

Lighthouse Beacon

A Guide in the 21st Century

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QUARTERLY REPORT

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Lighthouse Investment Commentary

Stock Investors Adapt to Market's Transition

Every market cycle inevitably has its natural transitions as the pace of economic growth moves from one stage to another.

The U.S. economy has just moved beyond the first stage of a growth cycle as the recession that began in 2001 was followed by a period of rapid, accelerating growth in both Gross Domestic Product and corporate profitability. Within that period, stocks generally climbed higher, often in rapid spurts followed by some interim volatility.

Now, we have moved into a period characterized by a more gradual expansion of the economy and improvement in earnings. Accompanying this development have been higher interest rates and worries about a possible pickup in inflation. This is normal. Unfortunately, it also has become normal for investors to get more worried that—perhaps—the economic recovery may be ending and we may be heading back into a recession and a bear market in stocks.

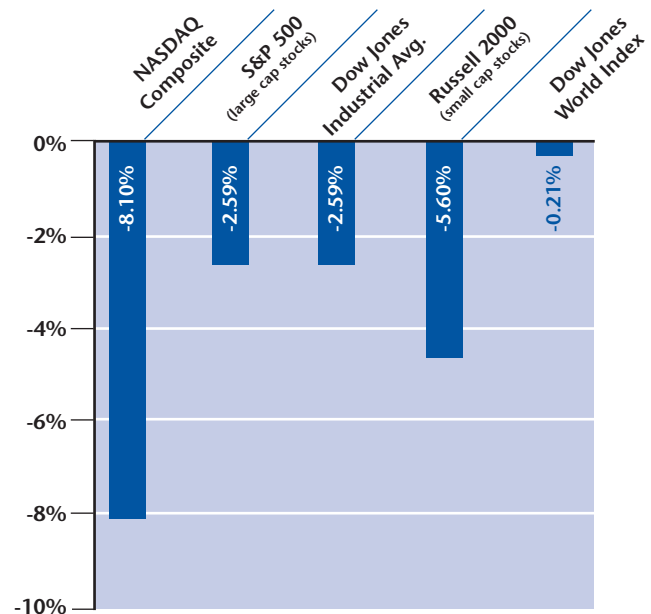
To be sure, the first quarter of 2005 had its share of volatility—much of it on the downside. However, don't forget the final quarter of 2004 featured an almost explosive surge in stock prices. It shouldn't be surprising that there was a correction in the first two months of the year. As investor confidence began to return, stocks started rising again in late February and early March, with index averages hitting highs they hadn't seen in more than 3½ years. That rising confidence, though, was shaken when world oil prices leapt in March, exacerbating fears of inflation. The threat of inflation first received serious attention in March's commentary by the Federal Reserve Board when it raised short-term interest rates for the seventh time in just a few months.

In March, the fears of persistently high oil prices and rising inflation overshadowed the good news of the sustained

The major equity indexes declined in the first quarter of 2005 after surging higher in the post-election rally of the final two months of 2004.

Focus on the Markets

Small-cap stocks fell harder than large-cap issues in the first quarter, but technology shares fell even harder, as evidenced by the return in the NASDAQ Composite.



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

growth in the economy, continued improvement in corporate profits, and the steady rise in stock dividends paid out by corporations with healthy cash flows.

It seems that stock investors rarely adjust to the reality that uncertainty is just a fact of investment life: There never is a perfect investment environment! Even with the best possible backdrop, investors always will be reminded of concerns, problems, challenges and risks. Don't forget: just 12 short months ago, the market was focusing on worries about deflation, a stagnant economy, the lack of new job creation, and a feared crisis in corporate governance. Now, it is focusing on oil, the dollar, current account deficits and in-

flation.

Oil, in particular, gets a great deal of attention, especially weekly reports of oil inventory levels. Perhaps a little lesson from the past is in order. Historically, weekly oil inventory changes have been very difficult to measure, and reports of these inventories have been extremely volatile and unreliable. Just look at the past two months. In late February, people were warning of dangerously low inventories. Then in March, crude oil inventories were reported at their highest levels in three years. Did the situation change that much, or were we merely paying too much attention to unreliable statistics?

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The value of the dollar has been another cause of concern, as some commentators have cautioned that weakness in the American currency might cause foreign investors to move money elsewhere, leading to sharp jumps in interest rates in the U.S. These commentators seem to overlook the fact that if investors sell their dollars, they will need to buy other currencies. What other currencies? The two most frequently mentioned alternatives are the euro and the yen. But, don't forget, when you buy a currency, you are investing in another economy. Is it rational to take money out of the U.S. economy and allocate it to the sluggish European economy or the even more troubled Japanese economy? Of course not! But we probably have already dwelled on this too long, because at this writing the dollar already has started to recover on international currency exchanges. At Lighthouse, we continue to watch the bond markets here and abroad carefully for any signs that currency is becoming a problem. To date, the demand for U.S. Treasuries remains high, however, implying continued confidence in the U.S. economy.

We need to refocus away from short-term headlines and return to economic fundamentals and long-term trends. Although we have been seeing gradual increases in both interest rates and inflation in recent months, we should be reminded

Lighthouse Spotlight

Corporations Share Growing Profits with Shareholders

As profits steadily climbed during the past two years, the cash positions of American corporations increased significantly. As a result, more and more companies are returning some of those profits to shareholders, either in the form of higher stock dividends or in stock buybacks that help support outstanding shares by increasing demand. Some technology companies even have paid dividends for the first time ever.

Standard & Poor's reports that dividends for companies in the S&P 500 Index increased by more than 15% during 2004 and are projected to increase by another 12% this year. If that projection proves to be accurate, this would be the best two-year period for dividends in more than 50 years.

The combination of increasing dividends and stock repurchases can only be good news for investors.

that both interest rates and inflation were at extraordinarily low levels just a year ago. Those levels could not be sustained. Moreover, we should remember that there is no clear correlation between the direction of interest rates and the direction of stock prices.

As we enter the second quarter of 2005, the overall investment environment actually should be encouraging—especially if we look at history. We have moved out of the typically explosive first-growth phase of a recovery and into a period of a more gradual expansion. This second phase normally is accompanied

by rising interest rates which, when under control, should not be considered too dangerous. In this phase, it is reasonable to anticipate growth in GDP at an annual rate of 3%, with corporate profits rising at an average 7-to-8%. This is not a bad environment!

During this normal transition, investors should re-assess their portfolios to determine if they still are:

- Positioned to meet their long-term goals;
- Well diversified among appropriate asset classes;
- Comfortable with present stock holdings.

It is at times such as these that all stocks may not move in the same direction and individual stock selection becomes increasingly important. It is more important than ever that a portfolio be concentrated more heavily on stocks of companies that offer the potential to grow their earnings faster than the overall market.

When investing in fixed-income securities, it is wise not to reach too aggressively for high-yielding bonds with compromised credit quality. Look at opportunities among better-quality bonds with maturities of less than 10 years and consider some investments in preferred stocks and utility stocks.

Most of all, relax and don't be overly concerned about this changing environment. It's normal and should present some interesting opportunities.

Lighthouse Guides

Q: Why aren't newly accumulated wealth gains counted as savings?

A: We commented on the savings rate in last quarter's newsletter, prompting some readers to question the published rate's reliability. The short answer to those questions is simple: the federal government sometimes does things in strange ways.

The government's published savings rate is calculated simply by looking at total earnings over a particular period and then subtracting what was spent. That's fine until you start looking at what isn't counted. Capital gains, for example, are excluded from savings, but capital gains taxes are deducted from earnings. According to the government formula, if someone were to take \$5,000 in earnings and then toss it into the ocean, that would be counted as savings.

Some studies have suggested that a more reliable way to calculate a savings rate would be to look at the total amount of money going into savings accounts, CDs, mutual funds, other investments, and subtract that total from earnings. If you did it that way, you would find that the savings rate has been fairly stable for decades, but personal wealth has risen dramatically.

What is the lesson? Don't put too much stock in commentaries based on pessimistic reports of the nation's savings rate.

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