

Lighthouse Beacon

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Lighthouse Investment Commentary

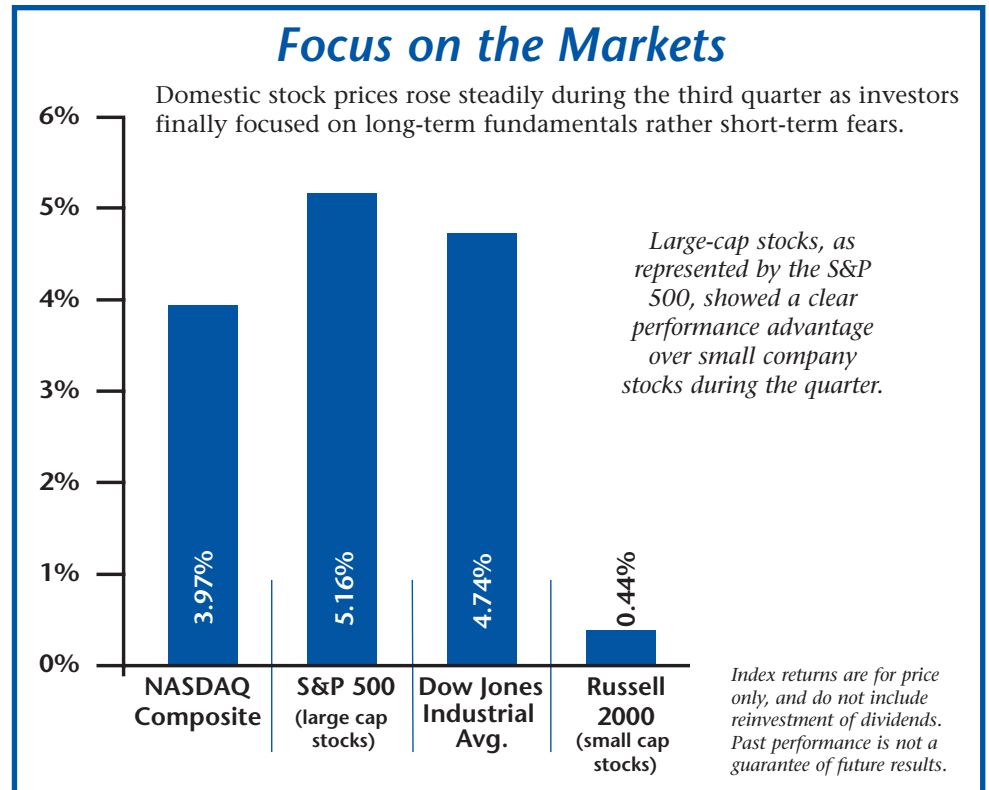
Glass Appeared Half-Full during 3rd Quarter

Just when the equity markets appeared on the edge of free-fall, investors in August again started considering the durability of the economic expansion and persistence of corporate profit growth. The result was a two-month surge that propelled the Dow Jones Industrial Average to a height very close to its all-time peak by the time the third quarter had ended on September 30.

The reversal in market trends and subsequent brisk stock market rally demonstrated again the folly of trying to anticipate the best time to move into or out of the market. The big losers were those who grew discouraged and moved out of stocks after the market declines of the second quarter were extended through July, pushing some indexes into negative territory for 2006. These investors missed out on a market surge of from 8% to 11%, depending on the index, during August and September. As a result, by the end of the third quarter, the major indexes were able to show modest-to-impressive gains over the first nine months of 2006.

The experience proved once more that events in the market move so quickly that those who are out of stocks at any time run a significant risk of missing the best opportunities that the market subsequently offers. It only is through hindsight that anyone can identify the point at which stock prices had hit bottom and it was time to move back into equities.

It is interesting that the positive results for the third quarter of the



year—as well as for the first nine-months—came in the face of a persistent bombardment of negative views and outlooks from the financial media, and even from some economists and Wall Street analysts.

Perhaps it all derives from the residual effects of the bursting of the dot-com bubble in early 2000, or of memories seared in the consciousness of some observers by the three-year bear market of 2000-2002, or even of a general loss of optimism after September 11, 2001. Whatever its roots, this persistent negativism allows its practitioners to put a nega-

tive spin on even the most positive developments. They seem compelled to search for the bad amidst the good. As an example, almost everyone else thinks the recent decline in energy prices is a good thing. But the resilient pessimists see lower gasoline prices as fuel for greater consumer spending in areas—leading to higher inflation, rising interest rates and, ultimately, recession. Whew!

Let's put a more positive—and we think more realistic—perspective on declining energy prices. Gasoline prices at the pump, as of this writing,

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have plummeted from more than \$3 to less than \$2.25 per gallon. The market has responded positively because this is what it appears to be –good news. In addition, the Federal Reserve Board has let short-term interest rates remain stable at 5.25% at the board's meetings for two successive months –August and September. Moreover, the third quarter of 2006 looks to be the thirteenth consecutive quarter in which year-over-year corporate profits have grown at a rate of more than 10%.

And, despite the recent rally in the market, corporate profit growth continues to exceed the performance of U.S. stocks. Stocks actually are more reasonably priced than they were 4½ years ago, when the current market ascent began. Just remember, although the equity markets did post truly impressive results for 2003, the returns in 2004, 2005 and, thus far in 2006, have been modest when compared to the expansion of corporate earnings.

It is true that by the end of the third quarter the Dow Jones Industrial Average almost had fought its way back to its all-time highs of 2000. However, other major market indexes such as the S&P 500, the NASDAQ and the Russell 2000 remained far below their record highs.

Surveying the outlook as we enter the final quarter of 2006, we see a strong, vital economy that should continue its expansion, with growth persisting at a moderate, sustainable level of less than 3% a year. While corporate earnings may decelerate to grow by less than 10%, they still should grow. The strong economy has led to rising tax revenues, which have slowed the growth in the federal deficit.

The Federal Reserve, having raised short-term interest rates steadily over two years, appears to have done a reasonable job of engineering a soft economic landing, with inter-

est rates stabilizing and inflation remaining under control. The greatest dangers of inflation had come from rapidly rising energy and housing prices, but both finally have started receding in recent months. This all adds up to a very nice picture.

Let's be sensible. The market performed better in the third quarter this year because investors paid more attention to the long-term fundamentals than to fears, and began realizing that the economic glass was at least half full.

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Q: Exactly how do hedge funds work? Are they a sensible way to try to beat the market?

A: The term "hedge fund" covers a very wide landscape, encompassing an enormous array of investment strategies, all with risks that are not always evident.

One common ingredient of hedge funds is that they take large positions –or bets— when they make investments, whether those investments are in a single company's stock, a type of bond, a particular currency, or a futures option on a certain currency. Their holdings are more concentrated than those of a more diversified strategy. While this type of investing can offer out-sized returns, it often carries the risk of out-sized losses. Where they take these positions will vary widely, so one type of hedge fund can suffer great losses while another hedge fund might garner great gains.

Another common ingredient is that they use leverage or borrowing to increase the potential gains. As an example, a traditional investment strategy might invest \$1,000 in a certain stock. The hedge fund, however, might borrow \$1,000 and then invest \$2,000 in the same security. If the value of the investment

increases by 30%, the hedge fund would be a big winner, as it would gain 30% on \$2,000 rather than on the original \$1,000. In reality, it would be \$600, or a 60% gain after the borrowed \$1,000 is paid back. So, \$1,000 has grown to \$1,600.

But look what happens if the situation is reversed and things go the other way! The leverage magnifies the potential loss if things go wrong. Instead of a 30% loss on the original \$1,000, a hedge fund's misstep could result in a 30% loss on the \$2,000 investment (original principal plus the amount borrowed). After the \$1,000 loan is paid back, the investor would have suffered a \$600 loss from the original \$1,000. So, \$1,000 will have shrunk to \$400.

In addition to considering the greater risk of hedge funds, investors also should understand that these vehicles are largely unregulated. That means investors often are not fully informed about what the hedge fund is doing with their money.

We are not suggesting no one should ever invest in hedge funds. If you are interested, just make sure to ask tough questions and make sure you don't commit more money than you are willing to lose.

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