

Lighthouse Beacon

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Lighthouse Investment Commentary

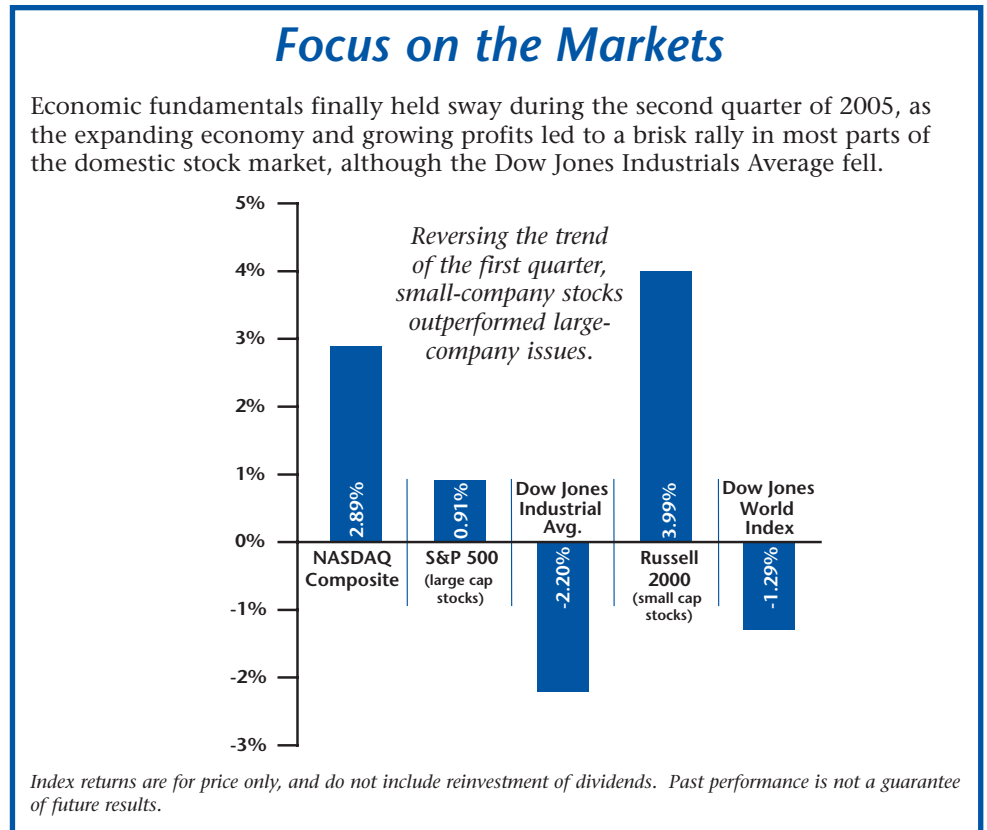
It's Fundamental! Investors Focus on Market Underpinnings

Finally, it appears that investors are re-focusing their attention on the fundamental issues that drive long-term stock performance. Things like economic growth, corporate profitability, interest rates and inflation.

Except during the relatively brief rally in the final two months of 2004, for more than a year the primary influences over the financial markets have been transitory background noises and the anxieties that they have provoked. These have included worries about the course of events in Iraq, fears that the Federal Reserve would raise short-term rates too far too fast, and concerns about the impact of rising energy prices.

While some of these headline issues can have an influence on the economy, the anxieties that they have produced over the past 15 months have been largely overblown. The Federal Reserve, for example, has done exactly what it said it would do: raise rates gradually in measured steps that would not threaten the economic recovery. If anything, rising oil prices have helped prevent the economy from growing too fast. Whatever is happening on the ground, Iraq has not had a noticeable impact on the economy. And, even the tragic terrorist bombings of London's transportation system on July 7 had only a brief direct impact on the financial markets.

Since the end of April, we have seen stocks surge in a fairly broad-based rally in which most sectors of the economy—and companies large and small—have contributed. This rally has been driven by economic and business fundamentals, rather than any speculative



excesses that can result in extreme performance results by one part of the economy. The companies that have turned in the best stock performance have tended to be those that reported the best profits. The concerns that weighed on the market earlier appear to have dissipated. Inflation remains in check—the Consumer Price Index (CPI) actually declined slightly in May. The core rate of inflation—which excludes food and energy costs—rose by only 0.1% during the month. Meanwhile, the nation's unemployment rate for June was the lowest of the past four years.

Even after a year of hikes in short-term interest rates, engineered by the Federal Reserve, rates still are only half of what they were at their peak in 2000. And, the expectation is growing that the Federal Reserve may be nearing the end of this round of rate increases. The nine successive quarter-point hikes in the key overnight lending rate have not had the disruptive effect that many had feared. The economy is growing at a moderate, sustainable pace, corporate profits have continued to rise, consumers still are spending and businesses continued to

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invest in expansion. The Fed has done its job. The gradual increases in the fed funds rate have kept the economy from growing at excessive rates that could trigger higher inflation and much-higher interest rates in the future.

At the midpoint of 2005, investors are finding value in stocks. While corporate earnings have climbed steadily and impressively over the past 15 months, stock prices have risen only modestly. The result is that, based on price-to-earnings ratios as well as other common measures of a company's worth, stocks in general are reasonably priced—especially when considering the low levels of inflation and interest rates.

In our opinion, the overall stock market has gone from being somewhat overpriced to being undervalued. This is a situation which arises when investor sentiment has been more pessimistic than the underlying fundamentals justify. The economy has demonstrated that it has the strength and resilience to deal with the issues that have arisen—whether they be the perceived threat from China to the reality of \$60-per-barrel oil.

Lighthouse Spotlight ***Stock Prices Appear Reasonable***

Don't look now, but stock prices have become very reasonable—maybe even cheap.

During the past year, the economy has continued to rise impressively and persistently and corporate earnings have reflected this growth. Profits have risen by 15.4% over the last 12-month period.

Have stock prices kept pace? Hardly. The Standard & Poor's Index climbed just 6.32% over the past 12 months, while the Dow Jones Industrial Average eked out a paltry 0.66% return during the period.

As a consequence, the average large-company stock is selling at a ratio of 14 or 15 times projected earnings for 2005. That's pretty low, especially when you consider the low inflation and low interest rates.

Right now, stocks may be the best deal around.

We expect that the economy will continue to grow at a moderate pace, pushing business profits higher. Corporate balance sheets are as strong as they have been in recent memory, which should bode well for policies that help shareholders. We anticipate that dividends will continue to increase, more corporations will announce stock buy-backs,

and that some companies will redeploy their funds to make strategic acquisitions that enhance their businesses.

Keep diversified and focused on longer term objectives. As investors look at the fundamentals, this should be a good time to be invested in the stock market.

Lighthouse Guides

Q: Could a bubble in real estate prices lead to trouble in the economy?

A: While real estate prices have risen rapidly—and some regions and communities have witnessed prices seemingly rising to the stratosphere—we are not persuaded that the real estate market is going to collapse suddenly and seriously affect the overall U.S. economy.

In the end, real estate will rise and fall consistent with the laws of supply and demand. In some of the hottest real estate markets, we already have seen basic economic forces take hold. Record high prices have prompted more homeowners to put their properties on the market to take advantage. This has added to supply and helped stabilize prices.

As opposed to the infamous dot.com bubble, which was driven by speculation about unproven products and

uncertain demand, higher real estate prices have been a result of the great demand for housing in relation to supply. While the need for basic housing has kept growing, the baby boomer generation's approach toward retirement has fueled a new demand for second homes. So the prices have kept rising.

As with all markets, there may be price corrections along the way, especially in some regions and neighborhoods. To be sure, speculators will suffer ultimately and lose a considerable amount of money. Such phenomena as "condo flipping," pre-construction speculation and exotic, interest-only mortgages will backfire and prices may drop sharply in some "hot" markets, thus affecting local economies. However, looking at the total real estate market, we are more likely to see more moderate increases in housing prices after a correction than any collapse in the entire market.

For information, please call or write us or visit our website at www.lighthouseasset.com.

James R. McCall, CFA, President
1111 Washington Street
West Newton, MA 02465
617-332-1203
jmccall@lighthouseasset.com

Dana P. Blake, Jr., Executive VP
85 Eastern Avenue
Gloucester, MA 01930
978-282-8285
dblake@lighthouseasset.com

Frank H. Gorke, Jr., Senior VP
1100 Fifth Avenue South, Suite 201
Naples, FL 34102
239-261-5500
fgorke@lighthouseasset.com