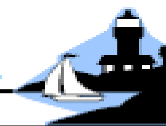


January 2012

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

MARCEL HEBERT has a B.S. in Finance, an M.B.A., and is a Certified Financial Planner (CFP) licensee and a Chartered Financial Analyst (CFA) charterholder.

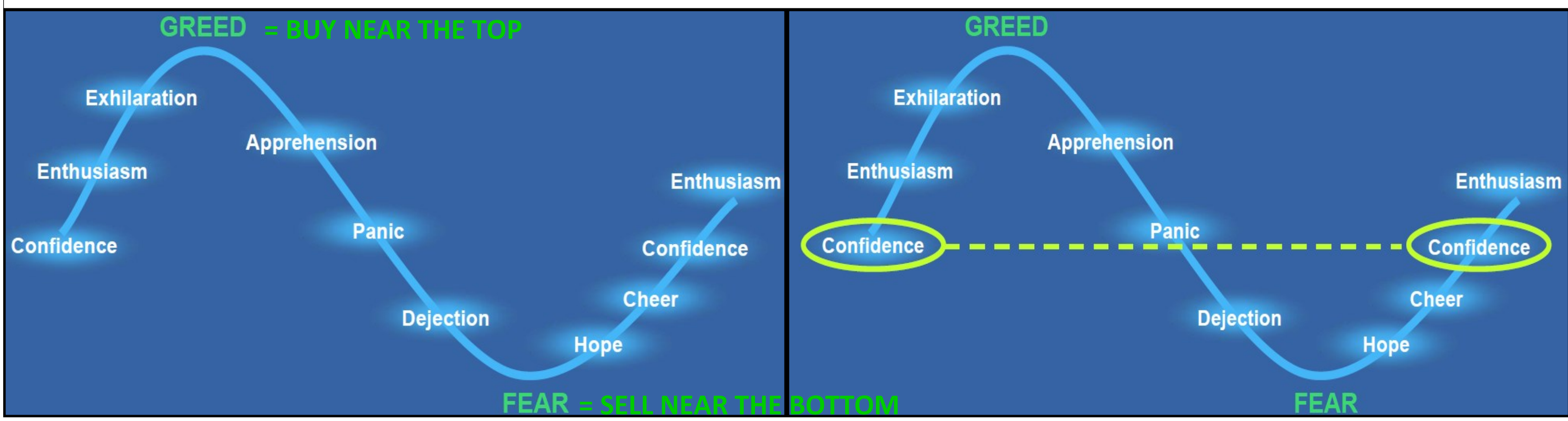
JOSH HEBERT has a B.S. in Accounting, an M.B.A., and is a Certified Internal Auditor (CIA) and a Certified Financial Planner (CFP) licensee.

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.

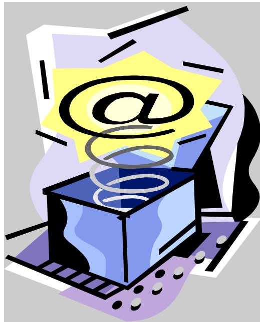
An important note: Where reference is made in VIEW to Beacon's relative performance, or individual mutual fund performance, it applies to fully invested portfolios for the period. Actual results vary among clients, as risk tolerance levels and the timing of asset purchases & sales are unique to each 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.

Ulysses (of Greek Mythology) sought safe passage by the coast of the Sirens (nymphs with power of charming by their song such that mariners cast themselves into the sea to destruction). Lest they succumb to the beauty of the Sirens song, Ulysses plugged the ears of his seamen with beeswax, and had himself bound to the mast with instructions not to release him until they passed the Siren's island. So beautiful was the Siren's music that Ulysses struggled and begged to be released, but his seamen were obedient to his prior command and bound him even more secure. They held their course, the Siren's music grew fainter until silent, and Ulysses and his men joyfully returned home in triumph.

Ulysses would have made a fine investment advisor. At least that's the assessment by the folks at Allianz Global Investors in their 2011 white paper Behavioral Finance in Action: Psychological challenges in the financial advisor/client relationship and strategies to solve them. We've excerpted the 4-page chapter Reigning In Lack of Investor Discipline: The Ulysses Strategy alongside VIEW for your reading pleasure. It underscores tenants **Beacon** has long espoused that successful investing—buy low(er) and sell high (er)—requires substantial discipline by CONFIDENCE in a proven investing strategy. Today there are plenty of Siren's songs enticing investors to deviate from course and fall victim to the dreaded emotional **GREED / FEAR** cycle. **Bind me to the mast!** ■



A Look Back at 2011...

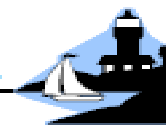


Coiled Spring is the term that comes to mind as we consider 2011's investment climate. 2011 was shaping up well for US stock investors until a late-July selloff as the government stalemate over the debt ceiling prompted ratings agency Standard & Poor's to downgrade the quality ratings of long-term US Treasuries and this spooked investors. Until then stocks moved unevenly higher and by late April were up 10% before the summer retreat due to the political acrimony noted above. The S&P 500 Index declined over –18% from July 22 to October 3. A recurring theme in this very volatile 2011 was the so-called "risk on/risk off" trading pattern by high frequency traders, hedge funds, etc. Generally the "risk off" assets won the day with safe investments outperforming risk(ier) assets as many investors continued their (perceived) "flight to safety". For example the broad US bond index Barclays Aggregate returned over 7% (in an environment of near-zero interest rates for cash investments), while the S&P 500 Index of stocks returned just over 2% (see Stock and Bond charts on pages 6-7). Major factors that weighed on the US investment markets included fearful investors, deferred spending, and uncertain government regulations. The July-October period we noted above reminded **Beacon** of the late 2008 to early 2009 period in which $trillions left the global equity markets in a panicked "flight-to-safety". Much of this capital has remained on the sidelines (in cash), or reentered *defensive* stocks even as the broad, global stock market indexes have recovered most of the prior declines. By late 2011 economic news was getting firmer, and investors became a bit more confident as evidenced by increased flows into stock mutual funds, and movements into *cyclical* and economically *sensitive* stocks. A robust Q4 helped stocks end up near even.

Outside the US, market conditions and results were far worse. Globally investors wrestled with the European debt crisis, lackluster economic recovery, and monetary tightening in emerging markets like China. The result is 2011 produced flat-to-negative global stock returns. In the US bonds outperformed stocks, the latter finishing generally flat (as noted above). In European and Emerging markets, stocks fell by double-digit %'s. For example, German and Japanese stocks declined over –15%, and emerging stocks combined fell over –18% (alone Chinese stocks fell –24%). And it wasn't any better for bond investors outside the US as those markets reflected increasingly higher default risks for both sovereign (government) and corporate bond issuers. In contrast to the US Barclays Aggregate Bond Index's 7%+ return noted previously, the European Government Bond Index returned less than 2%.

Fear Trumps Fundamentals

Despite truly superb corporate fundamentals, many investors are still scared and, in uncertain times, fearful investors tend to pull in their horns. The global Great Recession that began four years ago is officially over but thus far the recovery is weak by historical standards, and the prevailing mood among many investors is to remain risk-averse as they focus on headlines rather than fundamentals. Despite the Washington D.C. policy intransigence, elsewhere much went in a positive direction in the US in 2011: the jobs picture is not worsening and slightly improving, auto sales have recovered nicely, the states and municipalities are on balance well advanced in addressing their fiscal issues and their borrowing costs have improved, and housing starts improved markedly over the prior three depressed years to exceed 600,000 units annualized. In Europe, the fits-and-starts of dealing with that mess is looking like it will get worked out towards the best-case scenario of complete fiscal integration, albeit it will take awhile. On to 2012 next!



...and Looking Ahead to 2012

"*Avoiding Disaster Should Set the Stage for Stock Outperformance*" is the sub-title in Blackrock's* Market Outlook for 2012 (*one of the world's largest money managers with AUM > $3Trillion). That's sort of the "win by not losing" concept. And most Wall Street market strategists and economists have US economic growth forecasts that cluster in the "muddle-through" range of 2% to 3% GDP. Plus, those same seers also see ongoing European debt struggles and a recession across the pond, and continued deleveraging (debt reduction by US consumers that serve to constrain discretionary spending). And, wouldn't you know it 2012 is a US Presidential and Congressional election year. There are also major elections in over thirty-seven developed countries. So, political bickering and posturing will be at it's zenith across the globe.

So, what to make of Blackrock's case for stocks to outperform, or restated the **"what can go right" case**? For that matter, the forecasting folks at Fidelity, AllianceBernstein, Federated Investors (just to name a few) also think stocks will perform well and almost certainly outperform US Treasury bonds in 2012. A *large part of the answer lay in the price of stocks relative to the operating earnings of corporations*. In 2011 the 500 companies in the S&P 500 Index earned about $100/share versus a consensus estimate at the year's start of about $95/share. So, despite all the problems in 2011 discussed previously US corporations set an all-time record for operating earnings and have more cash on hand than at any prior time both in absolute terms and as a percentage of their balance sheet assets. In short, earnings in corporate America are to die for (Hollywood lingo notwithstanding)! Legendary stock researcher Benjamin Graham reminded us that in the long-run, stock prices are based on earnings (in the short run, prices are often driven by investor sentiment; see p. 1 for on the emotional **GREED / FEAR** cycle). At the start of 2012 the S&P 500 Index was priced at about 11X the estimate for corporate earnings in 2012 (the so-called P/E ratio, or Price/Earnings). That compares to a 50+ year historical average of nearly 16X. So we have a nearly 5-multiple "discount", an inflation outlook that appears reasonable, record high US corporate earnings, record cash on corporate balance sheets growing at $1.5 trillion/year (and at banks and in money-market accounts of individuals, with near-zero interest rates for all that cash), excellent corporate productivity (unit of income per unit of cost), and profit margins that continue to exceed forecasts. Liquidity abounds!

Like the two-handed economist (on the other hand!), we have Blackrock's **"what can go wrong" case** that includes a systematic banking crisis, a true double-dip US recession, a hard landing in China (economic growth collapses), a Middle-East flare-up resulting in $150/barrel oil, etc. As Blackrock's chief stock strategist Bob Doll penned:

"The main risk, in our view, continues to be that of a potential financial breakdown in Europe that could tip the developed world, if not the emerging world as well, into recession [we do not expect that outcome].

In our view, stocks are priced for an environment significantly worse than what we expect, suggesting that muddling through and avoiding disaster should be enough for markets to post appreciable gains.

We believe decent corporate earnings and some improvement in confidence levels should allow equity markets to move higher, with US stocks leading the way."

Turn the page for 2012 perspectives by our mutual fund partners on the markets in which they operate on behalf of all our clients.

Our STOCK Fund Partners for 2011 and 2012

STOCKS Generally **Beacon's** stock fund partners followed the same general pattern discussed on page 2-3 in that our US funds were either slightly positive or slightly negative (overall flat), and our international funds were either slightly or substantially negative. Despite the difficult year for stock investors, two of **Beacon's** stock partners were named among the ten finalists for US stock fund and international stock fund managers of 2011 by Morningstar. Sequoia (SEQUX) nearly two-peated as the US winner having won in 2010, while Tweedy, Browne Global Value (TBGVX) was the 2011 winner on the international side. How you ask, could TBGVX win this award with a –4% return? Because most of the rest of the non-US world did far worse, so they won by not losing (nearly as much)!

To read hyperlinks, hold CTRL + click (mouse)

- http://www.morningstar.com/advisor/t/48650994/sequoia-still-rock-solid-at-its-core.htm?q=sequoia+still
- http://www.morningstar.com/advisor/t/51166799/sequoia-looking-for-the-next-berkshire.htm
- http://www.tweedy.com/resources/library_docs/articles/2011MngrOfTheYearCommentary123111.pdf

Other long-term Beacon holdings Gabelli Asset (GABAX) and Jensen Quality Growth (JENIX) ended just under 0% return. Mario Gabelli is particularly constructive on companies that will support a recovering homebuilding economy in the next several years including big-box suppliers like Home Depot and Lowes. Gabelli notes the recent annualized 600,000 home starts is about 50% of what the US will need in the next five years. JENIX is just as concentrated as Sequoia (SEQUX) as it has but 29 stocks to SEQUX's 33, and at the start of 2012 the two largest holdings were Procter & Gamble and PepsiCo. Both funds remain top-tier in Morningstar's universe of ratings.

- http://www.gabelli.com/Gab_pdf/MorningStar/mstar-40511112010.pdf
- http://www.jenseninvestment.com/mutualfund/documents/IShare4pgfactSheet4Q11_Final.pdf

All clients will recognize Dodge & Cox (San Francisco) as core holdings in **Beacon's** portfolios for nearly 15 years. DODGX is our US large cap value manager, and DODFX our international value manager (currency unhedged). In 2011 DODGX and DODFX trailed their benchmarks. **Beacon** is not concerned and we plan no changes. *Notably, among all fund firms employee-owned Dodge & Cox has the single best record* for "eating their own cooking": $1MM is the average manager investment in their funds, 21.5 years is the average manager tenure, and the manager retention rate is 96.5%!* (*source: InvestmentNews.com, 1/16/12). We encourage our clients to spend a few minutes listening to key Dodge & Cox managers discuss 2011 and their view on the US and international stock markets going forward.

- https://www.dodgeandcox.com/about_video_gallery.asp?video=vid2

Continuing our review of major **STOCK** partners our new US small cap fund Third Avenue Value Small Cap (TASCX) managed by Curtis Jensen returned just under –5% for 2011 slightly outperforming it's benchmark the Russell 2000 Value Index. TASCX holds 67 stocks with names unfamiliar to most investors. However, TASCX's October shareholder letter reported the portfolio of quality companies is trading at prices relative to book value, equity value, and operating earnings lower than at any time in the fund's storied history, and about 60% relative to the S&P 500 Index. We think those prices layered in with the quality of the fund's businesses makes for a bright future. We encourage clients to spend a few minutes listening to Steve Forbes interview Curtis Jensen:

- http://www.forbes.com/2011/03/25/curtis-jensen-third-avenue-funds-intelligent-investing-video.html

Finally, 2011 was very kind to REIT investors and our Cohen & Steers Institutional Realty (CSRIX) finished up just over 6%. Like the broad stock market, CSRIX stumbled in Q3 before gaining 14% in Q4.

- http://www.cohenandsteers.com/downloads/monthly_insight_reit.pdf

Our BOND Fund Partners for 2011 and 2012

BONDS Generally **Beacon's** bond fund partners were the "anchor to windward" in our client's balanced portfolios in that our taxable funds were solidly positive , and our tax free municipal funds were substantially positive.

Fundamentals Trump Fear

One of the really BIG STORIES in 2011 was the defaults that didn't bark in the **municipal** bond world. In a late 2010 interview on CBS's 60 minutes analyst Meredith Whitney made a startling prediction there would be "hundreds of billions of dollars" in municipal defaults in a market totaling just over $3 trillion in state and local debt. Economist Nouriel Roubini made similar observations. Those dire forecasts were likely behind the huge amount of redemptions (sales) of municipal bond fund shares late in 2010 and into early 2011. **Beacon's** muni bond managers at AllianceBernstein and Fidelity made compelling cases those prediction not only were wrong, but that municipal bond assets were poised for great returns in 2011. And boy were they right. Our clients enjoyed total returns ranging from 7% to 13%+ in our four municipal funds in 2011 (as a client reminder, IRA's and other tax deferred accounts do not hold municipal bonds as the accounts are already tax-deferred; further, among our clients taxable accounts only those clients in the higher brackets hold municipals). For their efforts, **Beacon's** fund partner Fidelity's municipal bond team was one of five nominated by Morningstar for Fixed-Income manager of 2011. Going forward, there is almost no chance the high returns in 2011 will be duplicated in 2012. Nonetheless, **Beacon** remains constructive on municipals. State governments and many local ones are in better shape than the past couple years as state and local municipalities continue to rely upon the financial tools at their disposal and muddle through the hard times.

- http://blog.alliancebernstein.com/index.php/2011/11/29/navigating-rocky-municipal-bond-markets/

Over on the **credit (taxable)** side of the US bond world, our two partners MetWest/TCW Total Return (MWTIX) and Dodge & Cox Income (DODIX) returned about 5% each, below the near 8% of their benchmark. The reason: both are underweight US Treasuries, and as a surprise to almost everyone the US Treasury 10-year bond yield declined from 3.1% to under 2% (prices rise as yields fall). We're now in a low-yield environment in the US, and mid-single digit expected returns are called for in this sector. With low inflation and near-zero cash returns, even a mid-single digit return for investment grade bonds is meaningful. So, as **Beacon** has previously written and discussed in client meetings, we think now is the time to diversify our client's fixed income portfolios to include non-US sovereign and corporate bonds (see below). We encourage our clients to spend a few minutes listening to key Dodge & Cox and MetWest/TCW managers discuss 2011 and their view on the US taxable fixed income market going forward.

- https://www.dodgeandcox.com/about_video_gallery.asp?video=vid3
- https://www.tcw.com/News_and_Commentary/News/Webcast_Schedule_Replays/01-18-12_Rivelle_Whalen.aspx

The Strategic Case for Global Fixed Income

Two compelling reasons to diversify our US bond holdings are:

1. the very low US interest rates; we expect as the US economy and global economy eventually gains growth traction again central bankers and bond participants will bid yield higher. Prices move opposite yields, so active management is crucial.
2. the expanding opportunities of global bonds (especially in emerging markets), and their role in a diversified universe.

Beacon's research is nearly done, and our final selection of partner(s) awaits. We expect to rebalance client portfolios in Q1. Stay tuned! ■