

Lighthouse Beacon

A Guide in the 21st Century

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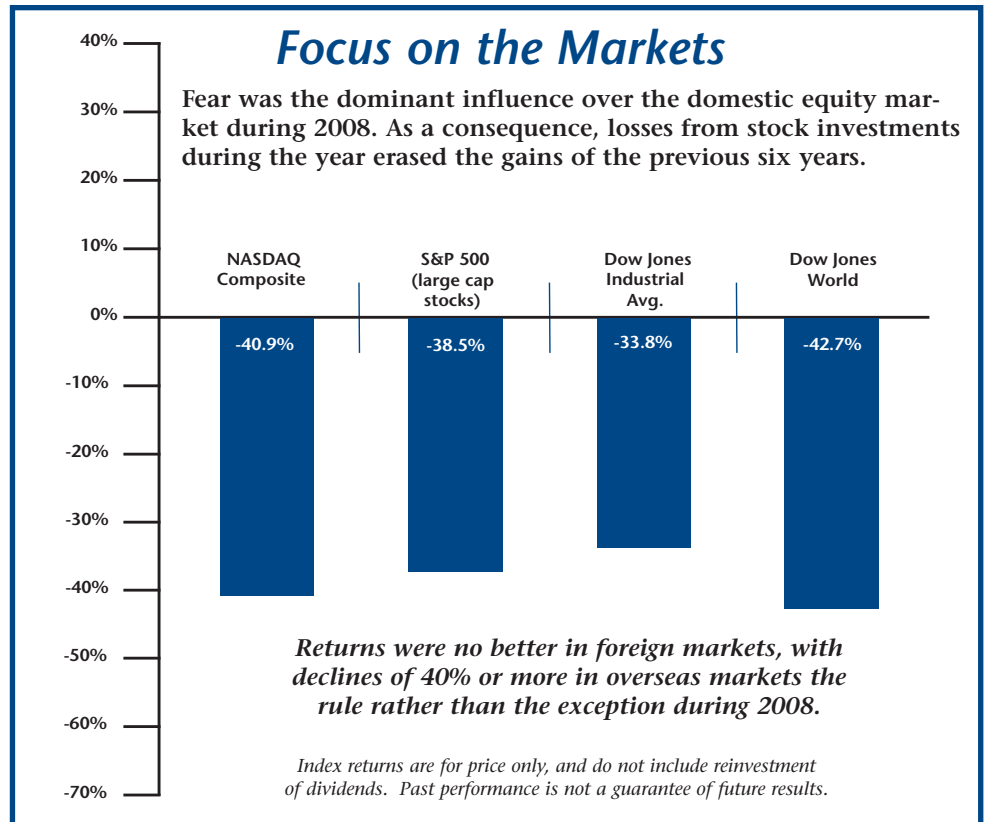
Lighthouse Investment Commentary

Confidence Will Return, but It Will Take Time

The end of 2008 brought a collective sigh of relief heard throughout the world's financial markets, with hopes that 2009 might bring some improvement. And, we believe market conditions should improve this year as the end of the downturn finally appears and confidence starts to return. However, you should not expect a return to the highly speculative environment that ultimately led to a near-meltdown in the capital markets in 2008.

We can safely state that nothing in 2008 turned out as expected. Over the course of the year we witnessed the bursting of the speculative bubble in real estate, the freezing up of much of the credit markets, the dramatic rise and then fall of the prices of oil and other commodities, a surprise-filled presidential election campaign, the collapse of several once-mighty financial institutions, and allegations of an unimaginable investment fraud. As all this happened, stock prices at times seemed to be in free-fall, with most domestic indexes falling by 30-to-40 percent or more for the year, even after appearing to stabilize and post some gains over the final weeks. (See accompanying chart). Corporate bonds performed almost as badly. Investors couldn't avoid calamity by fleeing overseas. Most major foreign stock indexes plummeted by 40% or more, with China turning in some of the worst results found anywhere.

Nevertheless, as we look ahead, we can say with confidence that the world has not come to an end . . . despite the financial carnage we have witnessed



and the overwrought commentaries to which we all have listened.

It all started with the appearance of problems with subprime mortgages in the summer of 2007. For a while, it appeared that the damage was contained and limited to some big banks and investors. How wrong that first impression turned out to be! It soon became clear that these dubious mortgages were embedded in complex derivative securities whose true values were very difficult to identify. Added to the mess were poorly understood, arcane derivatives such as credit default

swaps that injected even more risk into the financial system. When the inter-connecting web started to unravel, the financial system seemed to teeter on the verge of collapse in an environment dominated by fear, anger and distrust, where confidence virtually disappeared. Forced mergers and takeovers were announced almost daily as unprecedented volatility hit the capital markets and the economy dropped into recession. Somehow, trillions of dollars of capital disappeared. As a consequence, the government had to step in with unprecedented measures in an effort to save the financial system from

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complete collapse. We won't attempt to catalogue everything that happened during 2008. That has been reported almost endlessly, and no doubt many bookshelves will be filled with yet-to-be published chronicles of the financial debacle of 2008. However, we have learned some lessons.

The market collapse that occurred last year came because no one understood all the risks associated with all the derivatives products that had been developed in recent years. No one . . . not the people who developed them, nor the brokers who sold them, nor the investors that bought them, nor the institutions that insured them.

The important issue facing us at the start of 2009 can be summed up simply: What happens now? We believe we are **not** heading into another 1930s-style depression, despite many popular predictions otherwise. The failure of the old way of conducting business in the capital markets has created the opportunity to begin again, painfully restructuring a system which is more reliant on prudence and patience. This new system must be less tolerant of a free-wheeling culture that ignored risk and brought enormous gains to a few on Wall Street who produced short-term profits by using highly risky strategies and products. What will emerge will be a system with less risk, more transparency and greater oversight.

As a new administration takes office, we will see a new economic stimulus, with infrastructure projects, tax cuts and job creation programs. We also are likely to see further measures to halt the slide in housing prices. Change is in the air, although it will take time for these changes to take full effect. We need to be patient for the excesses of the past to be worked through and the full effects of new programs to be felt. It may not be until mid-2009 before we see some improvement in the economy. Clear

evidence of solid growth may not appear until 2010.

A recovery may not be very apparent at first, as we probably will continue to receive very discouraging reports about slowing economic growth, rising unemployment and declining manufacturing output for a few more months. The current period, at the end of 2008 and the start of 2009, may very well turn out to be the time when we receive the worst news about the recession.

We believe current stock prices already factor in the effects of the negative economic news we are likely to receive in the coming months and that new opportunities are arising now. In fact, the stock market produced positive returns in the final weeks of 2008. Stock valuations

remain at historic lows, in effect priced as if no growth will ever occur. The stock dividends for some solid, blue chip companies now are higher than the yields on many bonds. While investing in Treasuries has been popular because of their perceived safety, Treasuries offer anemic yields while their prices are vulnerable to any rise in interest rates. We must keep in mind that the capital markets usually move well ahead of economic change.

We are likely to see more fits and starts in the market as we go through 2009, and we should not be surprised by new bouts of volatility, especially in the next few months. It will take time to rebuild investor confidence.

A return of confidence should be the key to the recovery.

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Q: Why not invest in safe, secure Treasuries while a lack of confidence continues to undermine the stock market?

A: We do not think that it makes sense to invest for little or no return. Interest rates have come down sharply. Early in January, the return on 3-month Treasury Bills was 0%. That's correct, there was no return. If you purchased 10-year Treasury Notes, you would receive 2% while 30-year Treasury Bonds yielded just 2.5%. By locking money up at these rates, you are likely to lose money ultimately. Inflation will rise as all the stimulus packages kick in and the economy starts to grow again. We would expect that the 2-to-2.5% returns on Treasuries would be less than inflation. As a conse-

quence, if you were to hold them to maturity, the inflation will undercut your returns from interest while the spending power of your principal will have been eroded. In addition, as the economy eventually picks up and interest rates start to rise, the market price of your Treasuries would decline and you would very likely lose principal if you were to sell the securities before they mature.

Make no mistake: Treasuries *are* safe. However, the decision to own them in the current environment may be a bit irrational in that it would be based more on fear than on logical investment analysis. There are plenty of alternative investments in high-quality securities that have significantly higher yields or better growth potential or both. That makes more sense to us.

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