VIEW from the Lighthouse

2008 2nd Quarter

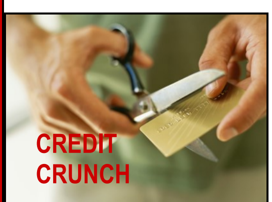
Beacon Financial Advisors, Ltd.

Please remember to contact Beacon Financial Advisors, Ltd. if there are any changes in your financial situation or investment objectives, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. A free copy of our Form ADV, Part II is always available upon request.
<u>An important note</u>: Where reference is made in VIEW to Beacon's relative performance, or individual mutual fund performance, it applies to fully invested portfolios for the period. Actual results vary among clients, as risk tolerance levels and the timing of asset purchases & sales are unique to each of our clients. Each client's unique results are revealed in the performance reports inside their Investment Review.

(GLOBAL) ECONOMIC REVIEW AND OUTLOOK

DETRACTORS: HOUSING, CREDIT & OIL

In the red corner **housing**, **credit** and **oil**, oh my! These are the lead *<u>detractors</u>* in an interesting and unusual mix of **<u>economic crosscurrents</u>**. The downtrend in home prices—depending on US location—is in its 3rd year. Like the "tech-stock mania" that soared in the late 1990's only to crash in the early 2000's, the housing sector soared on the wings of easy credit before the sub-prime mortgage crisis began in earnest in 2007 and is still unfolding. Housing prices across the US are in decline—in some places in very sharp decline—such that the National Association of Realtors and the Federal Reserve Bank forecasts housing prices (in aggregate in the US) will by late 2008 be down 20% from 2006 peak prices. Of the 50 million US homeowners with mortgages, some 7 to 8 million would owe at least 10% more than their homes are actually worth! Legislators are busy with bills—keep an eye on Congressman Barney Frank and Senator Chris Dodd as they chair relevant housing committees.



Prices at the gas pump north of $4/gallon have now matched the 1970's gas-lines price, inflation-adjusted. US consumers are shifting spending patterns and making choices. SUV's are out—and Walmart is in! Clearly consumer spending is slowing, so where do we look for evidence of positive economic crosscurrents? Lets look at the *<u>contributors</u>* next.

CONTRIBUTORS: INTEREST RATES, TAX STIMULUS & $US DOLLAR

In the green corner **low rates**, **tax rebates** and the **US dollar**—the lead *<u>contributors</u>* in the economic crosscurrents. In contrast to past credit crunches and previous oil shocks—normally accompanied by high interest rates—this time we have interest rates not far from all-time lows. Also, US taxpayers are in the midst of receiving $150 billion in tax-rebates—a one-time boost large by historical standards and likely to boost retail sales over the summer.

One reason we featured ***GLOBAL*** in the title above is because much of the world outside the US is experiencing growth, with especially strong growth in emerging country economies (e.g. China, India, Brazil, Israel, etc.), enabling US manufacturing companies to prosper with the twin-pillars of strong global demand and a weak US dollar. As recently as March 2008, the IMF (International Monetary Fund) estimated emerging economies now account for 44% of global economic <u>output</u>, and will source over 70% of global <u>growth</u> in 2008. Also, consider that to date financial companies have taken net capital <u>write-offs</u> (losses) from sub-prime mortgages of over $250 billion, while those same companies have <u>raised</u> nearly $300 billion in new capital. So, clearly while the US is experiencing an economic slowdown, much of the rest of the global economy is still expanding and eager to invest <u>in</u> the US! ■

BEACON'S BALANCED, GLOBAL PORTFOLIOS

Perspective—one's point of view,'the choice of a context for opinions, beliefs and experiences.

Given the recent volatility in global stocks and bonds, it's a good time to gain some perspective. A recent page 1 article in the WALL STREET JOURNAL proclaimed investors in the S&P 500 Index experienced no gain from 1999 to 2008—that's 0% return for nearly 10 years! As CHART 1 below shows, the S&P 500 peaked March 2000 at about 1,527 before plunging to about 800 by September 2003—a nearly 50% decline. Many investors swore off stocks, only to miss the dramatic surge in the S&P 500 Index back to 1,565 by October 2007—a near 100% gain from the September 2003 low. What the WALL STREET JOURNAL noted was the insidious math of investing: $1 invested *before* a 50% decline requires a 100% gain *after* just to get back to $1! That's nearly 10 years with no gains.

And this get's us back to *PERSPECTIVE*. An investor's best friend, and one **Beacon** vigorously pursues for our clients, is global diversification with balanced portfolios for these benefits:

- Capture gains from the world's best performing assets classes, while limiting exposure to losers
- Dampen the effect of sharp market losses and volatility for smoother-results.

As CHART 2 below shows, **Beacon's** portfolios have done just that. Our actual composite of clients investing with a "moderate" risk profile of 60% stocks and 40% bonds returned about 7.50% net annual compounded while the S&P 500 returned 0% from late 1999 through 2007.

CHART 1

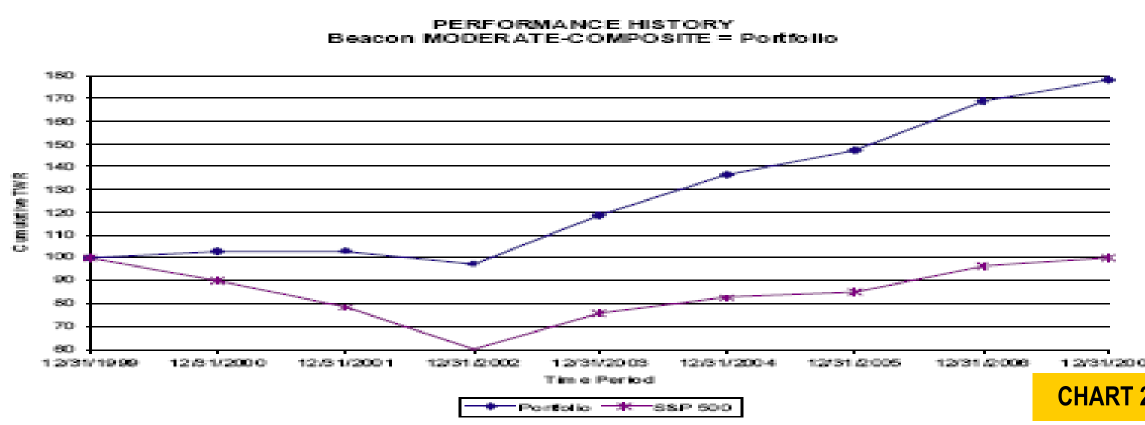


CHART 2

Fires, Drought, & Stocks

Last week two magazines arrived at my home with lead articles about two recurring forces of nature—fire and drought. In Yellowstone Discovery, the article focused on the great wildfires in Yellowstone National Park in the summer of 1988, 20 years ago. Milissa and I visited Yellowstone last September and witnessed the scars that still remain from the fire. The byline of the article was *"Research reveals that fire is **essential*** [emphasis **Beacon's**] *to the ecological health of the Greater Yellowstone Ecosystem."* In like fashion, the July/August issue of Ducks Unlimited featured an article entitled "The Positive Effects of Drought" with the byline *"Wetlands **have to** dry out occasionally to provide habitat for waterfowl."* To the layman (e.g. non-geologist, biologist), these seem like strange conclusions. No doubt a fire that destroys natural objects like trees and wildlife, or a drought that destroys habitat, seem to the contemporaneous observer to be *destructive.* And yet the facts are opposite; they are *constructive* for all that depends on them.

After reading the articles I was reminded of a similar truism in investment markets—bull markets are born in bear markets. In other words, you cannot buy stocks *cheaply* if they never go on sale. **Question: How does an investor survive a bear market?** Let's face it, times like this test our nerve as investors (and advisors too!). Its never satisfying to observe a shrinkage in our wealth as those monthly brokerage statements arrive in the mail. It doesn't feel good in any way, shape, or form—so lets admit that.

However, there are several keys to prosper even in the midst of a decline in stock prices.

1. Never let emotions bubble over and assume control over your *plan.* **Beacon's** design of each client's investment plan is based on successful use of thoughtful diversification. Our balanced, global portfolios are designed to preserve most of your wealth in tough times, and recover your wealth in better periods.
2. Don't believe "timing markets" is a winning strategy. Remember that reversals in stocks to the upside usually happen abruptly and robustly—be patient, viewing the long term.
3. Buy common stocks in great companies when they're on sale, as many are now.

So, let's take a look at what our stock-managers are doing as stocks have gone on sale.

Spotlight on Stocks

Large Stocks

UMBIX (Columbia Value & Restructuring; New York)—Of Beacon's stock mutual funds in 2008 the one that has held up the best in this difficult period has been Columbia* Value & Restructuring (UMBIX;*renamed from Excelsior after US Trust's acquisition by Bank of America). UMBIX's 80+ stock portfolio features overweights to energy, materials and industrial stocks, and is significantly underweight in financial and technology stocks. As co-manager David Williams noted in a recent conference call: *"Although we are always disappointed to report sub-par performance, we take some comfort in know the fund weathered a volatile environment better than its benchmarks"* [Russell 1000 Value & S&P 500]. The top *contributors* for UMBIX included energy, gas, and coal holdings that were beneficiaries of rising prices and attractive growth in emerging markets. While beneficial that UMBIX was underweight financial stocks, among the funds *detractors* were several financial sector stocks including Ambac, CIT Group and Lehman Brothers. Williams's is optimistic about the US economy and noted he's *"taking advantage of deep market discounts to upgrade the quality of holdings in the portfolio."*

DODGX (Dodge & Cox Stock; San Francisco)—Dodge & Cox Stock is the laggard among **Beacon's** three US large cap managers thus far in 2008. We are reminded of the most recent 20-

"...times like this test our nerves...However, there are several keys to prosper even in the midst of a decline in stock prices."

1/4 years at Dodge & Cox. In those 81 quarters, DODGX outperformed the S&P 500 Index 40 times, and underperformed 41 times. However, because DODGX had more consistent results with less volatility, their 20+ year annual compounded return of 13.3% was substantially more than the 11.1% of the S&P 500 Index. Members of the company's investment policy committee acknowledge headline economic news in the US is sour—but they believe there are sufficient economic positives to support buying stocks in this discounted market in that the patient investor will eventually be suitably rewarded. DODGX has added several financial stocks of late to it's 80+ stock portfolio, including

- Financial: Wachovia, Capital One, Sallie Mae, Citigroup.
- Technology: Motorola, Sprint/Nextel.
- Healthcare: WellPoint, GlaxoSmithKline.

JENIX (Jensen Portfolio, Portland) - Of **Beacon's** three US large cap manager's JENIX has the most concentrated portfolio with only 28 stocks. While UMBIX and DODGX use variations on "value" investing for stock selection, Jensen is a quality "growth" manager so that our clients get a "multi-style" benefit to owning both types. During a recent visit to **Beacon's** office, Jensen's chief business strategist Eric Schoenstein reviewed recent performance and stock acquisitions. Among Jensen's top holdings are Proctor & Gamble, General Electric, Johnson & Johnson, Abbot Labs, Emerson Electric, and Stryker (medical devices). The most recent addition to Jensen's 28 -stock portfolio is Adobe Systems, maker of graphic design, publishing and imaging software for print, web and video production. Jensen believes Adobe Systems will continue to benefit from the explosion of Internet advertising in that their products enable creative professionals to prepare the advertising content for the web. Jensen believes the recent stock volatility provided an excellent valuation entry point to re-acquire Adobe Systems—a stock they previously held before selling profitably near the peak of the "market bubble" in the late 1990's. As for Jensen's overall investment outlook for their "quality growth" stock holdings, these are the key points Schoenstein made:

- Financial stocks (banks, brokers etc) will likely continue to struggle to 2008 Q2-Q3;
- All stocks, including Jensen's holdings, have difficult conditions to navigate (e.g. high oil prices, etc.), but with strong balance sheets and high free cash flow today's prices provide very compelling valuations.

Mid-Small Stocks

GABAX (Gabelli Asset Fund, New York) - Manager Mario Gabelli believes the recent market reversal is a result of the downward adjustment in earnings estimates of US companies; he also believes inflation is now a greater risk and is actively positioning GABAX for a period of above-trend inflation (driven by energy and food prices), with an emphasis on investing in companies that have pricing power to act as inflation-conduits. While Gabelli is not surprised by the dampening of US stock prices in a slowing domestic economy, he cited low (relative) US interest rates, the fiscal stimulus unfolding via the tax rebates, and the boom in US exports as prime factors *"...that should bring a return of prosperity."*

TAVFX (Third Avenue Value, New York) - As **Beacon** has noted in recent client memos, TAVFX has recently experienced it's worst relative performance in the fund's near 20 year history. Manager Marty Whitman has discussed his fund's performance at length in his 2008 Q1 and Q2 shareholder memos. The primary *detractor* in TAVFX's recent performance has been Whitman' early investment in companies that issue insurance for municipal bond insurers. As we've often noted TAVFX is dissimilar from our other mutual fund partners in it's wide-berth of security positions it will acquire including common stocks, secured and unsecured debt or other junior securities, private placements (equity or debt). As a long-term Beacon recommended holding, Whitman has earned our confidence over the past 15+ years and we expect a recovery.

Foreign Stocks

DODFX (Dodge & Cox International Stock, San Francisco) - Beacon previously wrote clients about DODFX's decision to implement a (non-normal) strategy to hedge the portion of the portfolio with exposure to the Euro and British Pound-Sterling. That action is based on the view that the US dollar's multi-year decline is nearing an end. As the stock chart on page 6 reveals, stocks globally have been in decline across almost every industry as the MSCI-EAFE Index (Morgan Stanley Capital International-Europe, Australia, Far East) has declined like US indexes. DODFX has spent considerable time and energy the past two quarters re-assessing the original investment thesis for each of the 100 or so stocks in the portfolio in light of price declines. To illustrate, a company they've recently reaffirmed is SONY, a holding since fund inception in 2001. DODFX has substantially outperformed over the past several years in large part because of it's investment in several developing regions and countries in Latin America.

Spotlight on Bonds

As our clients know, **Beacon's** balanced, global portfolios means stocks are "balanced" by bonds as fixed income serves as an integral key to long-term successful investing. Bonds always produce steady income, and almost always enjoy positive returns (at least the type bonds we use). That means bonds are the "anchor to windward" for more volatile stocks. Our taxable clients often have municipal bonds, while our tax-deferred or tax-free clients (IRAs, ROTH-IRAs, etc.) have taxable bonds. The past 12 months the bond market, excluding US Treasury securities, has been negatively impacted by the "sub-prime" mortgage crises across the board.

SMBIX, STMIX (Schroders, Philadelphia) - Beacon has written several Investment MEMOs to clients this year detailing the general problems in municipal markets sparked by the sub-prime mortgage mess, and the specific problems of Schroders related to their investment in Percent of LIBOR Notes. Since our most recent 3/24/08 MEMO, we're please to report SMBIX and STMIX have returned 1.45% and 2.26% respectively; annualized those returns are 6% and 9%, so clearly the values Schroders wrote about in the municipal market are bearing fruit now.

DODIX (Dodge & Cox Income, San Francisco) - Dodge & Cox is very bullish on the bond market as a result of *"...the extreme valuation discrepancies between bond market sectors that have resulted* [from the subprime mess]*".* Their strategy is to remain overweighted in the Corporate and MBS (Mortgage Back Securities) sectors, as yield premiums* in each are at near-record levels (*extra return versus Treasury). DODIX believes the balance sheets of US companies, with some exception in financial companies, are extraordinarily strong and can withstand a slowed US economy. In the MBS area, DODIX believes the tougher lending environment (fewer re-financings) has slowed prepayment in loans backing MBS holdings, promoting a steadier income stream.

MWTIX (MetWest, Los Angeles) - Sounding much like our analogy on page 3 about fires and droughts and stocks, MetWest's CIO Tad Rivelle noted the US economy had its boom (in housing via easy credit) and now is having it's essential slump he calls *deleveraging*. As Rivelle wrote, *"Deleveraging periods are inherently messy, although history suggests they are also manageable. Simply put, deleveraging events are part of the DNA of a functioning capitalist economy."* MetWest projects it will take years to restore equilibrium in the US housing market, but the mortgage securities that undergird mortgages are producing some compelling values today.

FPNIX (First Pacific Advisors, Newport Beach) - While DODIX and MWTIX (above) are **Beacon's** core bond managers investing in LBAG Index securities, FPNIX is Beacon's core-plus manager with greater latitude to stray to where manager Rich Rodriguez finds values. FPNIX is quite defensive in terms of duration exposure (short) and security selection.