VIEW from the Lighthouse

2009 3rd 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.
An important note: 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.

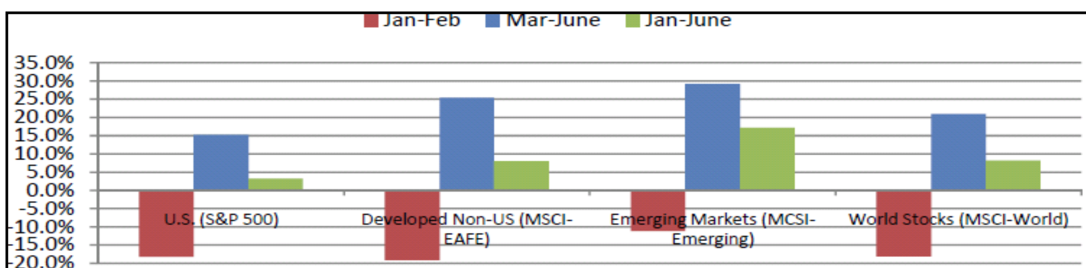
July 2009

About Beacon Financial Advisors, Ltd.
Beacon is an independent fee-only advisor with a clear mission statement: To provide our clients long-term value-added financial counsel and investment performance with *exceptional service.* **Beacon** is a Registered Investment Advisor with the U.S. Securities & Exchange Commission.

About the Author
Marcel Hebert has over thirty years experience serving as a financial and investment advisor to individual clients. Marcel has a B.S. and an M.B.A. in Finance, and is a Certified Financial Planner (CFP) licensee and a Chartered Financial Analyst (CFA) charterholder.

ROADMAP TO RECOVERY: Leading Economic Indicators

As **Beacon** noted in prior client communications, global stock markets continued their slide in early 2009 before carving a new bottom on March 9. But since then stocks have risen sharply with April and May particularly strong followed by a so-so June.



Stock market rally began with—the bond market!

Undoubtedly there is relief among long-term investors to observe the stock markets respond in a positive direction following the agonizing final months of 2008. Nonetheless, almost no market observer has opined that we're out of the economic and investment "woods" yet. So why the dramatic reversal in the stock market? For some answers, lets observe what has been happening in the credit (i.e. bond) markets of late. The 2nd half of 2008 featured an historic U.S. credit market crisis (anyone recall Lehman Brothers?). Along with a deterioration of the U.S. and global economy, and with the financial system under extreme stress, the flow of credit to business and consumers essentially ceased. Many fearful investors panicked and began a "flight to safety" that created a surge in demand for bonds backed by the federal government (e.g. Treasuries et al). This increased demand for government-backed bonds drove the yields down to such low levels that by November 2008 the yield on short-term Treasury Bills fell to 0%—investors accepted no nominal return for the government to borrow their money. Clients will recall that bond prices move opposite yields, but the lower yields did little to nothing for the prices of bonds not backed by the federal government as investors were so fearful there was no strong buying demand. These included municipal bonds and corporate bonds. During this period yield spreads—the difference in return needed to prompt investors to buy bonds not backed by the federal government (so-called "credits")—had risen to historically high levels. In other words, the "sale price discount" (opportunity) was substantial but buyers remained scarce. **Beacon** emphasized this point in several of our PERSPECTIVES on INVESTING client emails.

As 2009 unfolded, this trend (investors buying government, shunning credits) has reversed itself as we predicted it eventually would. Many credit-sectors have handily outperformed bonds backed by the government. And yet, despite this reversal the yield-spreads remain historically high as yields on Treasury bonds remain historically low. This strongly indicates that rare opportunities continue for our active bond managers like Dodge & Cox and MetWest.

Bond market recovery began with...LEADING economic indicators!

If the stock market reversal took it's queue from the bond market, the bond market took it's queue from the LEADING economic indicators. In contrast to economic indicators classified as COINCIDENT or LAGGING, *"economic indicators that are considered 'leading' are the most helpful to investors because they tend to do a better job of identifying future economic trends."* (Fidelity's MARE May 2009). This excellent review from Fidelity of 5/09 underscored the economic backdrop that has heretofore produced the improved investment climate for bond and stock returns. We've inserted their KEY TAKAWAYS table and INDICATOR TREND for review.

KEY TAKEAWAYS

- Economic indicators that are considered "leading" are the most helpful to investors because they tend to do a better job of identifying future economic trends.
- During the past two months, a significant proportion of U.S. leading indicators have become less negative, signifying a slower pace of economic decline.
- Further improvements will be necessary to confirm whether the U.S. economy is moving toward a recovery, but this trend has provided hope that the worst of the recession may be in the past.
- Because stock markets tend to anticipate recoveries, early signs of upward movements in leading indicators often have accompanied stock market rallies, with most gains typically occurring before all indicators had moved directionally upward.

In recent weeks, the rate of decline for some LEADING indicators of the U.S. economy has slowed and one indicator (S&P 500 index) has turned positive. Historically, early signs of upward movements among LEADING indicators have coincided with stock market rallies, and sustained upward movement has presaged or accompanied an economic rebound.

Indicator	Description	Recent Trend
Yield Curve	The difference between long-term (10-year Treasury bonds) and short-term (federal funds) interest rates. Large positive differences in the yield curve create profitable environments for banks and other lenders.	Very positive
Money Supply	The total amount of money available in an economy. Increasing money supply (M2) helps support financial market liquidity and economic activity.	Very positive
Avg. Manufacturing Workweek	A measure of labor market health. Companies tend to adjust hours worked before firing or hiring workers to cope with fluctuations in business activity.	Very negative
Manufacturer's New Orders for Consumer Goods	A measure of new orders for manufactured (consumer) goods and materials. Increasing new orders of consumer goods tend to lead consumer spending increases.	Stabilizing
S&P 500 Index	An index that measures the performance of the U.S. stock market. Is seen as a proxy for investor and business confidence.	Positive
Initial Unemployment Claims	Weekly measure of people filing for unemployment benefits for the first time.	Positive/Stabilizing
Vendor Performance	A measure of how timely vendors deliver components of production to manufacturers. Increased delivery time implies increased demand as vendors struggle to keep up with increasing orders.	Negative
Housing Permits	The number of permits issued to build new homes earmarked for construction. An increase in newly issued permits can indicate an expected increase in construction.	Negative/ Stabilizing
Consumer Expectations	A component of a consumer sentiment survey that measures expectations for the economy over the next six months.	Stabilizing
Manufacturer's New Orders for Non-Defense Capital Goods	A measurement of business investment. An increase in capital spending often suggests companies are expanding their operations in anticipation of greater growth potential.	Stabilizing

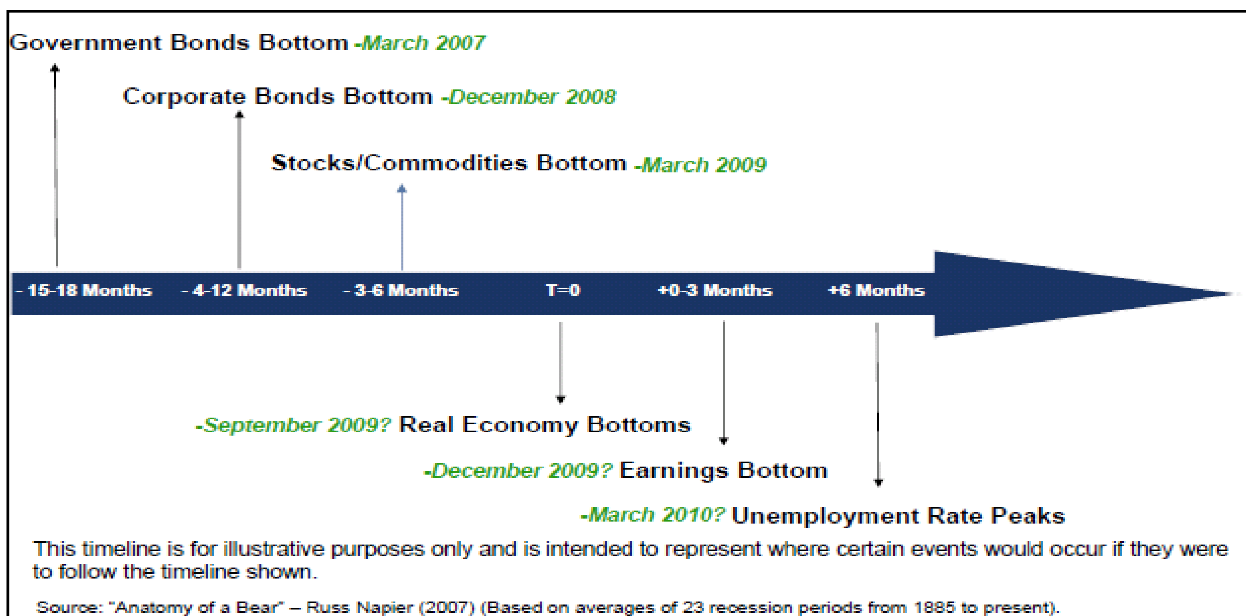
Source: FMRCo. (MARE) as of May 13, 2009

Where Do We Go From Here? All Eyes on ~~Wonderland~~ Washington D.C.

Like all professions investment management challenges the mind and body. The innumerable variables that constitute the global financial landscape are complex and intertwined. Sovereign governments pursue their interests and often conflict with others in matters of policy. At the national level, like the U.S., individual states, industries, and companies pursue their interests as well. Add to that the stew of emotional human beings pursuing their interests and you've got a real potpourri. **Beacon** often reminds clients that many investors are not long-term players and often pursue investment strategies that profit from price *declines* in individual company securities and whole markets. With this backdrop, **Beacon** believes (more than ever) that the closest thing in investing to a "free lunch" is effective diversification among investment types that are weakly correlated to each other—this assures clients will always have exposure to the best performing assets, while limiting exposure to the worst. In the U.S. Washington D.C. (aka "Wonderland") is one factor in how investment markets behave. The government in the form of legislators and regulators directly or indirectly hold the controls to essential components of the financial system, namely through fiscal policy (spending, taxes, etc.) and monetary policy (money supply, interest rates, etc.). **Beacon** has written about the extraordinary policy steps the U.S. government, and those in other countries, have taken to plug the global financial system. In the U.S., the Obama Administration has undertaken very aggressive fiscal policy initiatives that foretell substantial increases in the annual budget deficit and the long-term debt. The Federal Reserve (FED) faces a delicate balancing act in preparing to shift monetary policy from protection against deflation to one that abates future inflation pressure. Paraphrasing Hippocrates' counsel to physicians toward politicians:

"As to the economy, make a habit of two things—to help, or at least do no harm."

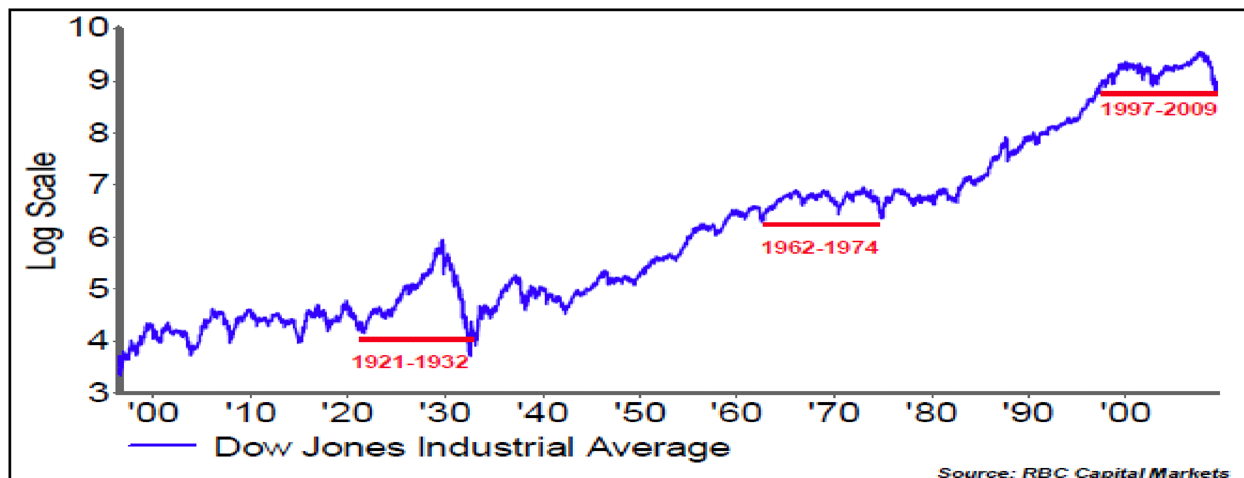
Writer Russell Napier has charted (below) the current recession in the context of the average of 23 recessions from 1885 to now, and provides a timeline for consideration if this recession follows the past patterns. Note the stock market (a LEADING indicator) "anticipates" the turn in the real economy by some months, and unemployment continues to rise (a LAGGING indicator). The U.S. stock market's surge from March 9 (good) and the continuing rise in the unemployment rate (bad) is consistent with past patterns.



This timeline is for illustrative purposes only and is intended to represent where certain events would occur if they were to follow the timeline shown.

Source: "Anatomy of a Bear" – Russ Napier (2007) (Based on averages of 23 recession periods from 1885 to present).

As the Dow Jones 30 Industrials dipped to March 9 lows newspaper headlines reported the venerable index of blue-chip U.S. stocks had wiped out all gains the past dozen years. In fact, as the chart below shows it was the third time in the past 100+ years the Dow has been flat over a dozen or so years.



While that is sobering news for investors (misery loves company), the final chapter hasn't been written yet—where do we go from here? While the immediate future is cloudy, there are good reasons to be more optimistic about stock returns over the long term. For evidence, we can look at the relationship of stock prices with corporate earnings and economic gross domestic product (GDP)—or the tangible wealth of our businesses and economy. As the table below shows, global stock prices by the end of 12/31/08 had fallen to match that of 12/31/97, twelve years prior. However, the earnings of companies and economic output of economies had doubled. Restated, today's stock prices may bode well for future returns.

Stocks retrace 1997 levels, but earnings and economic output have doubled

	1997	2008
Global Stock Market Index	**228**	**228**
Global GDP ($ Trillions)	**$35.9**	**$69.2**
Global Earnings Per Share	**$10.09**	**$21.29**
Price/Book Value Ratio	**2.8x**	**1.4x**
Global Dividend Yield	**1.8%**	**3.9%**
US 10-Year Treasury Yield	**5.7%**	**2.2%**

Source: Bloomberg, FactSet, IMF, MSCI, and AllianceBernstein

Beacon's Balanced, Global Portfolios

Lets talk **STOCKS**—stock returns in the 2009 Q2 completely washed the losses from January to early March, and **Beacon's** balanced, global portfolios have mid-year net total returns in the 4% to 9% range, depending on each client's risk profile and asset allocation. During the extreme volatility from 9/29/08 to 3/9/08, a key theme **Beacon** wrote was stock returns often are most robust following the poorest periods, and it is normal for those stock returns to come in uneven bursts—often when headline economic news is poor. As a LEADING economic indicator, stock returns normally turn positive often months before the economy reaches a turning point. That tendency is depicted clearly in the timeline chart on page 3. Most all of **Beacon's** stock partners enjoyed returns well ahead of the S&P 500 Index as the 2nd quarter proved to be one of the best in several years. REIT's also advanced very strongly in Q2. This serves a as good reminder that the "current news" is not a basis for decision making.

Lets talk **BONDS**—bond returns in 2009 Q2 were exceptionally strong, extending the modest gains from Q1. As **Beacon** noted on page 2-3, the stock market took it's queue from a strong rally in "credit" sectors of the bond market—those bonds issued by entities NOT backed by the federal government. Throughout 2009 investors have awakened to the abnormally high yield spreads in the credit sectors as a harbinger of investment opportunity. For instance, Dodge & Cox Income (DODIX) presently holds 483 bonds in the portfolio, almost all of which are in sectors other than government bonds (especially investment grade corporate bonds). The current yield (interest payments divided by NAV) is just over 7% annualized, and yet DODIX has produced a total return for six-months of nearly 8%, indicating bond prices in the portfolio have risen. Metropolitan West Total Return (MWTIX) has returned over 5% YTD with a big overweight in mortgage-backed bonds. As always, bonds are the "anchor to windward."

The Lighter Side...