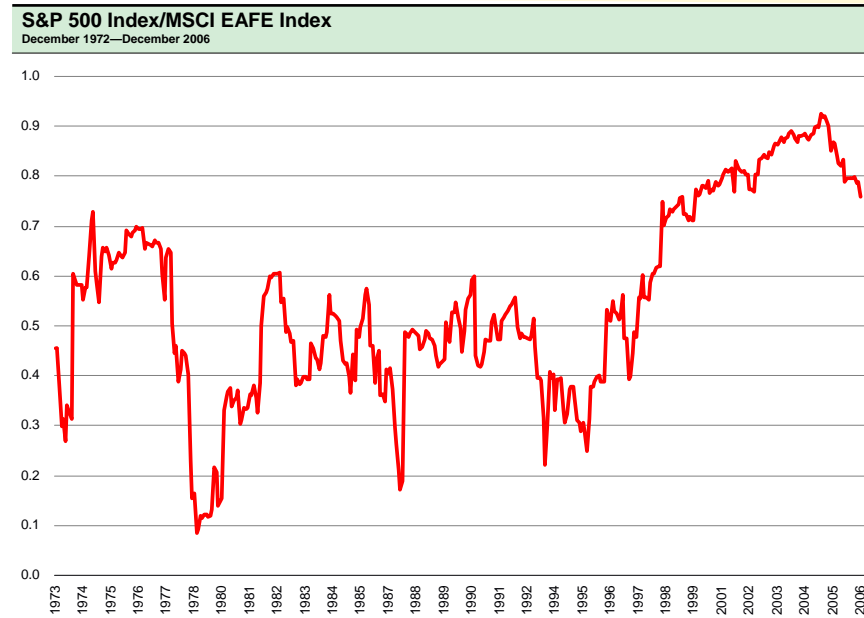


## **Second Quarter 2007 Market Commentary and Outlook**

In the face of increased concerns regarding the U.S. sub-prime mortgage markets and the spill over effect into the U.S. consumer and housing sectors, the outlook for global growth continues unabated. As of June 30<sup>th</sup>, the best performing equity sectors continue to be the global cyclical sectors including (Energy, Materials, Industrials and Information Technology). Late in the 2<sup>nd</sup> quarter, solid signs of continued global growth emerged, leading to a sharp (70 basis points) increase in U.S. government bond yields. This hurt fixed income and hedge fund investors, many who had invested in bonds, anticipating what they thought would be a much needed Federal Reserve rate cut to cushion the economy from the aftershocks of the sub-prime debacle. Several commentators have pontificated about the decoupling of the U.S. market and economy from the global markets, defying the conventional view that the world is one large global market. Morgan Stanley highlighted this point noting the recent decline in U.S. and non-U.S. markets correlation (see chart below). Despite this decoupling and signs of a slowing U.S. economy due to the ongoing sub-prime/housing malaise, growth outside the U.S. continues at a solid pace. As we have entered the 2<sup>nd</sup> quarter reporting season, we are seeing tangible signs of this reality reflected in the results of several large U.S. multinationals.

### **U.S. and Non-U.S. Equity Correlation of Returns**



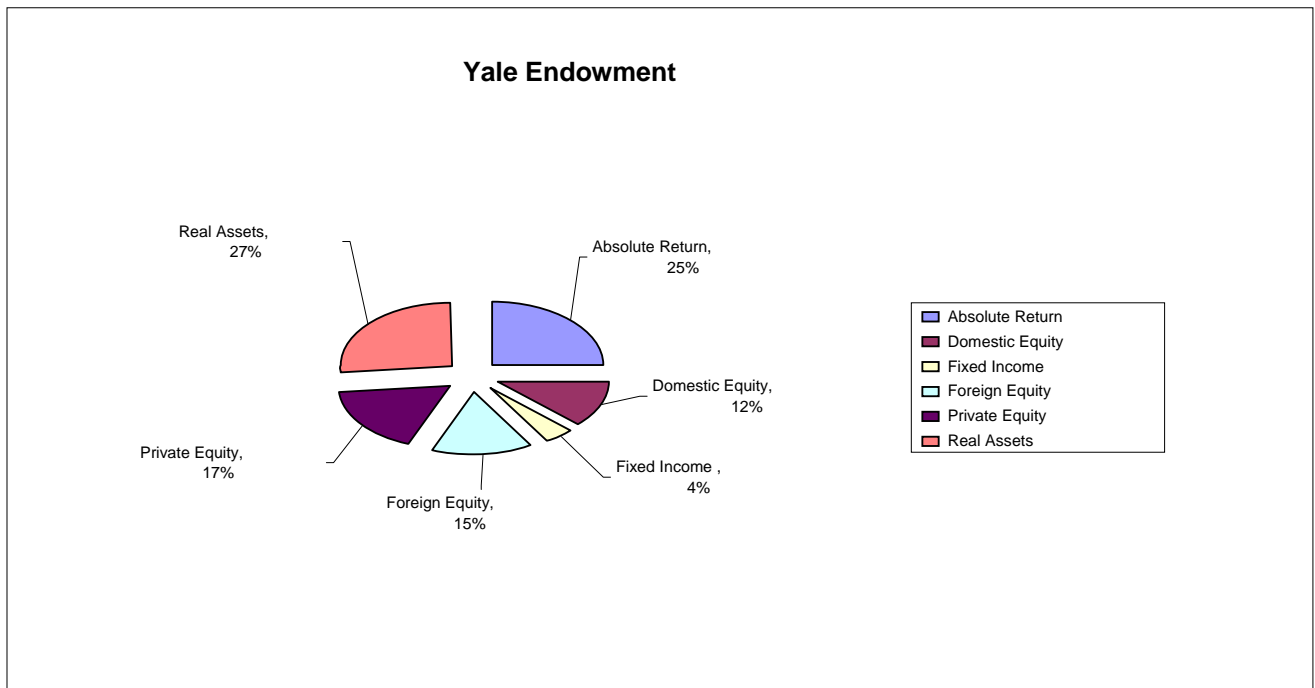
SOURCE: MORGAN STANLEY

## How are Beaumont Financial Partners Clients Positioned to Take Advantage of the Global Growth Theme?

### **BFP ASSET ALLOCATION STUDY RESULTS**

During the quarter, we did a review of our overall asset allocation (now approaching \$750 million in personal assets under management). We thought it would be insightful to see how our strategy compared to that of prominent endowments like Harvard and Yale. Interestingly, from an asset allocation perspective, our findings were that Beaumont Financial Partners overall is similar to the sophisticated global allocations of both the Yale and Harvard endowments.

During the early 1980's, these endowments realized that the simplistic, 70% U.S. equity, 30% U.S. bond allocation that they had traditionally implemented no longer allowed them to meet the growing financial demands placed upon their endowments. With the arrival of leaders like Jack Meyer at Harvard and David Swenson at Yale, these organizations led the charge, diversifying toward a more robust, global asset allocation (see chart below). Utilizing sophisticated statistical techniques to combine expected returns, variance and covariance analysis, they constructed what Nobel laureate Harry Markowitz would deem "efficient portfolios". At Beaumont, we apply a similar investment philosophy and process. We agree with the likes of Yale and Harvard in that the alternative/real asset classes tend to be less efficiently priced than traditional securities, which provide more opportunity to exploit these less efficient markets. Unlike traditional securities, absolute return investment returns are often independent of overall market moves. Yale notes that over the past ten years their alternative assets have provided 12-13% returns with little or no correlation with domestic stocks. Lack of correlation, simply put, means more diversification and hence less risk.



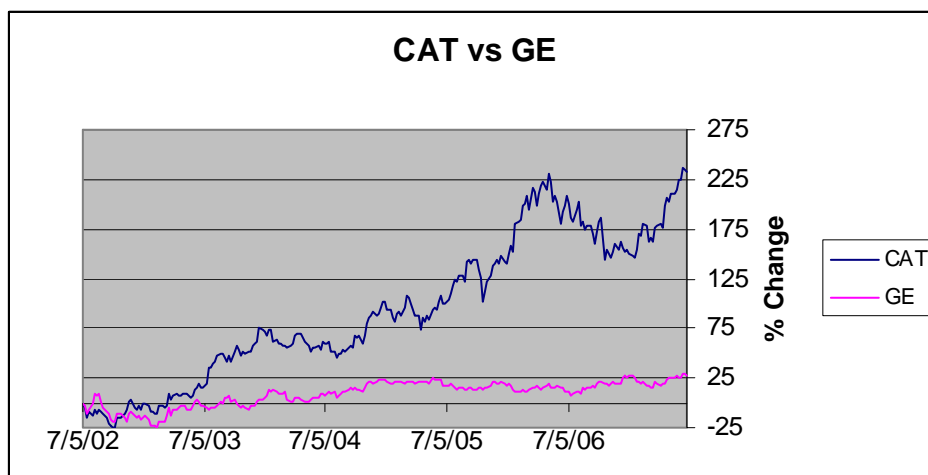
## **BFP's Asset Allocation – Let's Drill Down Into the Specifics**

### **AGGRESSIVE EQUITIES - (Alpha or Performance Generators)**

In the aggressive equities segment of your portfolios (risk and return objectives permitting), you may see holdings in names including Aquila Resources, Petaquilla Minerals, Northern Star, Gammon Gold and the Central Fund of Canada. These industrial metals, energy, and precious metals exposed companies have been sourced from our research expertise. Compelling arguments made by Phil Dubuque (former portfolio manager for the Harvard University Endowment, current portfolio manager of the Walnut Street Absolute Return Fund), suggests there will be continued demand for commodities from emerging markets. Chronic underinvestment, driven by sub-par inflation adjusted pricing during the 1980's & 1990's, have made and will continue to make these "Consumable Assets" more and more valuable. As Phil explains, with respect to precious metal stocks, the "store of wealth from in the ground reserves" will likely add significant value to these companies over time as many of these holdings are valued at significant discounts to the value of their reserves. Also, in a highly inflationary period, gold typically appreciates in value as investors flee depreciating fiat currencies in search of wealth sustaining "real assets".

### **COMMON STOCKS – (Core Holdings)**

Recently we have added select U.S. multinationals names including General Electric, Colgate Palmolive and Proctor & Gamble to many client portfolios. The common theme underlying these companies is better than market yield, with a consistent dividend payment and growth history combined with a low risk, cheap, and high quality way to benefit from continued global growth. With significant levels of non-U.S. sales (55%, 65%, 55% respectively) these companies should all continue to benefit from the declining dollar and the emergence of the middle class in countries like China and India. In addition, over the past five years these names have not participated in the "Global Growth" rally as have some of the more obvious names like Caterpillar (see chart below).



The following are some details behind GE's long term growth story driven by their infrastructure business. GE's locomotive, power turbine and aircraft engine businesses are all feeling the

dramatic pull from the continued infrastructure build out in countries like China and India. In China for instance, the long term demand for power turbines will continue as the country struggles to meet its electric power demands. According to UBS securities, China needs to add 2 times the power consumed in the United Kingdom every year just to keep up with demand. In addition, to stay competitive with other Asian countries, China needs to become more power efficient. The bottom line is you have a rapidly growing country that is already power short, which also needs to become more power efficient and environmentally sensitive at the same time. China has decided that their best option is to actually overbuild and shutter the many old, smaller, inefficient plants and replace them with new larger technologically advanced plants powered by GE turbines. Importantly, going forward these equipment sales will lead to increased revenues from services needs and spare parts which have historically been the basis of the GE business model that has delivered a superior 15 year dividend growth rate of 13%.

### **FIXED INCOME STRATEGY**

Our fixed income strategy has been (and continues to be) to stay with high quality bonds having short-term maturities. Credit spreads (the difference between riskier bonds and the lowest risk U.S. Treasury bonds) have declined dramatically. The Bear Stearns High Yield Index, which historically has traded at spreads (interest rate premiums above U.S. government bonds) as high as 8-10%, are now as low as 2-3%. The bottom line is you are not getting paid to assume additional default risk with bonds at present. In addition, with a flat to down-sloping yield curve, you are not getting paid to assume additional interest rate risk by extending out the maturity of the bonds that you are buying.

One ominous note regarding the bond market, this from Donald Coxe, Global Portfolio Strategist with BMO Financial Group, is that the unprecedented collapse of credit spreads that we have seen over the past five years is due in large part to the proliferation of credit derivatives. Credit Swaps, which are sold by Wall Street, are essentially an insurance policy for eliminating underlying company specific credit risk. Hence, the mind set has been, if you can eliminate the company specific risk then you should swing for the fences. Twenty years ago the “sure thing” was “portfolio insurance” which contributed to the October 19, 1987 correction. Nine years ago, it was the academic certainty of Long Term Capital Management, the highly leveraged hedge fund that collapsed when trades went against it during the July 1997 Asian Financial Crisis. These past experiences create plenty of skepticism for such “sure things”. How big is the hit going to be this time? Will it be from the ongoing sub-prime debt debacle or from some other derivative unwinding? Time will tell but we are constantly monitoring to make sure our holdings do not have exposure to these kinds of risks.

### **OTHER INCOME STRATEGIES**

Franklin Templeton Hard Currency Fund – this is a predominantly non-U.S. denominated short-term government bond fund which essentially provides shareholders exposure to the highest quality foreign government bonds while collecting a 3%-5% yield and experiencing the relative appreciation of the local currencies as they move up relative to the dollar. We remain confident that the U.S. dollar will continue to struggle versus the other major currencies making this conservative fund investment productive over the next 12-24 months.

## **SUMMARY**

Do Trees Grow To The Sky? – We all know the answer to this question, and especially as it relates to the global economy. However, at this time, do we dare say that it seems different? The major differences for this global expansion cycle is that the engine of growth (China), unlike past global growth drivers, is a very wealthy creditor nation. China is running a huge trade surplus and has a very high personal savings rate. China's currency peg to the U.S. dollar has netted them a \$1 trillion U.S. dollar foreign exchange reserve. Past economic cycles have collapsed from their own weight as the engine of growth in most cases becomes over leveraged. Some recent examples include cycles driven by the likes of Brazil and other Latin America countries. So far this does not seem to be the case with the current business cycle. In summary, we feel that the global growth story is still in tact and our clients are well positioned to participate in this theme via the sophisticated asset allocation and superior stock selection that we have implemented. Going forward we will continue to monitor this critical investment thesis and adjust your asset allocation accordingly.

## **What Keeps Us Up At Night?**

**Inflation** (also known as “death by a thousand cuts”) - We feel that inflation is the single largest long term threat to our client's personal wealth. This fear, combined with our confidence in continued global growth, drives our large allocation to real assets. These assets derive much of their value from their consumable nature in a continued tight supply and demand equation. In addition, as mentioned earlier, investors tend to flee fiat currencies (i.e. the US \$) for precious metals as their “store of wealth” characteristic comes into vogue.

**Higher Tax Rates** – We are starting to raise the yellow caution flag for future tax rate increases. The possibility of a Democratic President combined with a Democratic Congress makes the possibility of increases to the capital gains, dividends and/or income tax rates very likely. As Congress considers raising taxes on private equity and other financial firms, some House Republicans like Rep. Eric Cantor (R., Va) have started to portray this legislation as the first step by Democrats toward repealing the 15% rate on capital gains and dividends. In a Wall Street Journal article, David Hirschmann, the president of the capital-markets division of the U.S. Chamber of Commerce was quoted saying “I don't think people realize how much this has become a proxy fight for the 15% capital gains rate itself”. We are closely monitoring this situation and feel that it may be prudent to take some capital gains on highly appreciated positions over the next 18 months.

Going forward we would like to make our quarterly Market Commentary and Outlook available to you via the internet. We will post these comments to our web site and will notify you of their availability. In an effort to insure that we have your most current E-mail contact information, please forward your preferred E-mail address to [dciafattone@bfpartners.com](mailto:dciafattone@bfpartners.com) .

I hope that your summer is proceeding well.

Michael P. Stack CFA