



LIGHTHOUSE BEACON

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Lighthouse Investment Commentary

Bull Market Should Withstand First Quarter Correction

Is your stock portfolio down a bit? Don't be alarmed by the pause in the stock market during the first quarter of 2004. It's okay.

The favorable conditions that resulted in exceptional performance during 2003 remain in place, despite modest declines in some major stock averages in the first three months of 2004. Economic growth remains robust. Just look at the evidence. Gross domestic product grew at a 4.1% annual rate in the final quarter of 2003, according to the Commerce Department, which also reported that corporate profits in the final quarter of 2003 jumped by \$81.4 billion. Dividends paid by companies also are increasing, while interest rates and inflation remain at low levels. These conditions are not just present in the United States. Many of the same trends can be seen throughout the global economy. With all these positives, it was little wonder that domestic industrial activity finally began to show strength, with both durable goods orders and manufacturing activity improving. Still, many stock prices tended to slip somewhat in the quarter. (See accompanying chart to right.)

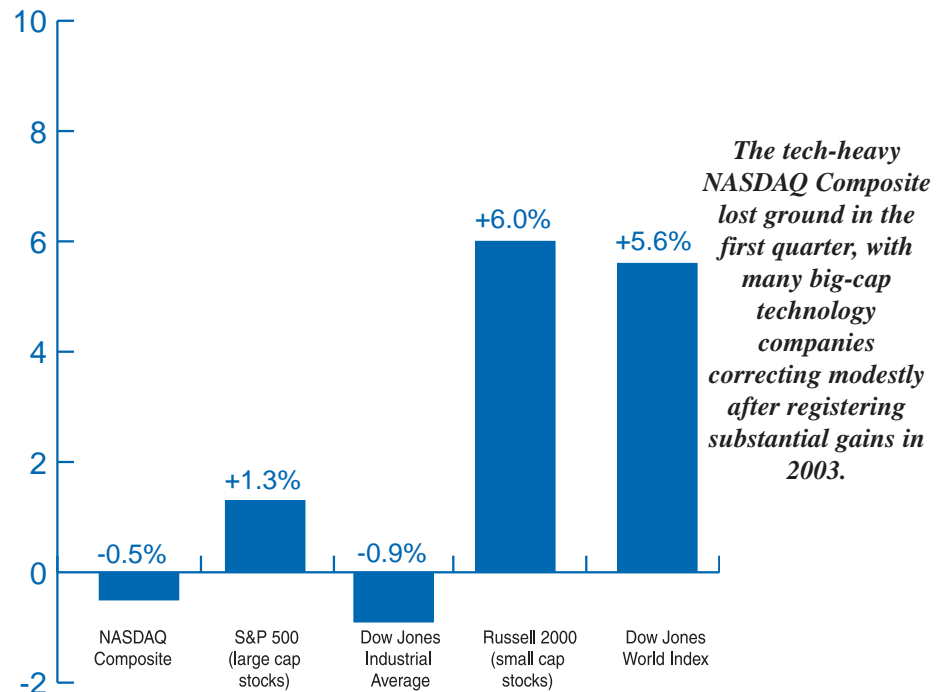
History has shown that corrections in rallies are normal and to be expected. Corrections of 5%-to-10% can happen at any time and actually tend to be healthy. They often defuse over-exuberant optimism and speculation and remove excesses in the prices of some stocks that have moved beyond levels justified by company fundamentals.

Market history shows that stock prices tend to move up dramatically in the first year of a recovery, frequently led by those sectors and asset classes that suffered the most in the previous downturn. That certainly occurred during 2003 when the S&P 500 Index' robust return of by 26.4% was eclipsed by the performances of technology and small-cap benchmarks.

During the first quarter, the terrorist attack in Spain and the resulting elections injected another factor to the normal "wall of worry" that

Focus on the Markets

Stock prices were volatile during the first quarter of 2004, with the major averages bouncing back more than 5% in the final days to finish close to even with the levels at which they started the year.



The tech-heavy NASDAQ Composite lost ground in the first quarter, with many big-cap technology companies correcting modestly after registering substantial gains in 2003.

Index returns are for price only, and do not include reinvestment of dividends. Past performance is not a guarantee of future results.

most bull markets climb over. The terrorist issue only adds to the other fears that on any particular day can capture the attention of investors: rising deficits; falling dollar; political uncertainty; increasing oil prices; and a sluggish job market.

A few words about jobs. The concern over the lack of job creation has been the focus of many warnings that this recovery might somehow be "different." It seems that we all have forgotten that as the economy and the stock market started their sustained rallies in 1992, observers were then warning of a "jobless recovery." Employment always has been a lagging indicator

of economic strength. Corporations finally begin to add new positions after they are persuaded that a recovery is real. Job growth typically comes after other indicators of an economic revival. We finally have begun to see that long-awaited new-job creation: the Commerce Department recently reported that 308,000 new jobs were created during March. With industrial production expanding and companies investing again in new equipment, it was only a matter of time before we saw strong evidence of expanding employment.

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There never is a perfect environment: we always have something about which we can complain. Those who said at the bottom of the bear market that we did not have enough pain now are saying that stock prices came back too far, too fast. Don't believe it! While we did enjoy a very strong rebound during 2003, it was only average on an historical basis. We fail to remember that many small-cap and technology stocks lost 90%-to-95% of their values during the three-year market slump. Even those that doubled during 2003 still may be down more than 80% from their all-time highs. The NASDAQ Composite Index, for example, still is 60% lower than it was in March 2000, even after the 2003 rally.

With low interest and inflation rates, the growth potential of stocks continues to offer a very attractive alternative to any other type of investments, including bonds. And, as a result of the tax cuts of 2003, the tax rates on stock div-

Lighthouse Highlights

Selected Lighthouse Portfolio Holdings First Quarter 2004 Performance

Company	Sector	Price Change*
Countrywide Financial	Financial	+26.4%
International Game Technology	Consumer	+25.9%
Motorola	Telecom	+25.1%
Schlumberger	Energy	+16.7%
Forest Labs	Health Care	+15.9%
S&P 500		+1.3%
NASDAQ		-0.5%

* Price change only. Neither company nor index returns include any dividends. Performance of individual stock holdings in portfolios managed by Lighthouse Asset Management are not intended to indicate future results.

idends and long-term capital gains are lower than the rates on interest income for many taxpayers. We happen to be entering a very

favorable period for investments. Taxpayers are starting to receive refund checks from the tax reductions implemented last year. This can only bring new liquidity to the market and bode well for stock prices. That being said, we need to remind ourselves never to forget the importance of diversification in any investment portfolio. We should never put 100% of our invested assets in just a couple of stocks or bonds. Where appropriate and depending on the goals, unique circumstances and risk tolerances of each investor, we should maintain some allocation to bonds and other fixed-income assets to reduce overall volatility and risk.

While the outlook for stocks continues to look good, we also should recognize that we have already gone through the initial stages of a recovery, when everything tends to rise. Going forward, we expect that investors will be more discriminating and favor higher-quality companies with good growth potential, leadership positions in their markets and solid management teams. As the recovery continues, we also can expect some moderate increases in inflation and some hikes in interest-rates. These, like short-term market corrections, also are normal.

The views in the Lighthouse Beacon's investment commentary are those of the professional staff of Lighthouse Asset Management, LLC. Our professionals each have more than three decades experience in the capital markets. The team includes: James R. McCall, CFA, President; Dana P. Blake, Jr., Executive Vice President; and Frank H. Gorke, Jr., Senior Vice President.

Lighthouse Guides

Q: Do stocks usually do better under Republican administrations than when we have a Democratic president?

A: The conventional wisdom is that because the GOP is the more overtly business-friendly party, it produces better investment climates. That's not borne out by the record, however.

If we take away the phenomenal stock rally of the 90s under the Democratic Clinton administration, the returns from stock markets during Democratic and Republican presidencies look remarkably similar. The rally of the 90s, of course, tips the averages to favor the Democrats.

This year, one of the key questions on the minds of investors is whether a Democratic administration will push through reversals of the 2003 tax cuts that benefited investors. However, we should keep in mind that a president alone can't reverse those cuts. Congress must pass the legislation, and that seems unlikely.

Uncertainty, not the party in power, tends to have a greater influence on the markets. Politics, like any other factor external to the economy, can affect uncertainty and contribute to market volatility. And this election year is shaping up as one likely to produce its share of uncertainty and market volatility.

In the long run, the fundamentals of companies and their earnings power are what drive the equity markets. For clues about where the market may be heading, keep your eye on economic output and corporate profits, not the politicians.

Lighthouse Guides is a regular column answering typical questions posed by clients discussing their portfolios.

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