BEACON POINTE

ADVISORS

BEACON'S POINT: THE ROAD LESS TRAVELED

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CONFIDENTIAL – PROPRIETARY

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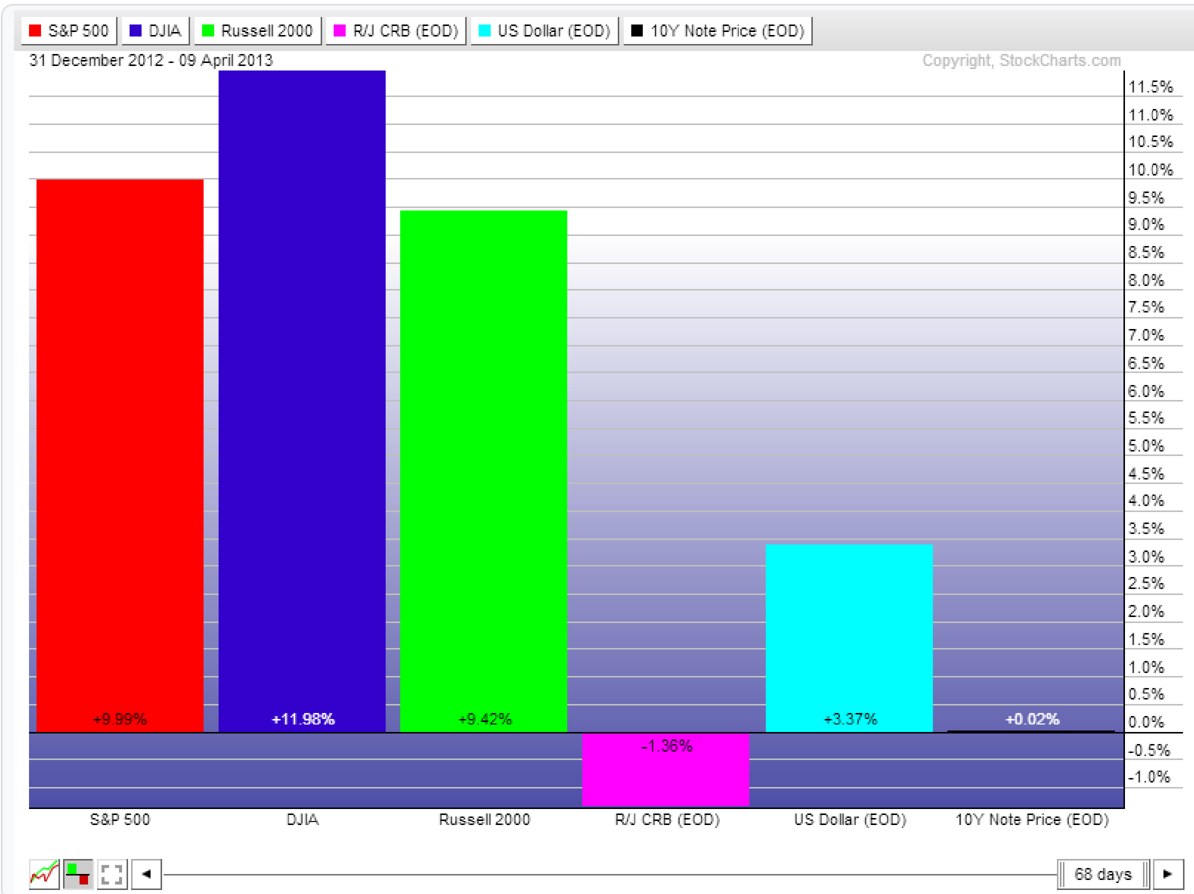
The Road Less Traveled

Calendar 2013 started off on a strong note for most risk assets, continuing the momentum of 2012. For the year-to-date period ending April 9th, U.S. stocks advanced approximately 10%. Non-U.S. equities (not shown in the bar chart below) posted mixed results: developed markets (represented by the MSCI EAFE Index) gained 5%, while emerging markets (represented by the MSCI EM Index) declined 3%. Over the same period, U.S. Treasuries were flat and commodities lost some ground.

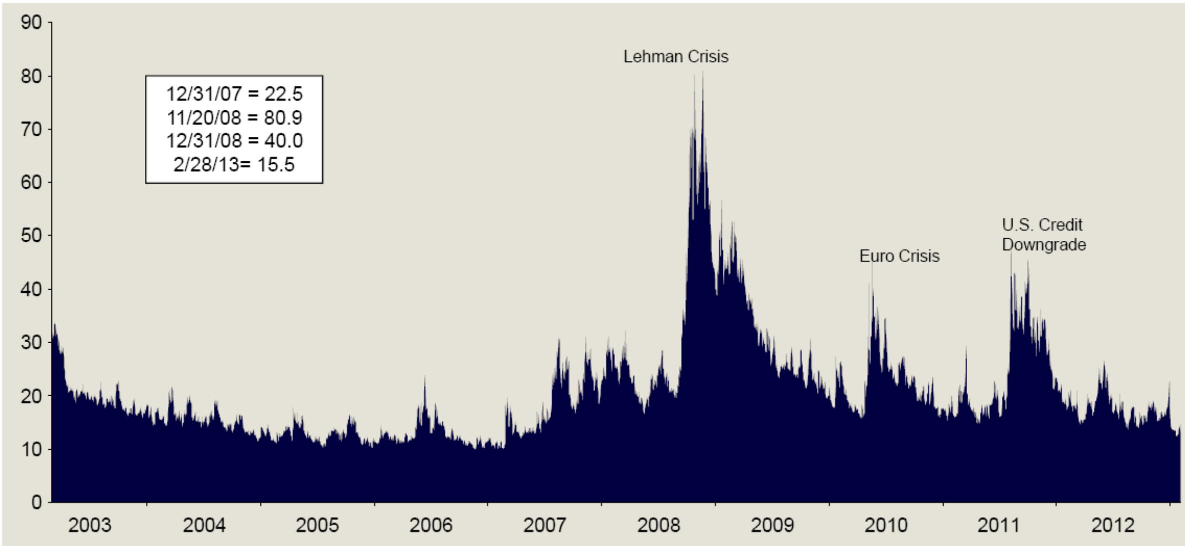


Source: StockCharts.com

In late March, the S&P 500 Index eclipsed its previous closing high set in October of 2007 and now boasts a new all-time record (the Index closed at 1,587 on April 10th). Can the rally continue? It is certainly possible. But after gains of 16% in 2012 and 10% so far in 2013, the S&P 500 Index -- and the U.S. equity market in general -- seems somewhat stretched. It is worth noting that stock market volatility, measured by the CBOE VIX Index, has been rather low compared not just to recent history, but to the long-term average. As shown in the chart on the following page, the VIX has hovered around 15 since the beginning of 2013. This indicates a certain level of comfort, if not complacency, on the part of equity market participants. Lower volatility is typically associated with increasing risk appetites. This condition may be justified to some extent by economic and market fundamentals. However, it is important to remember that complacency can be a dangerous mindset for investors.

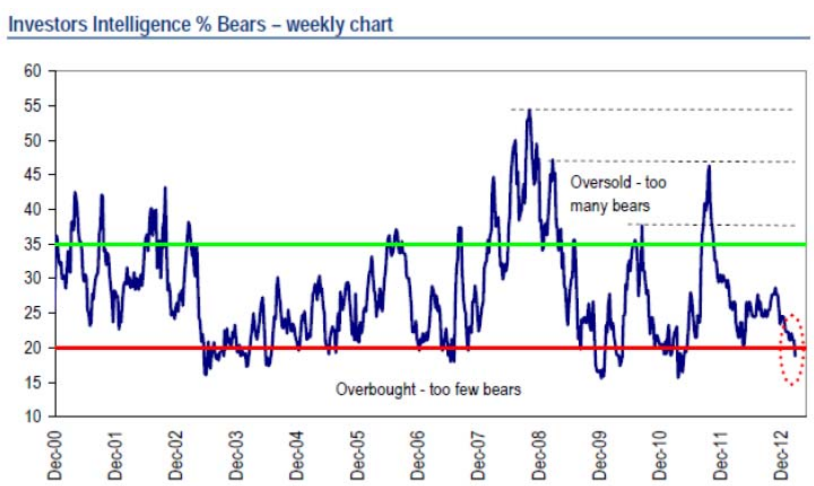
Equity Volatility (VIX)

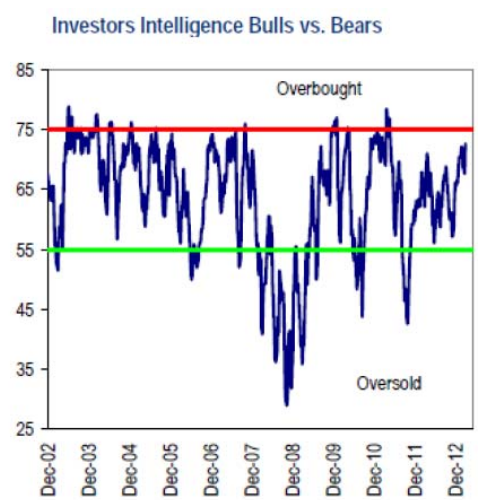
Projected market volatility spikes in times of crisis then drops into the normal range as fear, uncertainty and doubt subside — apparently the prevailing sentiment today.



Source: ING Global Perspectives

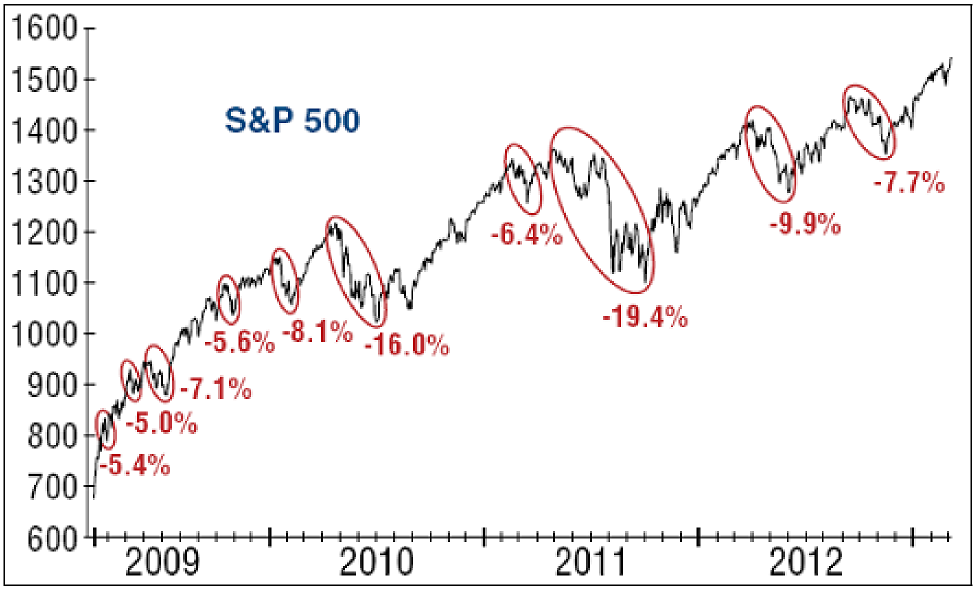
Investor sentiment has largely followed the lead of the stock market. A recent Investor Intelligence survey (results shown below) places sentiment in or near overbought territory. In addition, there is increasing talk of a "great rotation" of retail fund flows away from bonds and into stocks. We believe it is too early to draw conclusions about fund flows, but the media coverage is unquestionably contributing to the bullish sentiment. For contrarians, this is a reason to be cautious.





Source: Fidelity Investments, Investors Intelligence, BofA Merrill Lynch Global Research

Short-term corrections are not unusual and are, in fact, healthy for equity markets. From time to time, investors need to take a collective breath and pause to digest new information, take stock of current fundamentals, and consolidate their positions. According to InvesTech Research, since the market trough in March of 2009, there have been 10 down moves of 5% or greater. The most significant of those came in the summer/fall of 2011, when the S&P 500 retracted over 19%, just shy of the 20% loss that would have placed it into bear market territory. We caution that it is very difficult to accurately time these events, but we believe that investors should never lose sight of the risks inherent in the market. Attention to capital preservation ought to remain a critical element of investment strategy and portfolio structure decisions at all times.



Source: InvesTech Research

Global economic growth remains uneven and volatile. The drama in Europe continues to unfold, most recently with Cyprus in the starring role. A surprising announcement from the Bank of Japan last week means that one more Central Bank has joined the stimulus party in a meaningful way. China shows positive signs but, to a large degree, remains a wild card. In the U.S., Congress recently voted to suspend the debt ceiling limit by four months. Although the country's fiscal issues have temporarily relinquished their hold on the market's psyche, it is reasonable to expect that they will again dominate media headlines with upcoming budget and debt ceiling negotiations. Finally, U.S. economic news from the last couple of weeks has been mixed, reminiscent of slowdowns experienced around the same time during the last three calendar years.

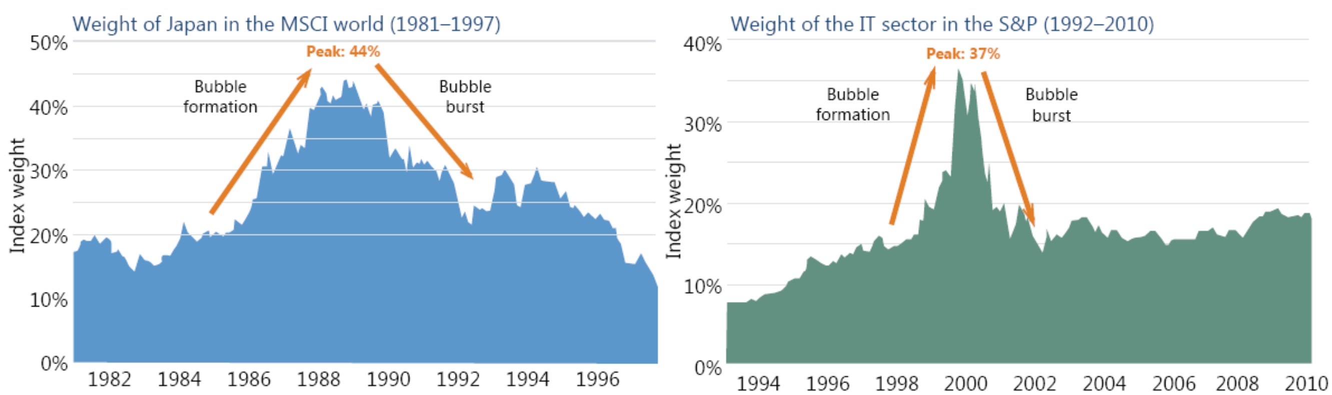
Furthermore, corporate profit margins are vulnerable to mean reversion from their current multi-decade highs. As one investment manager stated: *The good news is that Corporate America is "lean and mean". The bad news is that Corporate America is "lean and mean". (David Rolfe, Wedgewood Partners)* Even a slight decline in profitability would result in materially lower earnings expectations for the coming years. Moreover, if the denominator in the P/E (price-to-earnings) multiple is lower, then overall market valuations may not seem as compelling as they do otherwise.

Beacon Pointe's clients are <u>not</u> invested in market indices, but in active investment strategies managed by best-in-class investment management firms. As discussed in prior commentaries, despite the rapid ascent of ETF investing over the past decade (these passive vehicles recently eclipsed $2 trillion in assets), we contend that carefully researched and selected active strategies offer the best opportunities for our clients to achieve their investment objectives while taking the least amount of risk possible. Ours may be a "road less traveled" in this day and age, but we believe it is the way to go.

We employ a disciplined due diligence process that focuses on investment managers that are benchmark-agnostic; construct concentrated portfolios; focus on capital preservation in difficult markets while providing adequate upside participation; are committed to a strong valuation discipline with a "margin of safety" requirement; and exhibit a willingness to be contrarian and move against consensus. Looking different from a benchmark may -- on the surface -- sound more risky, but often the opposite is true. Specifically, when excess builds in a segment of the market, index-like strategies will replicate that excess and expose the assets to the threat of a "bursting bubble". Valuations increase dramatically during the bubble formation phase, making that asset or segment an increasingly risky investment.

As an illustration, consider the weight of Japan within the MSCI World Index over the years: it more than doubled from 20% to 44% in the late 1980s, only to fall to 15% in the late 1990s. An investment strategy that closely followed the global equity index' country allocations would have experienced a dizzying rollercoaster ride in returns. Similarly, the information technology sector presented a classic bubble in the late 1990s: its rise (to 37% of the S&P 500 Index) and subsequent fall during the 2000-2002 bear market destroyed capital for technology-heavy and index-like portfolios.

Too closely adhering to the benchmark may increase absolute risk



Source: PIMCO, MSCI, Bloomberg

Beacon Pointe's manager evaluation process is designed to identify those active managers that will generate market outperformance over the long term combined with strong downside protection. The typical active manager we work with has a lower risk profile and better risk-adjusted returns than the benchmark index and its universe of peers. This is accomplished through a solid investment philosophy, independent research, a disciplined process, and high-conviction portfolios that are substantially different from the benchmark's and peers'. Our intensive and thorough due diligence, backed by our robust quantitative analytical capabilities, give us a high degree of confidence when recommending active managers to our clients.

In his 1978 book "The Road Less Traveled", American psychiatrist and best-selling author Morgan Scott Peck focused on the importance of discipline for one's emotional and psychological health. Acknowledging that "life is difficult" and taking short-cuts is unsuccessful, Mr. Peck identified several tools (or elements of discipline) for problem-solving, including:

1. Willingness to delay gratification (sacrificing present comfort for future gains);
2. Acceptance of responsibility (for oneself and one's decisions and actions);
3. A dedication to honesty (in both words and deeds); and
4. Ability to balance/prioritize conflicting requirements.

Mr. Peck's discipline theory, we believe, applies not only to individuals' emotional and psychological health, but to investors' financial health as well. Successful investing requires making difficult choices and sticking by them. In our view, the tools of investment problem-solving, roughly equivalent to Mr. Peck's four elements of discipline, are:

1. Patience and a long-term investment horizon;
2. Clearly defined objectives and investment plans;
3. Staying true to one's strategy, including - and especially - when it is out of favor; and
4. Balance between risk and return, capital preservation and growth.

Notwithstanding the recent period of relative calm, investors' resolve is likely to be tested again in the coming quarters. Beacon Pointe is confident that the investment discipline described above will reward both our recommended investment managers and our clients in the future.

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