may not always be rewarded by the market over the short term, they matter very much for long-term investors.

The Fiscal Cliff Deal And The Market's Reaction

The latter part of 2012 was dominated by concerns over the looming fiscal cliff and the inability of Congress to reach a balanced compromise. After a high-stakes game of "deal or no deal", a last-minute agreement successfully passed through both chambers of Congress. The bill (H.R.8:American Taxpayer Relief Act of 2012) addresses primarily the tax portion of the fiscal cliff, while decisions about mandated spending cuts (the sequester) were, for the most part, delayed by a couple of months.

Highlights from the tax portion of the deal include:

- For individuals with income up to $400,000 and couples with income up to $450,000, the Bush-era income tax rates were permanently extended as was the maximum 15% tax rate on dividend income and long-term capital gains.
- For individuals making more than $400,000 or families making more than $450,00, the top income tax rate increased to 39.6% and taxes on capital gains and dividends increased from 15% to 20%.
- Furthermore, for individuals making more than $250,000, there are additional health insurance taxes that are part of the Affordable Care Acts (0.9% additional tax on income and 3.8% additional tax on investment income).
- Several tax credits, such as the child tax credit and the higher education tax credit, were extended by five years.
- The Alternative Minimum Tax (AMT) was permanently fixed and the exemption amount was indexed to inflation.
- The estate tax increased from 35% to 40% for individual estates over $5 million and family estates over $10 million. The exemption amount was indexed to inflation.
- The 2% payroll tax cut was allowed to expire as scheduled. This translates into a $120 billion reduction in take-home pay, will affect all workers, and is likely to put some near-term pressure on consumer spending.
- The accelerated depreciation for corporations was extended by one year along with tax credits for research and development costs.

On the spending side, long-term unemployment benefits were extended by one year and a scheduled 27% cut in doctor's Medicare payments was delayed by one year. Congress and federal civilian employees will not get a cost-of-living raise in 2013. Importantly, the agreement deferred the scheduled automatic budget cuts until March 1st. The combined effect of tax and spending decisions will have a negative impact on GDP growth, but may not push the economy into recession. Markets cheered the agreement, incomplete though it was, with a 2.5% jump during the first trading day of the New Year and have since maintained their positive bias. The S&P 500 Index is trading around the 1,470 level, a five year high and just 6% below its October 2007 all time record.

What's Next On The Agenda?

With the Tax Relief Act signed into law, the focus of the new Congress now turns to spending. Many more tough decisions will be required in order to address the $1 trillion annual deficit and $16 trillion federal debt. According to Wells Fargo Economics Group, "the deal this week to avert the fiscal cliff provides some clarity to individuals and business decision makers; however, the relief may be temporary. What the deal does not include is how the process of automatic budget cuts, known as sequestration, will be addressed beyond the two-month deferral. Also occurring at the end of the two-month window, the nation will again face the need to raise the debt limit, which sets the stage for the next major debate over government spending cuts and the future path of federal spending."

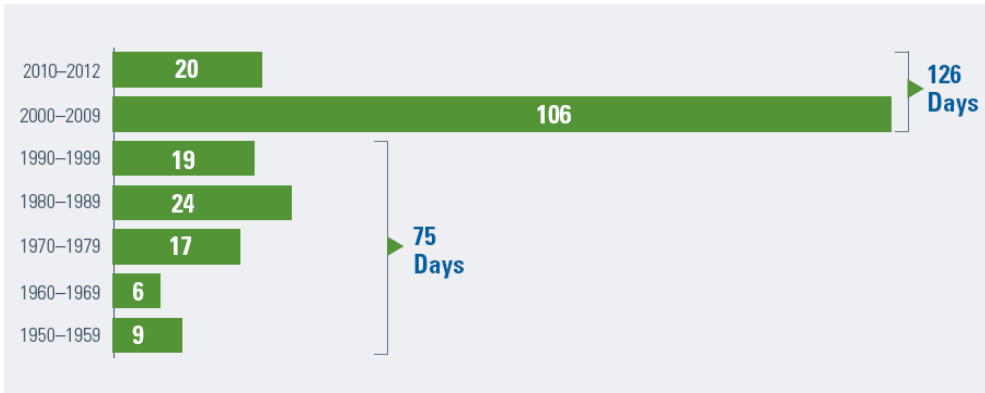
The long-term fiscal imbalances in the U.S. are yet to be resolved. The limited scope of the fiscal cliff deal in terms of spending cuts and the immediacy of the next set of deadlines means that we should expect more contentious negotiations in Congress, hard-fought debates between Democrats and Republicans, and increased market volatility in the coming months. Disagreements over the source of budget cuts -- discretionary spending versus entitlement programs -- will be front and center on the political stage. Defense spending will undoubtedly be a divisive issue. Potential changes to Social Security and Medicare benefits will be proposed and deliberated. And finally, what will happen to various exemptions and deductions in the current tax code is, at this stage, largely unknown.

A repeat of the summer of 2011 political showdown over the debt ceiling would almost certainly result in another credit downgrade for U.S. Treasuries. In addition, macroeconomic uncertainty is likely to impact both consumer and business spending decisions over the near term. Consumer sentiment, as always, is vulnerable to headline risk. Corporations, which are currently enjoying near-record margins, may be challenged to grow their top line (revenues) and bottom line (earnings). It is worth watching the direction and magnitude of year-over-year earnings growth and management guidance over the next few months as a gauge of business performance in the current environment.

"Patience Is Bitter, But Its Fruit Is Sweet" (Jean-Jacques Rousseau)

Investors' patience has been seriously tested in the years since 2000. Two severe bear markets, countless geopolitical events and natural disasters, and an overall increase in volatility have made the 2000s and 2010s very challenging for market participants. As shown in the chart below, courtesy of Natixis Global Asset Management, there have been significantly more days with big stock market moves (defined as larger than +/-300 bps) during the last 13 years than in the previous 50 years combined. This type of daily volatility often has little to do with stock market fundamentals, but tends to be driven by the macro environment and media headlines.

FIGURE 1: STOCK MARKET VOLATILITY HAS INCREASED DRAMATICALLY SINCE 2000
Days S&P 500 moved more than 3%



Past performance is no guarantee of future results.

Source: Standard & Poor's; data represents all daily returns available for S&P 500 Index since information has been tracked from 1950.

Source: Natixis Global Asset Management

In uncertain times, people tend to lose patience and significantly shorten their time horizons. However, this is precisely the time to focus on the long-term in order to ensure wealth creation and the achievement of one's investment goals. Well-defined long-term goals keep investors from being frustrated by short-term challenges. Beacon Pointe has always advocated a long-term investment perspective, efficient portfolio diversification, and prudent manager selection with an emphasis on proven investment managers with intense focus on fundamental research and capital preservation. These guiding principles protect our clients' assets during tough periods for the market, yet allow client portfolios to capture unique appreciation opportunities in more favorable investment environments.

We believe that patient, disciplined investors who remain committed to their strategic investment plans, are willing to ignore the noise of short-term market trends, and resist the temptation to change course in reaction to what is currently working, are most likely to be rewarded with solid long-term results. We recommend an overweight to patience as U.S. and global markets work their way through the uncertainty that awaits us in 2013.

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