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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 US Securities and Exchange Commission.

Beacon's Advisors

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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 FIRM BROCHURE (Form ADV, Part 2) 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. Clients are urged to compare the custodians (Schwab Institutional et al) account statements with Beacons reports.

"The U.S. economy continues to defy the predictions of economists of all stripes by neither collapsing nor breaking out on the upside."
 Robert Johnson, Morningstar Director of Economic Analysis, 9/27/11

As the chart below shows, the S&P 500 Index reached a bottom on 3/9/09 as the US Great Recession (officially) ended July 2009 (#1). Hence, the US recovery is a tad over 2 years old. The US stock market anticipated the emerging economic recovery and the S&P 500 Index returned about 100% from 3/09 to 4/11—but not without interim stalls. The 2010 Spring/Summer stall was headlined by the European sovereign debt crisis (PIIGS = Portugal, Ireland, Italy, Greece & Spain), and stocks declined 20%. The US Federal Reserve introduced QE2 (Quantitative Easing) in the 2010 Fall and stocks resumed their rise. The 2011 Spring/Summer stall featured the Japanese tsunami, resumption of the PIIGS crisis, and the US debt ceiling political squabble and the downgrade of the US Treasury (long issues) by Standard & Poor's. Other stressful headlines included the violent overthrow of the Hosni Mubarak government in Egypt, the NATO incursion in the Libyan civil war, and mass killings of civilians by the Bashar al-Assad's forces in Syria. Of all these flashpoints, the **European sovereign debt crisis** is the new "tail risk" to the slow-growth / robust-growth trend in developed (US et al) and developing (China, Brazil et al) economies. The EKG-like pattern of the stock market since July (see circle below) closely follows developments by the so-called troika's* efforts (*European Commission, International Monetary Fund, and European Central Bank) to arrive at a comprehensive solution to the problems across the big-pond.





In Beacon's Winter 1999 issue of ON WATCH, we wrote about the birth of a new common European currency—the EURO—another step towards European economic and monetary union ("EU"). We wrote: "The rewards and risks emerging from the EU and Euro are complicated and unclear." Prominent US economists like Chicago's Milton Friedman argued that a common monetary system without a common fiscal and credit system (no Eurobonds) would deliver negative unintended consequences. In 2000, Friedman famously predicted the Euro would not survive the first major European economic recession. The current PIIGS crisis following the US *Great Recession* may suggest Friedman was right. Greece has a lot of debt (too loose budget policies) it likely cannot repay (since it's economy is probably not globally competitive enough to grow out of debt, and it no longer has it's own currency (i.e. drachma) that it can devalue and inflate away the debt). Now, Friedman has more company among serious observers in questioning if the Euro can survive because the major ways for addressing the Greek problem involve a game of chicken between the tin-pan Greeks, wealthy EU members (e.g. German taxpayers), and French and German banks as to who will bear the most loss. In 2010 agreements were struck to forestall the crisis between the banks and governments for banks to continue to "hold" Greek debt/bonds. Now, those same parties are re-negotiating how much of a write-down the banks will take (21% is currently the haircut). German Chancellor Angela Merkel implied that may be too little. Meanwhile common stocks of European banks are crashing, the Euro is declining, economists are revising their predictions, and nervous investors are looking for the all-clear sign.

ON WATCH
TIMELY FINANCIAL AND INVESTMENT ISSUES FOR CLIENTS
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All Hail The United States of Europe

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Worth Noting!

Mexico's central bank had a field-day announcing the average 1% rate would get a mere 100-month pay raise from Social Security because inflation rose only about 1.5%. Less well-known was the much higher 5% increase in 2010. That's because the wage rate will rise from \$68,400 to \$72,000. Uncle Sam's guaranteed growth of 4.5% would make even an average specialist envious!

Uncle Sam once rated as the best credit-risk on the planet, but now he ranks a mere 4th behind Switzerland, Germany and the Netherlands. The credit ratings were published in the 9/9 issue of *Investment Advisor* magazine, and are based on input from 75-100 leading international banks. With 100 being the top rank, the US ranked 91. The sword for the world's worst borrower goes to North Korea!

EMOTION: THE INVESTORS' ARCH-ENEMY!

Consumers developed a theory about human decision-making in the investment world: *rational expectation*, which assumes people are coherent, accurate and unbiased forecasters. Let's see. As recently as Spring 1998, investors bought profitable companies (IPOs) the prices that would chase Sobeley's clients, invested heavily in Russia, predicted stock prices on the internet and, when polled, produced stock return expectations of 30%. *Street Street* reported surprise.

Fast forward a few weeks to August. The "Asian-Contagion" spreads to Russia, who promptly devalues and devalues. Investors panic and dump everything but US Treasury securities, driving US stocks down from 20% to 10% in the matter of a panic. FED Chairman Greenspan lowers interest rates. Panic retreats, and from October it's early November, investors push the US stock market up 10% in mere weeks. How's that for *rational expectation!*

Beacon's clients develop investment policies based on their life-time goals. Markets change, and bumps appear in the road. Yet, Beacon's clients seek to avoid the emotional roller-coaster of the prosaic "tick" with a thoughtful, visible long-term investing plan.

Despite the dour headlines, there persist silver linings for balanced, global investors with long time-horizons. While Europe may be in recession, the US is still on a low-growth tract. At the start of 2011 early signs of the traditional engines of US economic recovery were emerging. Consumer spending (the mother's milk) rose sharply in the 2nd half of 2010 prompting US companies to step up hiring. In 2011 March-May private payrolls averaged increases of 250,000 jobs per month. Stock prices continued to rise (see chart page 1). Two unexpected shocks curbed the trends: Commodity/oil prices rose sharply and cut into consumers spending power, and the Japanese earthquake/tsunami disrupted the global supply chain and depressed the output of the global motor vehicle industry. Those events rippled through the economy and growth slowed from about 3% annualized GDP to between 1% and 2%.

Today, what are some key silver linings that reside "below the headlines"?

(sources include the Federal Reserve Board, Haver Analytics, AllianceBernstein, Fidelity, and Morningstar):

- Consumer debt, spending trends—in the US, the household financial obligations ratio—a measure of how much disposable income is used for all financial payments—is 16%, lowest in 20 years. Despite negative consumer sentiment surveys, US consumers are still spending more each quarter. Consumers in emerging economies have the will and ability to spend.
- Corporations, cash, capital spending—as of June US corporations had \$2.05 trillion in cash, the highest on record. That cash is starting to show up in capital equipment replacement, mergers-and-acquisition activity, and stock buy-backs—all confidence indicators. US non-bank corporations free cash flow from ongoing operations remains near an all-time high. Growth in emerging economies has benefited US exporters and undergirded GDP gains.
- Bank lending improving, low interest rates—commercial bank loans are modestly growing. Banks have nearly \$1.5 trillion in excess deposits, and many are relaxing lending standards to both large and small businesses. The FED signaled interest rates will remain low to 2013. Individuals have \$4 trillion in near cash earning 0% that normally reside in stocks and bonds. Pensions may need to raise contributions to "risk" assets in low discount rate environment.
- Housing stabilizing—nationally there remains an excess inventory, but current new construction is so low in relation to demographic trends, housing experts estimate in 3-4 years home construction will need to double from current levels.
- Oil prices lower—with crude prices in the \$70's, pump prices are nearer \$3/gallon v. \$4, enabling consumers to spend elsewhere.
- Not 2008—there are numerous factors to support 2011 is not like 2008, notably in the pricing of the credit* sectors of bonds (*non-government). In 2008 credits declined at the same time as stocks in the panic-flight, muting the benefit of diversification for a time. In 2011, as stocks have declined bonds of all types have enjoyed solid returns.
- Political & Regulatory—public policy experts are focused on the "engaged" US citizen/taxpayer regarding government spending/regulation and the impact on private sector jobs.



STOCKS In the movie *Rocky 2*, challenger Clubber Lang (aka Mr. T) was asked by the interviewer what was his prediction for the fight—his reply, PAIN! Well, PAIN describes what investors got from the stock market in the 3rd quarter. Stockowners had no place to hide as every major US sector declined, and all major global stock indexes experienced double-digit percentage declines.

Beacon's major research *pursuit* the past year has been to evaluate:

- how the globalization of economies is impacting correlation coefficients between major and sub-major asset classes (including so-called alternative asset classes) and,
- how we can reduce downside volatility in times of market stress in our balanced, global portfolios, without a large impact on upside opportunity.

Diversification works when different asset classes are weakly correlated to one another. Said another way, when one zigs another zags, or zigs less. If everything moves together—up or down—diversification is not achieved. A trend the past few years is the increase in correlation between asset classes in times of market stress. For example, in the 2008 panic following the failure of Lehman Brothers many investors engaged in selling everything and buying Treasury bills. As all stocks and all bonds (ex-Treasury) slumped together, diversified portfolios declined further than our model suggested.

As for **STOCKS**, recent actions Beacon has taken towards our *pursuit* include:

1. Real assets—addition of AllianceBernstein Real Asset Strategy gives exposure to commodity-based assets like precious and industrial metals, industrial and agricultural commodities, and inflation-indexed bonds.
2. Lower beta*—replacing Columbia Value & Restructuring (UMBIX) with Sequoia (SEQUX); SEQUX held up best in the tough Q3 (*beta is a measure of risk relative to the broader market).

As for **BONDS**, we'll next discuss our plans towards our *pursuit*.

BONDS The bond world experienced a first in Q3 as the US Treasury was “downgraded” by a major credit rating agency, Standard & Poor's. And yet, the interest rate for 10-year US Treasury securities fell below 2%—meaning investors were willing to lend Uncle Sam their money for 10-years for a mere 2%. Also for the first time in post WWII, the market value of the US (stock market capitalization) declined to below 50% of the world. While it's always been important to diversify **STOCKS** globally, recent trends suggest it may be time to do the same in **BONDS**.

In Q3 **BONDS** performed their intended and classic role as portfolio “anchors to windward” with solid positive returns. Tax-exempt municipal bonds had abnormally robust Q3 and YTD returns as investors warmed to the actions by many states and local governments to address their near-term and long-term fiscal challenges. In our taxable bonds, both MetWest and Dodge & Cox also had positive Q3 and YTD returns.

Continuing the *pursuit* discussion in **STOCKS**, in **BONDS** Beacon has been evaluating if non-US sovereign and corporation bonds can enhance our portfolios' risk v. reward profile. In addition to our *pursuit* of lower portfolio volatility especially during times of market stress, we are concerned about the possibility of rising US interest rates over time since US interest rates are near all-time lows (recall bond prices move opposite interest rates).

Presently all our bond/fixed income investments are US issued and denominated. Our two taxable bond funds MetWest Total Return (MWTIX) and Dodge & Cox Income (DODIX) are “constrained” in that they are designed to invest in the sectors of the Barclays Capital Aggregate Index. The global fixed income sectors may offer access to sources of return less correlated to US interest rates and greater diversification. In bond parlance, we are seeking a manager with an “unconstrained” or a “go anywhere” approach. When the time comes, as always Beacon will keep clients posted.

“The key to making money in the stock market is not to get scared out of it.”

Peter Lynch, Manager Fidelity Magellan 1977-1990