BEAUMONT FINANCIAL PARTNERS
WEALTH MANAGEMENT SERVICES

2nd Quarter 2011 Market Commentary and Outlook

Global markets entered the second quarter bouncing off of a first quarter bottom that was caused by a series of macroeconomic events including extreme weather in North America, uprisings in the Middle East, and a Japanese earthquake which triggered a nuclear disaster. Impressively, markets digested this series of events as transitory and the uncertainty they presented was quickly replaced by a much better than expected first quarter earnings season. During this quarter (reported in mid April) companies represented in the S&P 500 index on average delivered double digit sales growth, which was significantly better than the mid to high single digit level of analyst expectations. The better than expected top line results were complimented by powerful operating leverage, with the S&P 500 bottom line up better than thirty percent over the prior year. Unfortunately the April recovery hit a second "wall of worry" as a series of weaker than expected domestic economic reports were released (including the May ISM Manufacturing Index and a significantly lower than expected May Employment Report). This data, ongoing European debt uncertainties, and The Federal Reserve (Fed), which indicated that they were not going to execute a third quantitative easing (QE), dragged the S&P 500 lower to finished flat for the second quarter. With the U.S. economy growing at only 1.8% and discussions about good inflation (asset) and bad inflation (commodity food and energy), the Fed's more passive stance sparked a debate around possible "buyer's remorse" regarding the results of QE2. At this stage in the recovery the thought of an impotent Fed, whose hands are tied by growing inflation trends is a very disturbing concept. The prospect of such a scenario has led to growing comparisons with past financial destructive periods including the "Stagflation" of the early 1970's.

Market Vulnerable to Slow Down Scares - Cautiously Optimistic That The Global Economic Recovery Continues

We remain cautiously optimistic that the global economic recovery remains intact, although we know that the market will remain vulnerable to continued slow down scares. As we have outlined in past letters, the greatest challenge of this recovery will continue to be its frustratingly slow pace. Essentially the growth rate in developed markets is less than half the rate of past cyclical recoveries. The analogy that we like to use is that of a jet taking off. Until the jet achieves escape velocity, passengers sit buckled, anticipating the transition out of this vulnerable state when a sudden wind shift could bring the aircraft back down. Mohamed El-Erian, PIMCO Chief Executive Officer and Co-Chief Investment Officer, describes this slow, post-financial meltdown recovery best in his "New Normal" postulate, an excerpt of which follows below.

Not So Normal "New Normal"

El-Erian recently gave this update at PIMCO's May 25th Secular Outlook Forum.

"The global economy is not recovering in a typical, cyclical fashion; it continues to display many aspects of the New Normal which include: sluggish growth in advanced economies, persistently high unemployment, debt and deficit issues, more regulation, more deleveraging, and continued improvement in income and wealth in emerging economies as they converge with advanced economies."

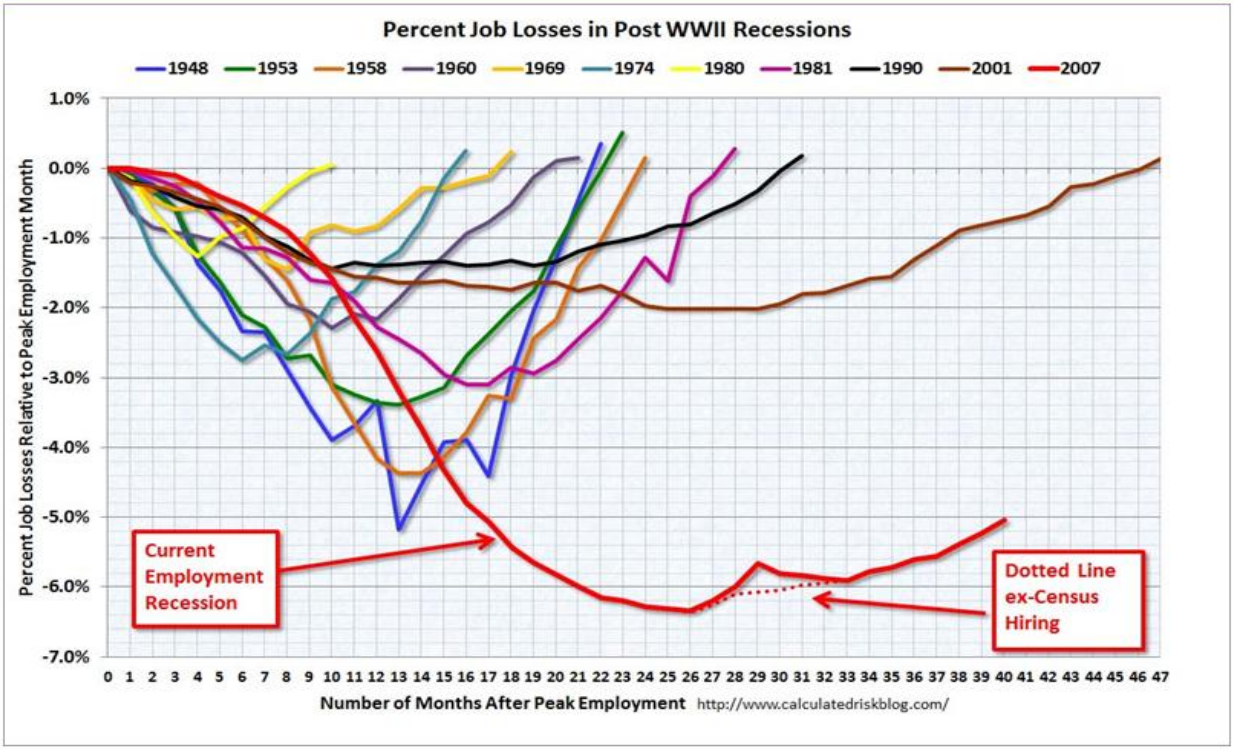
El-Erian continued "Over the next three to five years, we anticipate a global economy which will continue to recover at multi-speeds with slow real growth of around 2% in advanced economies and high real growth of around 6% in emerging economies, which will result in the following: policy makers around the world will try to stay in control, whether through artificially low interest rates, austerity measures or currency controls. Inflation will rise gradually. Inequalities in income and wealth will continue to widen. High unemployment in the advanced economies will persist. Balance sheets will be critical, with recurrent debt and deficit issues in advanced economies. Emerging economies will face many challenges in the management of their new found success, including the management of capital inflows."

We agree with El-Erian's thinking and will discuss how we will position your portfolio to take advantage of the winners in this not so normal "New Normal".

Continued Consumer Headwinds

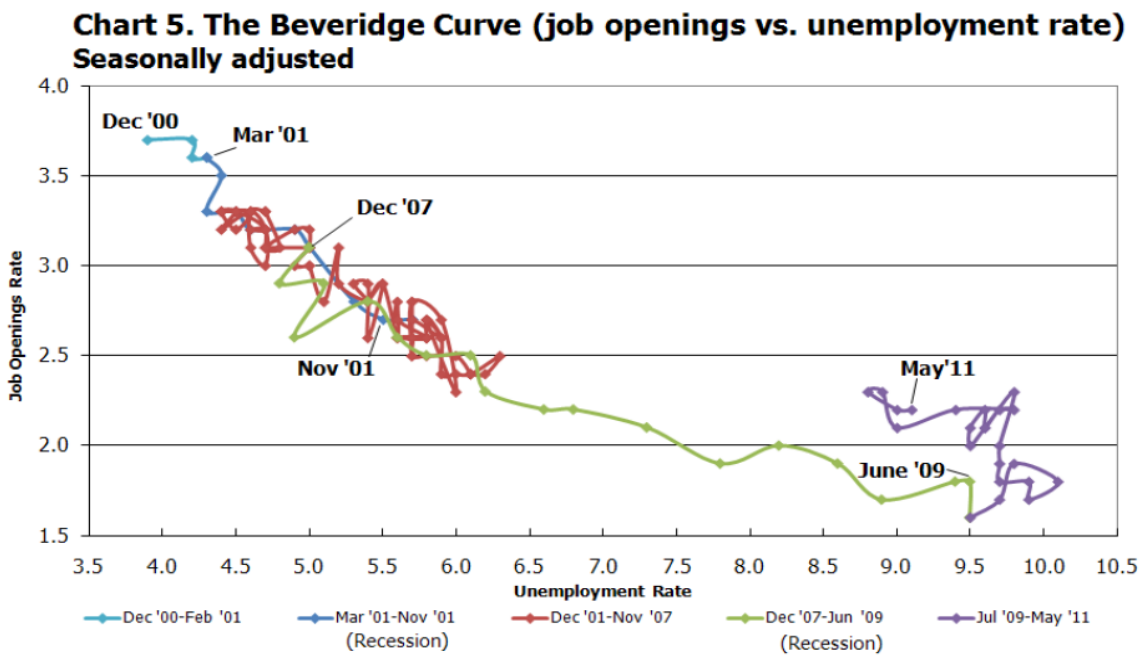
During the second quarter, more specifically, with May's extremely disappointing Non –Farm Payroll report, the markets were once again forced to face the harsh reality that there will be no easy answer for unemployment in this recovery. Due to high unemployment, the weak housing recovery, and the high consumer debt levels, we have concerns regarding investments that depend on consumer discretionary spending. As one can see from the June 2011 "Percent Job Losses in Post WWII Recessions" chart below, the depth and length of job losses in this recession is unprecedented. The economic and social implications resulting from this "long term unemployment" is a major concern. Federal Reserve Chairman Bernanke made clear in his June 7th speech (see comments below) that the U.S. labor market is significantly impaired with over six million Americans out of work for half a year or longer.

"Particularly concerning is the very high level of long-term unemployment, nearly half of the unemployed have been jobless for more than six months. People without work for long periods can find it increasingly difficult to obtain a job comparable to their previous one, as their skills tend to deteriorate over time, and as employers are often reluctant to hire the long-term unemployed." – Ben Bernanke



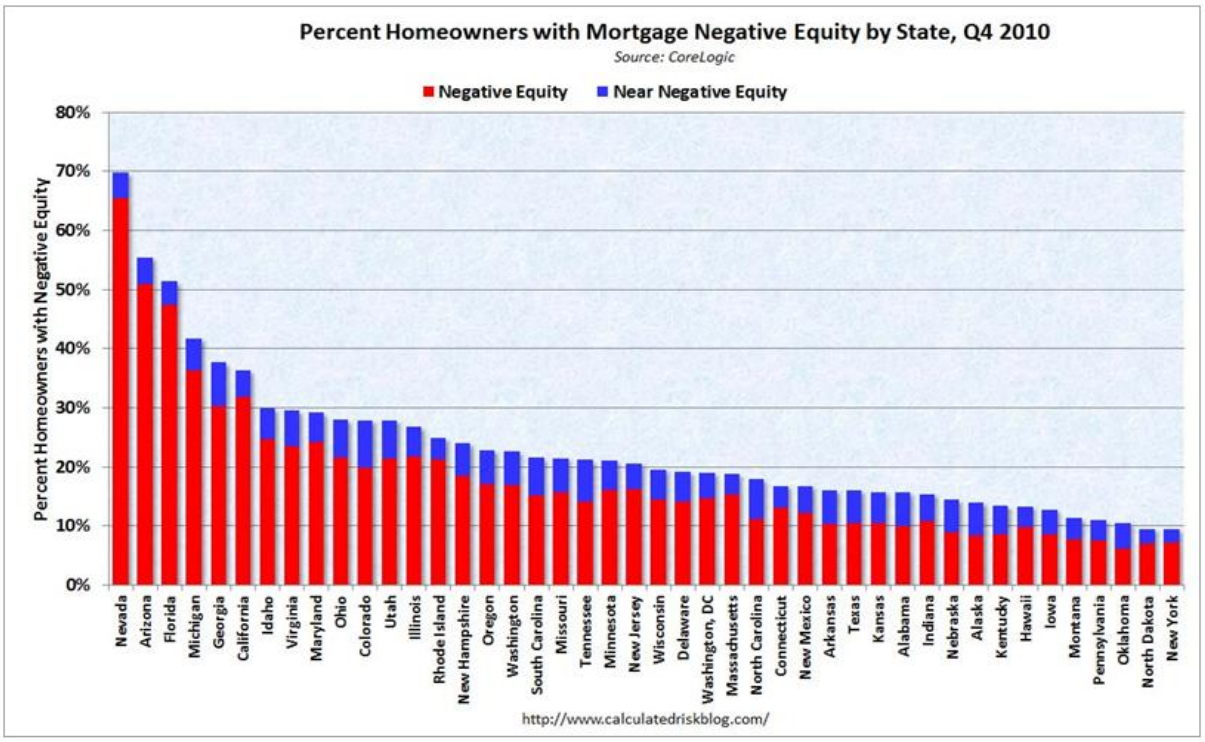
Employment's Structural Mismatch

In a Feb 14th, 2011 paper titled "What is the New Normal Unemployment Rate" (no direct relationship with PIMCO's "New Normal" concept), the Federal Reserve Bank of San Francisco concluded that the new normal structural unemployment level may be as much as 1.7% points higher at 6.7%. The bank reached this conclusion, in part, based upon observation from the so-called Beveridge Curve (see July 2011 Bureau of Labor Statistics below). This indicator plots the historic relationship between unemployment and job vacancies. Historically when the economy was expanding, the jobless rate was low and job vacancies were high. However, in the Fed's paper they point out that something strange started to happen late in 2009, as the Beveridge Curve has shown higher job openings in the face of high unemployment. The concern being, this was the first real evidence of a structural mismatch in the jobs market. Skills possessed by today's workers are not the ones being sought after by employers. Unfortunately if this is the case, it may take several years for excess construction and real estate related employees to be retrained and absorbed by sectors of the economy which are growing. Fiscal conservatives add that last year's decision to extend unemployment insurance to 99 weeks will do nothing to help resolve this challenge.

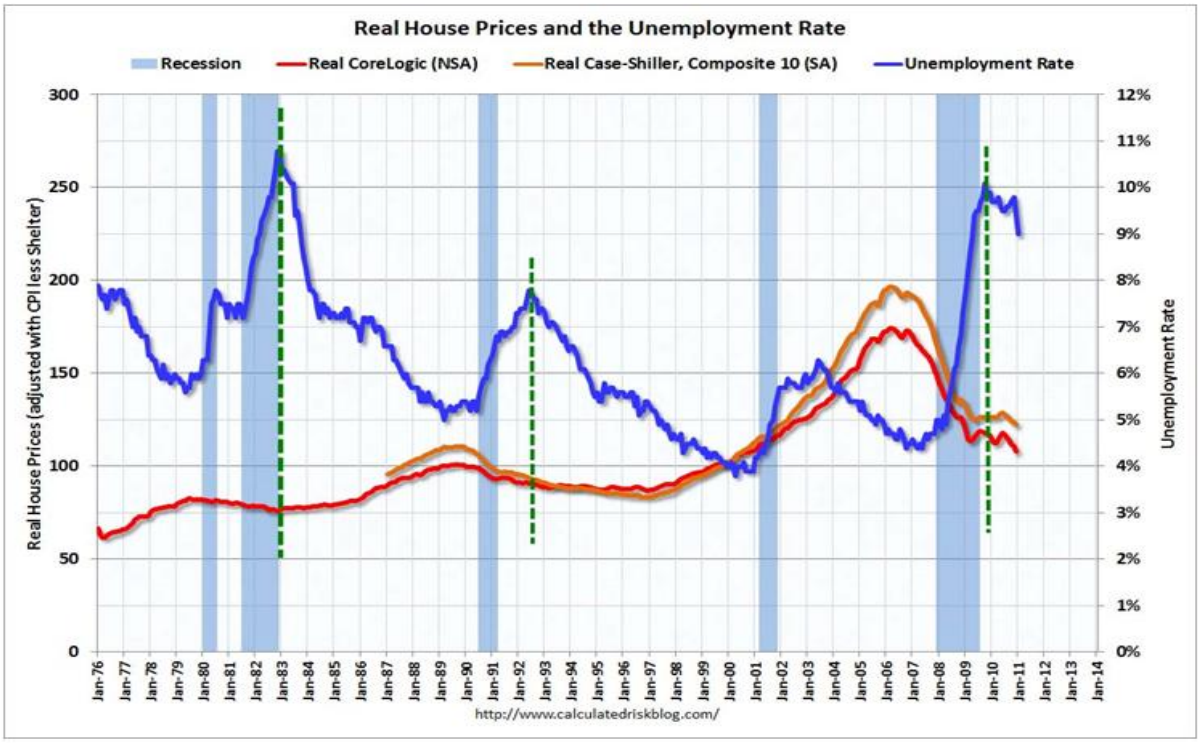


As outlined above, the consumer is caught in what appears to be a lose-lose situation. The jobs side of their income statement has entered a period of potential prolonged uncertainty. In addition, as outlined in last quarter's Market Commentary and Outlook, over the last 30 years, the U.S. consumer has been losing "real" spending power as incomes have not kept up with inflation. Recently this real spending gap accelerated when April's fairly robust nominal (actual dollars spent) consumer spending increase 6.8% (three month annualized growth rate) produced real consumer spending of only 2.1%. Over the past decade, the answer to this debilitating squeeze (especially for those in the low end of the income distribution) was to borrow to keep up. Unfortunately many U.S. consumers did so at just the wrong time, purchasing inflated real estate at close to the top of the market. With the market collapse and subsequent loss of jobs, many of these homeowners now find themselves in the precarious position of having negative

equity in their homes (see chart below from Calculatedriskblog.com "Percent Homeowners with Mortgage Negative Equity by State").



This mass of distressed homeowners continues to be a major underlying factor contributing to the ongoing weakness in the housing market. As of June 2011 it was estimated by the Federal Reserve that 40% of all transactions that are being executed are done by these distressed sellers. As one can see from the below Calculatedriskblog.com chart (Real House Prices and the Unemployment Rate), housing prices have resumed their decline after the temporary pause generated by the 2010 Federal First Time Homebuyer Tax Credit.



In summary, the growing gap between consumer income and costs, combined with a decline in the value of their largest asset (their home), has and will continue to create difficulties for consumer spending, retarding the pace of this economic recovery. We will continue to be very selective in choosing securities in the consumer space, and will gear our choices towards defensive Consumer Staples, especially those companies (such as Diageo (DEO) Colgate (CL), Kraft (KFT)) that have significant exposure to the developing global middle class, outside of developed markets.

Financial Repression – Stagflation Could Be Worse This Time

In the details of his "New Normal" description El –Erian comments, ***"governments with high debt loads will likely use several means to get out from under their debt including: adopting austerity measures, and keeping interest rates at negative (or artificially low) real rates. These measures will create an environment of 'Financial Repression' for investors because they lead to low returns on savings and investment and spark inflation."*** We agree with El- Erian and see the current artificially low interest rates as a stealth tax levied upon investors/savers to bail out leveraged governments and financial institutions. To this point, the consumer has mostly faced the "stag" or slow growth/low return portion of the potential stagflation scenario. Unfortunately, the inflation component, while not reflected in the bond market in the form of higher interest rates (income to investors), has started to surface in energy and food costs. While history may never exactly repeat, many times it does "rhyme". This time the low growth, high inflation combination historically referred to as stagflation may prove to be more lethal. Historically, real home prices (see Calculatedriskblog.com chart at bottom of prior page - Real House Prices and Unemployment Rate), provided a solid source of inflation protection for the consumer through the financially treacherous stagflation of the 1970's. Unfortunately, as a result of the ongoing structural/leverage dynamics outlined above, we do not think that housing will supply this important hedge this time. Investors will be forced to seek other alternative low volatility sources of inflation protection. Low volatility, high quality stocks with the ability to grow their above-market dividend yield at a rate faster than inflation should provide one answer.

The Tortoise Stocks

As we survey the uncertain global economic landscape outlined above, our highest conviction lies in the sustainability of corporate profits and the attractive free cash flow that well managed corporations are generating. Corporate profits and balance sheets continue to improve as a result of the aggressive structural cost cutting implemented in the depths of the 2008-2009 financial meltdown and the ongoing slow global economic recovery. The historic free cash flow being generated by corporations is funding growth via capital investment, acquisition, share buybacks, and solid dividend increases. According to MarketWatch, stock buybacks for S&P 500 companies jumped 63% to $89.8B in the first quarter versus the same period in 2010. In addition, as one can see from the Thompson Reuters table on the following page, the S&P 500 constituents accelerated the distribution of their impressive cash flow via a 13% year over year increase in their dividend payout during the first quarter. Simply put, the sustainability and growth rate of this equity-based annuity stream is and should provide a significant inflation hedge for our clients going forward. The challenge is to identify the companies that are best at sustaining and growing their dividend.

Beaumont Financial Partners Core Equity Strategy

The ability to identify and opportunistically buy these well managed companies with solid underleveraged balance sheets provides a key ingredient to long term success within our core equity strategy. The free cash flow that these companies generate is the raw material for the payment and more importantly the growth of their dividend. From a risk control perspective, we look to purchase companies that are generating significant free cash yields above their dividend yields. We refer to this gap as the headroom or cushion. The larger this headroom or cushion, the lower the risk in the dividend capture strategy. We think of these holdings as a collection of

stable yet growing annuity streams that sit at the core of our client's portfolios providing an important inflation hedge. While we do not plan a wholesale swap of equity for fixed income exposure in your asset allocation, we see this type of equity as a superior income solution during this period of artificially low rates. In addition, if another period of stagflation begins, we feel that these holdings will provide a better inflation hedge this time relative to real estate due to the market dynamics outlined above.

Classic Tortoise - Abbott Laboratories

An example of a core equity described above is Abbott Laboratories – ABT (see Thompson Reuters chart below). ABT has paid a 3.7% dividend yield, approximately 2% better than the current S&P 500 yield. Impressively, ABT not only maintained their dividend but grew it at a double digit rate through the worst of the 2008 /2009 financial meltdown. For context, this took place in an environment where the average S&P 500 constituent cut their dividend by 21% in 2009 and grew their dividend by only 1% in 2010. We evaluate these core holdings on a total return basis, factoring in their yield and the growth of that yield. In the case of ABT you would expect the long term total return to approximate 10-12% based on a 3.7% yield combined with a high single digit, low double digit growth rate - an attractive return from a stock whose volatility is less than half the volatility of the S&P 500 index. The combination of inflation hedge from increasing dividends with less than market volatility makes this an excellent example of the kind of equity that we look to hold in our core equity allocation.

ABBOTT LABORATORIES 6/23/11
(ABT) 51.92
Dividend Yield ..... 3.7 %

$ Dividends Per Share
F # of Increases Last 5 Years: 5
%s Based on Yr to Yr Comparisons
89 ◂ ▸ 11

	2006	2007	2008	2009	2010	2011
Mar	6 %	7 %	10 %	11 %	11 %	10 %
Jun	7 %	10 %	11 %	11 %	10 %	9 %
Sep	7 %	10 %	11 %	11 %	10 %	9 %
Dec	7 %	10 %	11 %	11 %	10 %	–
Spc						
	7 %	9 %	11 %	11 %	10 %	–
P/O Ratio	46 %	45 %	42 %	42 %	41 %	

S&P 500 6/23/11
(SPX) 1283.5
Dividend Yield ..... 1.8 %

$ Dividends Per Share
F # of Increases Last 5 Years: 2
%s Based on Yr to Yr Comparisons
89 ◂ ▸ 11

	2006	2007	2008	2009	2010	2011
Mar	10 %	10 %	9 %	–16 %	–8 %	13 %
Jun	12 %	7 %	10 %	–23 %	2 %	–
Sep	12 %	10 %	5 %	–24 %	6 %	–
Dec	13 %	10 %	–5 %	–21 %	7 %	–
	12 %	9 %	4 %	–21 %	1 %	–
P/O Ratio	28 %	32 %	41 %	34 %	26 %	

Source: Thompson Reuters

SUMMARY

Once again the market has demonstrated significant resilience in its ability to scale a series of macroeconomic challenges, climbing the proverbial "wall of worry" late in the first quarter and into the second quarter. As we move into the second half of 2011, the corporate outlook presented during the second quarter earnings reporting cycle will be critical for continued positive market psychology. Significant global macro challenges persist and the political/economic solutions presented can be at best described as "kicking the can down the road". We have seen the market learn to accept these background challenges as long as corporate fundamentals in the form of profits and cash flows continue to head in the right direction.

As always we look forward to guiding you through these challenging times and thank you for your trust and confidence. If you have not done so recently, please review your portfolios with your relationship manager. In the meantime, if you have any questions or comments please feel free to contact us at 781-237-7170 or email me at mstack@bfpartners.com.

Michael P. Stack, CFA

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