



LIGHTHOUSE BEACON

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Lighthouse Investment Commentary

Searching for Long-Term Trends amid Short-Term Swings

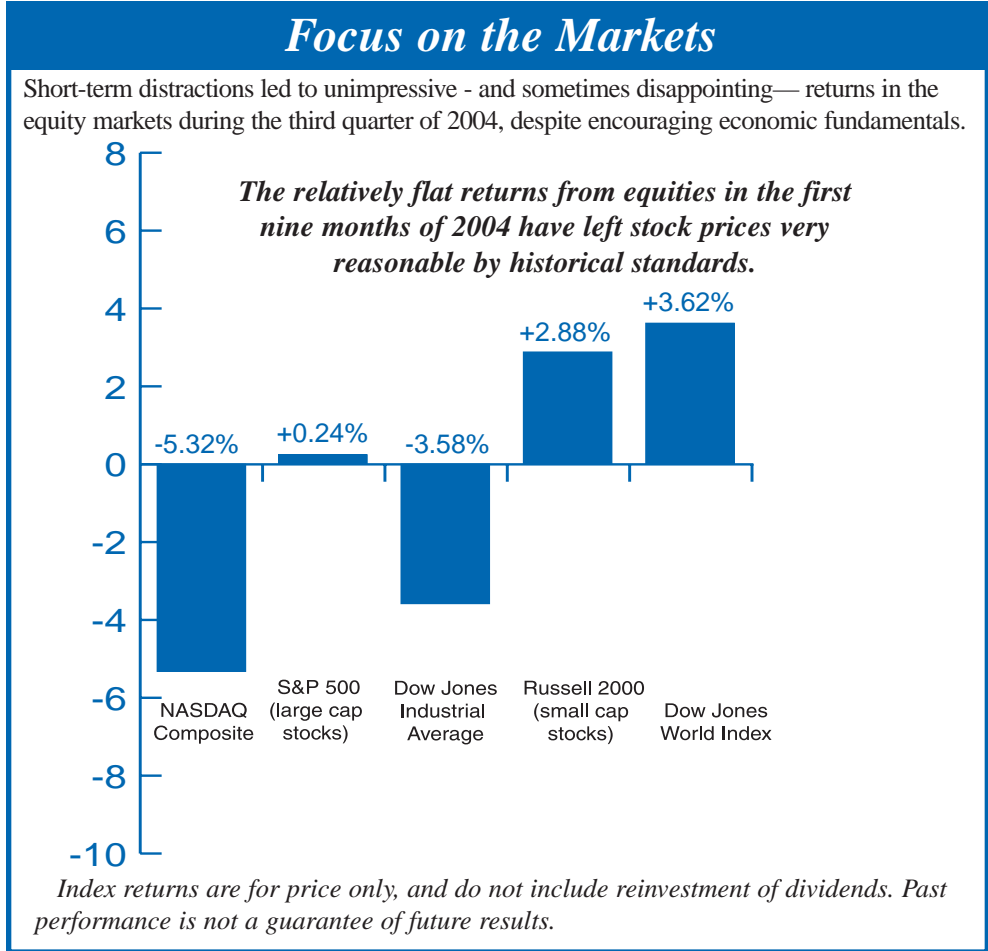
Those watching the daily swings in the capital markets during the first nine months of 2004 can be forgiven for being confused. While stock prices have risen and dipped in abrupt, short-term bursts, the major stock averages have shown little movement since the start of the year. As a consequence, investment results tended to be flat and investors pouring over the daily and weekly market results found few answers to where the market was going during each of the first three quarters.

As in the first two quarters, the third quarter of 2004 was punctuated by day-to-day volatility in stock prices. Despite continued growth in the economy and improvement in corporate profitability, investors' attention was drawn away from the big picture by daily headlines: Violence in Iraq; Sluggish Job Growth; Continuing Terror Threats; Rising Interest Rates; Polarizing Political Campaigns; Leaping Oil Prices.

What is going on?

The fact that valuations of some stocks and in some sectors have declined during 2004 should have come as no surprise. After the terrific results of 2003, everyone should have expected some corrections - which often are healthy because they remove excesses from the market. However, it has been frustrating to see that these corrections have been longer than normal, by historical standards.

Actually, many positive developments should give encouragement to investors. The economy continued to grow steadily during the second quarter -at an annual rate



of 3.3%— and corporate profits continue to rise. Manufacturing output, which has been increasing, has now finally recovered from the losses that it suffered in the slump that began in 2000. And, housing construction starts surprised almost everyone by rising in August. Although the Federal Reserve raised the fed funds rate three successive times since June 30, inflation remains restrained -the Consumer Price Index increased by just 0.1% during August. Partly as a consequence, the interest rates

on longer-maturity securities have started declining again. In mid-September, the yields on most types of bonds were at their lowest levels in five months. Consumer confidence remained strong during both July and August, although it dipped slightly in September in the face of higher oil prices.

The economy is healthy, and yet the stock market is flat.

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What is going on?

One interesting -and natural-result of this situation is that stock valuations now are much more attractive than they were several months ago. After a period of rising corporate earnings but muted stock returns, the price/earnings ratio of the overall market is in the mid-teens. By historical standards, that could be considered to be very reasonable, even undervalued during a time of healthy earnings growth and low inflation and interest rates.

With so many non-economic factors - from Iraq to political uncertainty—creating anxieties, many investors are remaining on the sidelines, unsure of what to do. They haven't been able to distinguish the long-term trends that move global economies

Lighthouse is Fully Compliant with New SEC Regs

We are pleased to announce that Lighthouse Asset Management, LLC, is fully compliant with new Security and Exchange Commission regulations requiring registered investment advisers to establish comprehensive compliance programs.

The SEC has mandated that all registered advisors have comprehensive manuals in place by Oct. 5, 2004 to ensure compliance with all securities laws. This document covers such diverse matters as codes of ethics, client rights and safeguards and trading policies.

At Lighthouse, we have spent considerable time and effort to produce and be guided by a lengthy compliance manual that covers all SEC requirements.

In addition, to ensure that material in the "Lighthouse Beacon" is consistent with SEC rules, we no longer will be publishing information on the quarterly performance of selected holdings in Lighthouse-managed portfolios.

from the short-term distractions that move the daily headlines. Historically, the U.S. economy has shown tremendous

resilience as it adjusts to events. No doubt, changes in the investment environment will continue. But the presidential election will be over soon (visit our web site at www.lighthouseasset.com to read our special report on the 2004 election), oil prices will become more stable - and perhaps even decline-and we will learn to live in a world of terrorist threats. We will adjust, as we have in the past through Cold War tensions, nuclear threats and other bitter political contests.

In the long run, it is the economy that matters. We continue to have a vibrant economy, propelled by a superior technology and the huge productivity gains that accompany it. These productivity gains have led to significant increases in output and have raised our standard of living. Moreover, as our demographic composition changes and the baby boomers get older, new opportunities will open up for investors in technology, health care and services.

Bull markets last longer than a year. Most last several years. The bull market that began in 2003 was based on economic fundamentals, but it became sidetracked by short-term distractions. When it comes back, the winners will be those who pay attention to long-term economic trends and are invested in the market.

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Q: With overall corporate earnings continuing to grow, why are so many companies releasing disappointing profit reports?

A: It all has to do with expectations and changing opinions about what to expect. Wall Street analysts have the unenviable job of trying to figure out -usually to the penny-what a company will earn in the upcoming quarter. Last year, most analysts underestimated what corporations would earn. As a result, stock prices rose sharply when company after company reported profits that exceeded consensus Wall Street estimates. The truth is that as markets overreacted to the good news, many stocks became overvalued, -especially when analysts overcompensated and became very aggressive in forecasting profits for 2004.

Quarterly earnings can be affected by a variety of changing and unpredictable factors - the price of oil, the weather, and the exchange rates between national currencies. In 2004, we have seen many corporations continue to post strong results, yet narrowly miss the inflated expectations of Wall Street. The result: corrections in the stock, at least for the short-term.

At the end of the day, we take confidence from the fact that the economy is expanding, corporate earnings are growing briskly (even if below some Wall Street expectations) and stock valuations are reasonable.

Another point: Corporate financial reports are much more credible now than they were in the 1990s. As a result of the accounting and corporate governance controversies of recent years, companies and their auditors are much more conservative in their reports. That should be another reason to be confident in the fundamental strength of the companies reporting growing earnings.

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

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