

Lighthouse Beacon

A Guide in the 21st Century

Volume 9, Number 2

Annual Report

January 2007

Lighthouse Investment Commentary

Market Fears Surrendered to Facts in 2006

The stock market rewarded investors with handsome, if not extravagant, returns during 2006, even though the first half of the year did provide a bit of an adventure. In the end, it was a profitable year for equity investors, despite all the angst and fears generated by warnings about everything that might possibly go wrong.

And, looking out at prospects for 2007, we see many reasons to retain confidence in the economy and the corporate profit outlook.

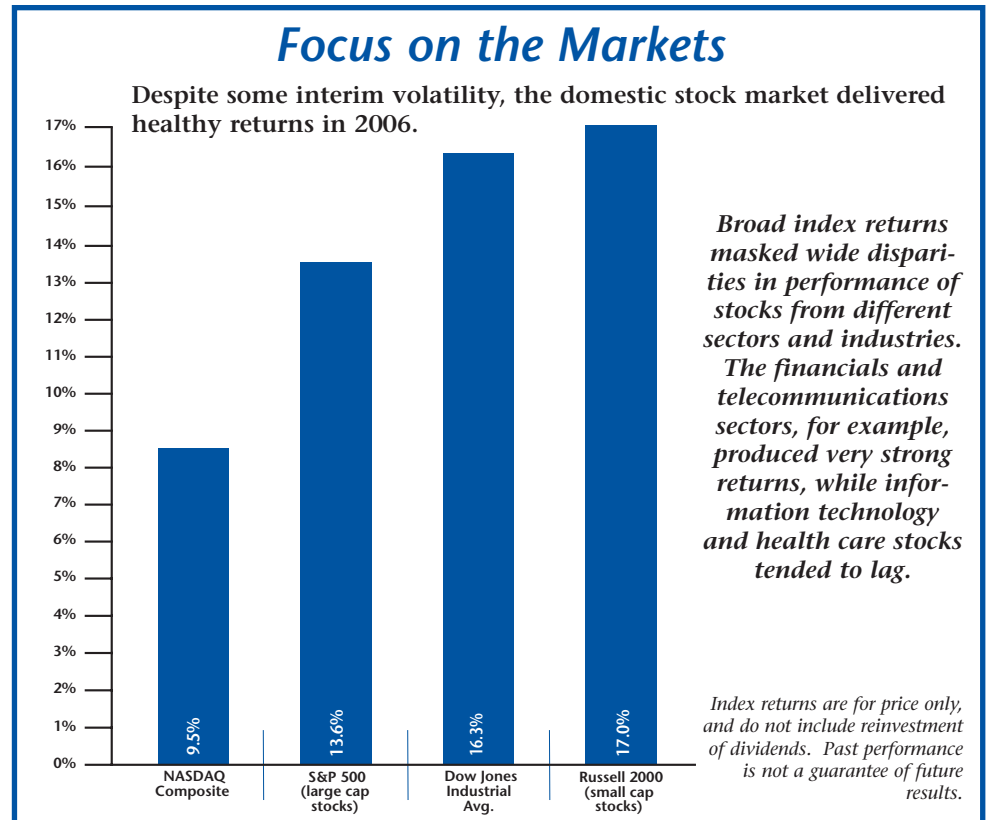
Given the final results for 2006, when the broad S&P 500 rose by more than 13.6% and other market indexes did even better, it's hard to believe we heard so much negativity and doom-and-gloom projections during the year. It wasn't too long ago that we were hearing reports that inflationary pressures were building too fast; that the Federal Reserve Board was raising interest rates too far; that rising energy prices would undermine the economy's foundations; and that the economy was about to enter a recession accompanied by hyper-inflation.

Economic Strength Overcame Fears

What actually happened?

As we have repeatedly pointed out, while transitory and sometimes emotional sentiments can move the market over the short-term, in the long-run, the market depends on the strength of the economy and the ability of corporations to improve their earnings.

Throughout 2006, despite all the noise, gross domestic product (GDP) continued to rise at a healthy pace,



while corporations maintained double-digit earnings growth rates. That's the unavoidable conclusion, but it wasn't always the story we heard along the way.

You may recall that throughout the first half of 2006 we saw dramatic and rapid increases in the prices of oil and natural gas, even in the face of rising supplies and inventories that should have been enough to dampen energy prices. There was no good explanation for the seeming contradiction between the high prices and the laws of supply-and-demand, with the possible exceptions of runaway fears and market

manipulation. On July 14, crude oil prices reached a high of more than \$78 a barrel, and some of the more enthusiastic pessimists were beginning to predict \$100-per-barrel prices. Those predictions, of course, were built only on projections that recent trends would just continue. They were not based on any sober analysis of the fundamental situation. July 14 –Bastille Day-- turned out to be when oil prices peaked. Since then, despite some normal fluctuations late in 2006, prices have generally trended down, not up, in conformance with the laws of supply and demand. While

Continued on back

Continued from front

none of us are happy paying more than \$2.25 for a gallon of gasoline, that's still far less than the \$3-per-gallon prices were faced in July.

Market Surged in July

Not coincidentally, July 14 marked the end of the stock market slump that began in mid-May and had wiped out all the gains realized during the first four months of 2006. From mid-July through the end of the year, the stock market surged. Most major domestic indexes finished the year with returns of 15% or higher. Most foreign stock indexes did even better. One of the influences that sustained that rally were the decisions of the Federal Reserve Board, beginning in August, to leave short-term interest rates stable after a cycle of 17 consecutive interest-rate hikes since June 2004.

Supported by the stabilization of interest rates, the economy continued to expand, leading to healthy profit gains. This improved economic backdrop came despite worries brought on by a host of issues, including: the well-publicized bursting of the housing market bubble; the continued deterioration of the situation in Iraq; a major realignment of political power in Congress with the Democrats' victories in the November elections.

The Debate Continues

What's ahead for the market in 2007?

We almost assuredly will hear more debates about the economy, inflation, interest rates, geo-political influences and energy supplies. We certainly will be seeing new reports on the economy, GDP growth, corporate profits, consumer sentiment, retail sales, and wholesale process.

We will hear more discussion about the direction of monetary policy under the Federal Reserve Board and the implications for the economy. Will we have a hard (read: recession) landing or a soft (read: decelerating growth) landing? Will the Federal Reserve resume hiking interest rates? Will the Fed cut rates?

Will the Fed leave rates alone? In truth, no one knows the answers, including the members of the Fed, who have made it clear that their decisions will be shaped by the "data" that emerges in forthcoming economic reports.

We also can count on hearing considerable analysis of the effects of politics –and political change—on the economy, on tax policies and on different industries of the economy –energy, pharmaceuticals, consumer discretionary, and financials and so on. Will the ascension of the Democrats in Congress lead to gridlock? Will gridlock be so bad? (Despite the conventional wisdom that Republican rule generally is good for business, the historical evidence is not so clear. The markets, for example, have tended to perform just as well under Democratic administrations as Republican administrations.)

Focus on the Fundamentals

Our challenge is to remain disciplined, to listen to the debates and review the reports with a longer-term perspective. We need to avoid zigging and zagging with every new forecast or revised statistic. We need to keep focused on our goals and remember that, over the long term, the market has been up more than it has been down.

And that is not a bad thing to remember, especially when the economy continues to expand at a moderate rate, when corporate profits keep rising and when companies are continuing to use their profits to improve stock dividends and invest for their future growth. Not a bad situation to be in as we enter a New Year!

Lighthouse Guides

Q: Why are many portfolios still below 1999 levels if some stock indexes have reached new heights?

A: The answer lies in the significant differences in what the market indexes measure and how these indexes are constructed.

The NASDAQ Index, for example, is highly influenced by the performance of technology companies. As a consequence, the NASDAQ still needs to double to get the record level it reached in early 2000, when the dot-com bubble finally burst.

Much has been written about how the Dow Jones Industrial Average has ascended to an all-time high. However, investors should understand that this index is not weighted by market capitalization –or the value of all

outstanding shares of the 30 individual companies in the index. In effect, stocks with high prices –because of company decisions not to have stock splits— influence the Dow more than do lower-priced stocks. That means, for example, that Caterpillar, because its stock was trading in the low \$60s in mid-December, had almost three times the influence on the index as did Intel, whose stock was trading in the low \$20s. And yet, Intel remained a much bigger company by market capitalization.

What really matters is what is in your portfolio. When you look at your holdings, you should ask yourself a simple question: Would I buy that stock today? Some people hold on to laggards in hopes that they finally will recover. However, if you wouldn't buy a stock now, this may be a good time to consider replacing it with something you find more attractive.

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
lighthouseasset@gmail.com

Dana P. Blake Jr., Executive VP
85 Eastern Avenue
Gloucester, MA 01930
978-282-8285
ibis22000@gmail.com

Frank H. Gorke Jr., Senior VP
11983 Tamiami Trail North
Naples, FL 34110
239-597-0500
fgorke@aol.com