



LIGHTHOUSE BEACON

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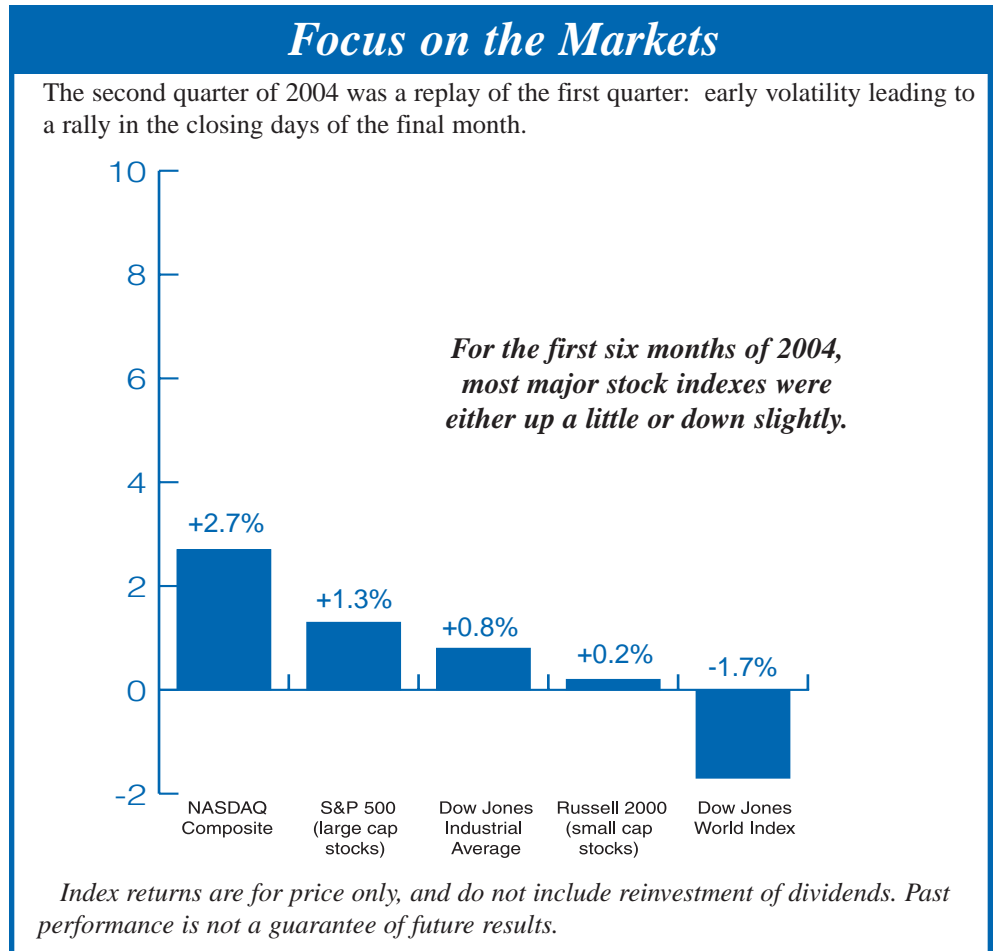
Lighthouse Investment Commentary

Market Psychology Competing with Economic Fundamentals

For the second consecutive quarter, stocks barely produced positive results, and everyone seems to be worried.

What has investors so worried? Certainly not the economy. Real Gross Domestic Product (GDP) rose at a brisk 3.9% for the first quarter of this year after registering a 4.1% rise in the final quarter of 2003. Corporate profits? Not a problem! U.S. corporations are expected to show a 20% increase in profits during the second quarter of 2004, compared to the same quarter last year. That will be the fourth consecutive quarter that corporate earnings have risen by more than 20%. Employment? Despite early fears of a jobless recovery, the economy is creating new opportunities. Inflation continues to be tame and lending rates still are at historically low levels, even after the Federal Reserve Board raised rates on June 30.

So, if economic growth, corporate profits, new job creation, inflation and interest rates are not concerns, exactly what are investors worried about? In a word: uncertainty. Iraq, oil prices, China and the apparently too-close-to-call presidential election (as of early July) all are contributing to investors' anxiety about the future. Markets are up one day, down the next as psychological factors battle with economic fundamentals for the attention of analysts, pundits and investors. Lately, as overly pessimistic views of current events are extrapolated into the indefinite future, psychology has been winning out over economics.



In the long run, economic realities always win out over psychological sentiment. And, make no mistake, we still are in the early stages of a strong, sustained economic recovery. As is normal in every economic expansion, interest rates can be expected to rise and inflation will creep up. Even after the Federal Reserve Board raised overnight lending rates by one-quarter of one percent on June 30, short-term rates remain at extraordinarily low levels. The bond market had already anticipated —

perhaps overly so—the effect of the rate hike. No one seriously believes that the economic rebound could be choked off even if rates were to rise from their recent low of 1% to 2%, or even 2 1/2%, by the end of the year. In fact, the Federal Reserve has done a very credible job of adjusting rates up and down over the past decade to make sure that the economy remains under control —expanding at a decent rate but not so fast as to strain resources and stimulate excessive inflation.

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Despite all that is going on today, corporate profitability remains the key factor affecting the long-term health of the market. Capital spending finally has begun to increase, inventories are being rebuilt and jobs are being added at a brisk pace. In May, 248,000 new jobs were created after more than 700,000 jobs were added in the previous two months. Remember Enron? WorldCom and Arthur Anderson? The sources of those problems are being addressed. The SEC, the Financial Accounting Standards Board and even Congress are fixing the systemic problems and people are going to jail for individual abuses. This country has an amazing capacity to adjust and move forward.

It is true that the tragic crises in the Middle East do not show signs of any easy

or early solution, but, as in the past, the violence eventually will begin to ease again.

Lighthouse Highlights

Selected Lighthouse Portfolio Holdings Second Quarter 2004 Performance

Company	Sector	Price Change*
Stryker	Health Care	+24.2%
Corning	Telecom	+16.8%
Staples	Consumer	+16.2%
Microsoft	Technology	+14.6%
Countrywide Financial	Financial	+10.0%
<hr/>		
S&P 500		+1.3%
NASDAQ		+2.7%

* 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.

Lighthouse Guides

Q: To participate in the stock market, why not just invest in an index mutual fund?

A: Index funds are fine if you don't mind having your investment decisions based upon the past rather than the future. And, index funds offer less diversification than you may think.

An index fund based upon the Standard & Poor 500 Index now has more than 20% of assets invested in financial services stocks, and even more when you consider that companies such as Ford and GE derive significant portions of their profits from their financial subsidiaries. The weighting is almost double that of just 10 years ago and is the result of the great run that financials have had. But, do you really want to have one-quarter of your equity investments in financial stocks right after they have done so well? Only if you like risk and are the type of person who enjoys driving with both eyes on the rear-view mirror. We do not mean to be negative on financials; in fact some financial stocks remain very attractive. We just don't think a well diversified strategy would include a 25% commitment to the sector.

Index fund allocations are based on the market capitalization of equities. Stocks of companies that have higher valuations and have outperformed in the recent past will account for a larger share of the investment than stocks that may have been out of favor in the past but that may have improving outlooks for the future. In 1999, for example, technology stocks comprised 28% of the S&P 500. Anyone invested in an index fund then would have been left vulnerable to the collapse of the technology bubble that was to follow. The same was true back in 1980 when energy stocks accounted for 27% of the S&P 500.

To be well diversified for the long-term, with a strategy that carefully considers risk control, you would be wise to avoid putting too much money in an index fund. As it says in the small type in mutual fund advertising, past performance is no guarantee of future success.

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

History teaches us that in times such as these, we should keep remain focused and stay properly diversified. In our equity investments, we in a period when stock selection will become increasingly important, especially as the rate of economic growth slows a bit. For those needing more income, we continue to recommend short- and intermediate-term bonds and high-quality, preferred stocks rather than longer-maturity bonds that are vulnerable to price losses as interest rates rise. Utility and REIT stocks which have good yields and increasing dividends also look interesting for income.

When investors once again pay attention to the salient issues of economic growth and corporate profitability, confidence will return. Then, the stock market will once again be driven by economic fundamentals, rather than the mob psychology too often driven by daily headlines.

In the long run, economics wins over psychology.

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.

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