

Lighthouse Beacon

A Guide in the 21st Century

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Lighthouse Investment Commentary

Time to Accept Economic Reforms and Plan for Future

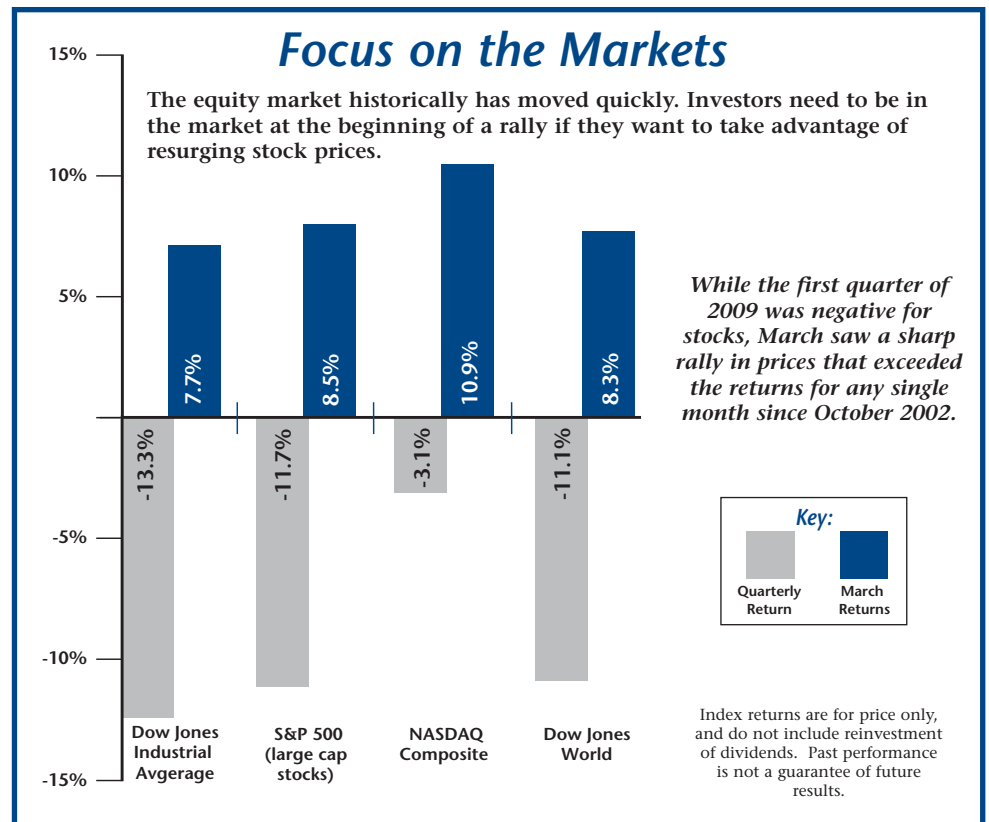
Change is necessary and change is coming. With that understanding, investors need to focus again on their futures.

We now know that the world's financial system has been undermined by the extraordinary risks that were beyond the oversight of regulators. As a consequence, credit markets collapsed, the economy stopped growing, corporate profits shrank and unemployment shot up. If you look at stock market performance over the past 18 months, trillions of dollars in the value of American corporations have disappeared. Millions of Americans have seen their life savings and retirement plans dissipate, jeopardizing their plans for the future.

We all need to start rebuilding those plans.

At a time when our economy and, particularly, our financial system face extraordinary challenges, we need to put aside convenient labels and partisan rhetoric to focus on reality. We need to avoid allowing the divisive nature of our national political conversation to infect our economic discussions. We can't view every policy decision as a choice between two polar opposites, casting every decision into an all-or-nothing choice between rival camps: Democratic vs. Republican, liberal vs. conservative, free market vs. tighter regulation; inflation vs. deflation. Deliberating over how the economy (and the markets) can recover should be conducted at a more rational level than a typical cable television free-for-all.

Our financial system lost balance and change is necessary to bring it back into balance. The old paradigm, which was guided by the philosophy of self-regulation, did not work and balance needs to be restored. We need to move toward the middle, restoring some oversight and safeguards. We need to accept the necessity of some changes to restore balance and reduce systemic risks without labeling every new proposal as "socialism." We are and will remain a free market economy/society.



Extraordinary measures are being taken to restructure the financial system, restore confidence and begin to pull us out of recession and toward a period of renewed growth. Whether from ideological, self-interest or psychological reasons, some highly vocal contingents have started to protest loudly. They seem to be unable to see the need for change or to recognize the failure of the system of self-regulation to control risks and prevent excessive damage to the economic system.

Indeed, the financial markets are in the middle of a very painful transition. Several outcomes will occur, although many will take some time. We believe:

- The financial system will be restructured along more conservative lines.
- The housing market will recover.
- Consumers will spend again.
- Corporate America, including the automotive and financial sectors, will survive.
- Gross domestic product and corporate earnings will be positive in 2010.
- The world will not end.

We believe this transition can lead the way to more prudent practices, greater transparency, and more careful management of risk.

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If we are correct, then what should we be doing as investors?

- Stop listening to all the excessive noise.
- Understand that every downturn is followed by an upturn.
- Look at our investments starting from today, going forward. This means having the discipline to put the market of the past 18 months behind you.
- Prepare for a return to a period of an expanding economy and growing corporate profits.

While we should learn from the past, we cannot allow ourselves to become paralyzed by the problems of the past year-and-a-half. We need to tune out the loud blame game and plan for the future. To be sure, we should not expect instant rewards. Indeed, widespread expectations of instant gratification had a lot to do with creating the economic and financial mess we find ourselves in. The key to a return to more rational markets will be confidence at all levels by the consumer, by corporate decision-makers, and by Wall Street.

Remember, we had a real estate bubble—not a stock market bubble—before the markets started collapsing in 2008. But since that collapse began, the stock market has lost \$10 trillion in value. Does anyone really believe American corporations actually are worth \$10 trillion less than 18 months ago? The recent spate of corporate mergers and acquisitions suggests that corporate leaders recognize the extraordinary values created by the market downturn. They are moving to take advantage of those values, planning for growth in the future.

Investors need to do the same.

The biggest victims of the market downturn will be those who sold out their positions in recent months and are too afraid to get back in. They are in danger of locking in their losses. History has shown that the equity market begins to recover well before the economy starts growing again. And, the market never goes straight up, without interruption. But to take full advantage of the eventual recovery, you have to be there at the beginning and you need to remain invested. The market usually moves in explosive bursts—just look at the performance during March when the major market indexes leapt up sharply from the lows of earlier in the month.

Already, we have started seeing data indicating some economic developments are not as bad as anticipated. Reports on home sales, new mortgage applications, retail spending and factory sales have actually exceeded expectations. Consumer confidence has shown some stabilization and inflation has remained restrained. The money supply has increased, interest rates have declined, and corporations have found they are able to issue new bonds. Major world governments have entered a new spirit of cooperation. Meanwhile, the effects of government stimulus programs, including tax breaks, are not yet being felt but are coming.

At the same time, officials have started contemplating new government regulations, including requirements for greater transparency and less leverage in the financial system, as means to control risk. With a few

loud exceptions, most observers recognize that the philosophy of self-regulation created too many uncontrolled and poorly understood risks to the world's and the nation's economies.

We need to focus on the future, recognizing that while we can't change the past, we can learn from it and be wiser as we move ahead.

We all remember Alan Greenspan's famous phrase about "irrational exuberance" in the 1990s. Let's not allow "irrational fear", in reaction to the events of the past 18 months, to paralyze us. We need to assess our own situations while understanding both the opportunities and the risks that changing markets will offer.

It's time to focus on the future.

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Q: What is "mark-to-market" and why is it so controversial?

A: This is one of those concepts that is both simple and complex. Mark-to-market accounting simply requires that a security be valued at its last trading price. This is relatively easy for most stocks because they trade every day and accurate prices are readily available and undisputed. The issue becomes more complex when a security, for whatever reason, does not trade frequently and an accurate price is not easily available.

The Financial Accounting Standards Board (FASB) had ruled that if a security does not trade frequently, the institution that owns it still must value that security on its books at the price at which it could be sold in the current day. This rule became controversial when it came to mortgage-backed securities held on the books of many institutions. As the housing market deteriorated, the mortgage market imploded and the financial markets froze up, no buyers could be found for many mortgage securities. The rule stated that the secu-

rities had to be marked down to the levels at which someone would be interested in buying them. In applying this rule, institutions might have to revalue a security that had been priced on its books at \$100, perhaps bringing the new value to \$20. This was true even if the asset clearly was worth much more. This happened even when many of the underlying mortgages were not distressed or toxic and they could reasonably be valuable if held for longer periods of time.

Writing these mortgages down to unrealistically low levels put many banks in the position in which they had to raise capital in order to shore up their balance sheets. To remain solvent and support their balance sheets, many banks had to cut their dividends, issue additional stock or bonds or obtain government financing.

Fortunately, the FASB approved a new plan in early April, allowing banks and other institutions to have more leeway. Institutions owning infrequently-traded securities now will have more flexibility to determine a more reasonable "fair value" of assets.

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

James R. McCall, CFA, President
343 Washington Street
Newton, MA 02458
617-332-1203
lighthouseasset@gmail.com

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

Frank H. Gorke Jr., Senior VP
6573 Marissa Loop
Naples, FL 34108
239-514-7240
fgorke@aol.com