BEACON POINTE
ADVISORS

BEACON'S POINT: MIDDLE GROUND

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CONFIDENTIAL – PROPRIETARY

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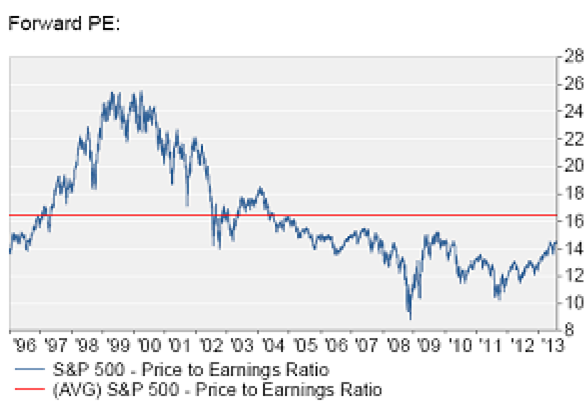
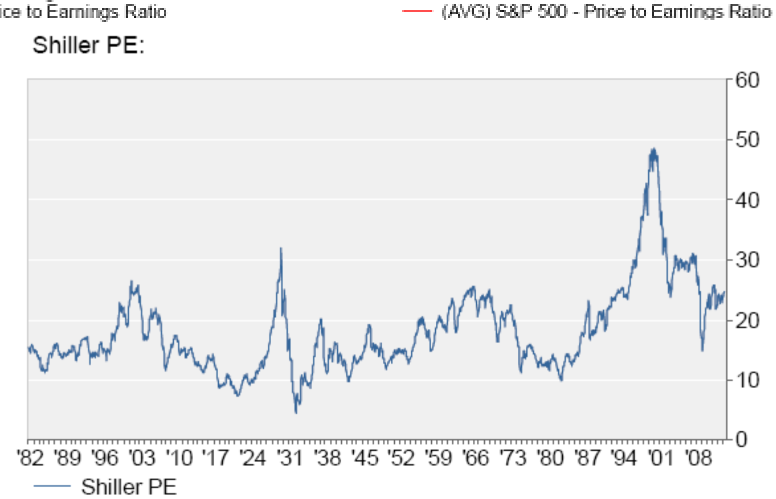
Middle Ground

In his most recent market memo "The Role of Confidence", Howard Marks -- acclaimed industry veteran and chairman of Oaktree Capital Management -- stated: "It is easier to know what to do at the extremes than it is in the middle ground, where I believe we are today... When there is nothing clever to do, the mistake lies in trying to be clever. Today it seems the best we can do is ***invest prudently*** in the coming months, ***avoiding aggressiveness*** and remembering to ***apply caution*** [emphasis added]." Not only do we agree with Mr. Marks' recommendation for prudence and caution, but we borrowed our title from his remarks because, in our view, "Middle Ground" is a fitting description of the current investment environment.

Through the end of July, 2013, U.S. equities gained almost 20%, while international developed markets advanced 8%. On the other hand, emerging market equities lost 10%, commodities and natural resources were weak, and even bonds are down approximately 2% over the seven-month period. For the most part, diversification has not worked this year. Any allocation away from domestic equities has been a performance drag to investment portfolios. An important implication of the continued strong run in U.S. equities is its impact on valuations. As shown in the charts below, the S&P 500 index appears undervalued based on forward and trailing Price/Earnings ratios. However, it looks fully valued or overvalued from a normalized, longer-term perspective, as evidenced by the Shiller Price/Earnings ratio (defined as price divided by the average of ten years of earnings, adjusted for inflation).





Source: Fidelity Investments, FactSet

Proponents of the Shiller P/E ratio argue that forward-looking price multiples are useless because of Wall Street's tendency to overestimate future earnings, while backward-looking price multiples are based on inflated earnings that are vulnerable to contraction (as record profit margins mean-revert to their long-term averages). In contrast, the Shiller P/E -- also known as the Cyclically-Adjusted Price Earnings ratio -- is seen as a more meaningful valuation signal based on the economy's sustainable earnings power. At its current level of 24x, the Shiller P/E is signaling modest real return potential for the S&P 500 Index in the coming decade, as shown in the data table below.

Figure 9:
Results for S&P 500 from Different Starting Shiller P/E Ratios (1926-2012)

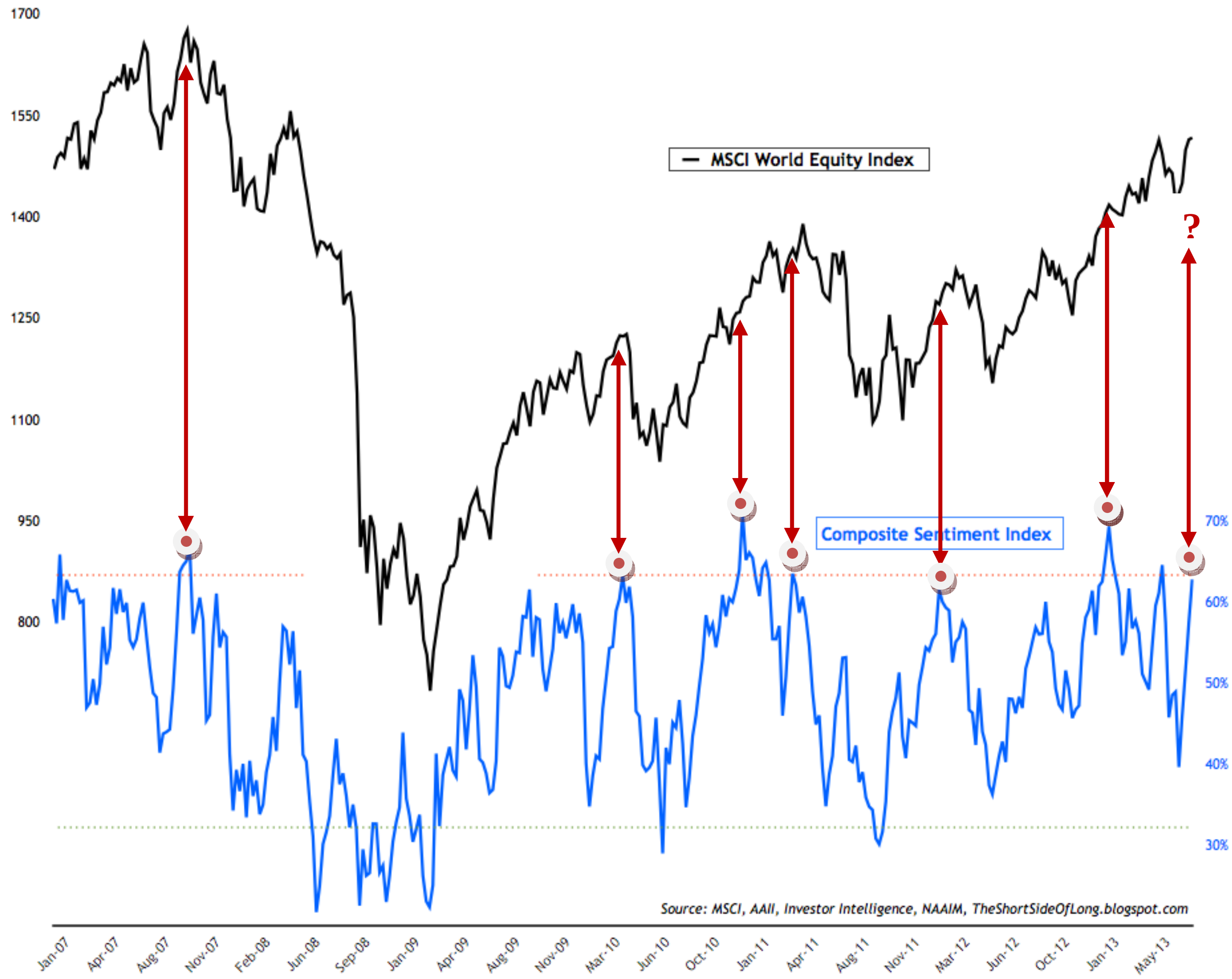
Starting P/E Low	Starting P/E High	Avg. Real 10 Yr Return	Worst Real 10 Yr Return	Best Real 10 Yr Return	Standard Deviation
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	**25.1**	**0.9%**	**-4.4%**	**8.3%**	**3.8%**
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

Source: Asness, Cliff. "An Old Friend: The Stock Market's Shiller P/E." AQR Capital Management, November 2012.

Source: John Hussman, AQR Capital Management

The danger of looking at an average is, of course, its tendency to mask the range of the underlying data. In this case, history shows that the S&P 500 Index has annualized just under 1% in real terms for 10 years when starting with a Shiller P/E ratio of 21.1x-25.1x. Yet, the difference between the worst data point (-4.4% annualized) and best data point (+8.3% annualized) is almost 1,300 per year. It would be unwise to build specific market forecasts based solely on such statistical analysis of past data. With so many variables at play -- from the health of the U.S. economy and the eventual end of QE (quantitative easing) to Europe's attempts to heal, Japan's new growth experiment, and China's managed slowdown -- the global economic, fiscal, and political fundamentals will undoubtedly dictate the future moods and movements of financial markets.

Investor sentiment, perhaps buoyed by the robust performance of U.S. equities in recent months, has once again approached the higher end of its historical range (data shown in the graph on the following page). This does not mean that it cannot get higher still, but it is worth pointing out that similar sentiment levels have occurred near past market peaks (either short-term peaks, such as March 2010 and April 2011, or longer-term, such as August 2007). Furthermore, investors have started in earnest to allocate assets away from bonds and into stocks. According to the latest data from Bloomberg and the Investment Company Institute (ICI), last month's equity flows exceeded fixed income flows by the largest amount since 1999. This shift in flows began in early 2013 and has accelerated since the yield spike and bond price declines during 2Q2013. If the trend continues, equity inflows could serve as a powerful tailwind; but from a contrarian standpoint this level of investor optimism may also signal a potential stock market correction in the near future.



Source: TheShortSideOfLong.blogspot.com

Beacon Pointe is not in the business of making predictions. However, we find great value in studying the past, analyzing the present, and preparing for an unknown future. Whether we are looking backward or forward, we maintain a long-term perspective, instead of focusing on the latest trend or immediate future. In the words of Colin Symons, Chief Investment Officer of Symons Capital Management, "People far too often get into trouble by reacting to a half-cycle -- to a current up market or to a current down market that, in the short term, looks like it will go on forever. Looking at the full cycle enables us to generate gains in a risk-averse fashion." Likewise, Beacon Pointe works diligently on behalf of our clients in order to achieve their long-term investment goals by investing prudently, avoiding aggressiveness, and remembering to apply caution.

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