

## **Achieve Excess Returns With Low Volatility**

*A New Pathway to Alpha*

Key balance sheet changes can predict the direction of future earnings, yet the market is slow to react thus creating a **market mispricing anomaly**. Combining this with another anomaly, **post-earnings announcement drift**, provides an opportunity to achieve **abnormal returns** on a consistent, repeatable basis **with no additional risk**.

*A U.S. Mega Cap Growth Strategy*

Summary, Winter 2009

Presented By

**BEACON STREET CAPITAL, LLC**

— INVESTMENT MANAGEMENT —

*Institutional-Level Money Management for Individuals*

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# MISSION / PHILOSOPHY

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## MISSION

Our mission is to consistently achieve excess relative performance with low volatility, while providing superior service and full transparency through a separately managed account.

## PHILOSOPHY

Beacon Street Capital believes that a portfolio of stocks with exceptional business fundamentals and improving internal growth potential will generate greater returns than the market over a three-to-five year period. Purchasing these stocks when mispriced by the market adds to the returns without adding market risk. Furthermore, using a quantitative trading system to capture these pricing anomalies makes the investment results both consistent and repeatable.

# INTRODUCTION

- Founded 2001 – Atlanta, Georgia.
- Independent – Employee owned.
- Provides foundations, endowments and affluent business professionals in the Southeast with a conservative approach to managing money.
- Traditional long-only **US Large Cap Growth** manager.
- Bottom up approach combines fundamental stock selection with quantitative trading system to create consistent, repeatable results.

**Product: DowJones/Select:** A Separately Managed Account of individually selected large-cap growth stocks chosen from the Dow Jones Industrial Average (“DJIA”). Designed for **conservative investors** who seek **excess returns with low volatility** over a 3-5 year time period.

## Strategy Characteristics

Assets in Strategy	Over \$4.3 million
Style	Large Cap Core
Process	Quantitative, fundamental bottom-up
Targeted Excess Return	2.5%
Targeted Active Risk	5 - 7
Common Benchmarks	DJIA, S&P 500 Index
Typical Number of Stocks	10-14
5-Yr. Average Turnover	31% per year
Minimum Investment	\$500,000



## Investment Approach

- Seek Consistent Alpha
- Low Volatility
- High Quality Dividend Stocks

# PERFORMANCE OVERVIEW

Our unique investment process **achieves returns** that **exceed** a broadly diversified **growth stock index** (Russell 1000®Growth) with a concentrated portfolio of large cap stocks selected from the DJIA Index. These excess returns come with the financial strength of **dividend paying Blue Chip** stocks but **without** the associated **market volatility** of either Index.

## DowJones/Select: U.S. Mega Cap Growth Strategy

### 5 Year Portfolio Analytics:

#### DowJones/Select vs S&P500 Index

5Yr. Excess Ret. 3.45    Alpha 2.51    Inf. Ratio 0.46    Std. Dev. 11.8

3Yr. Capture Ratio: Upside 90  
Downside 65

4Q09 Quartile Ranking:

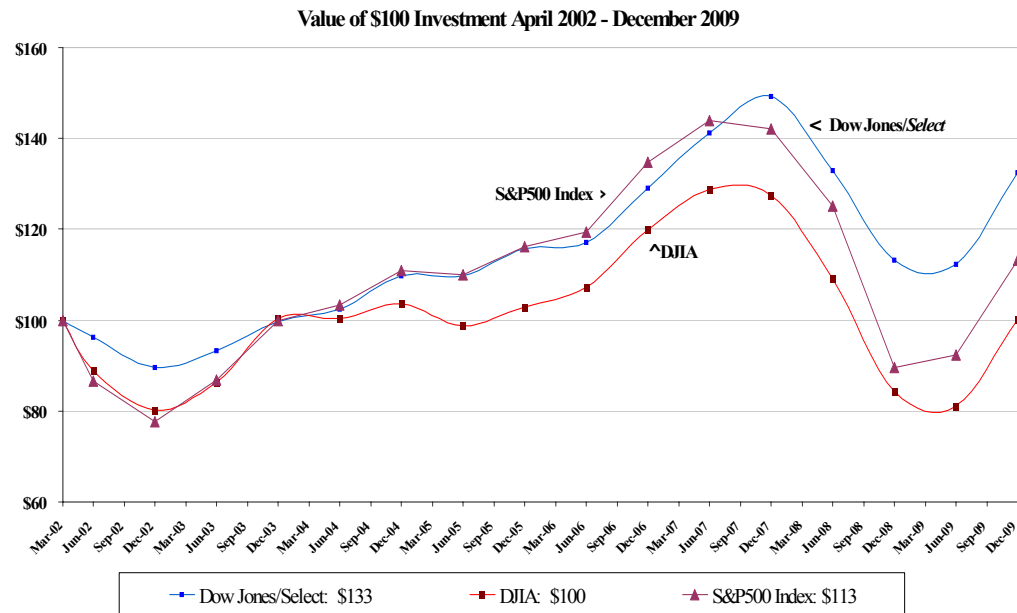
Latest Ort Top 5%    1Yr. 4th    3Yr. #1    5Yr. 1st    Inception #1

Source: Informa Investment Solutions  
Based on Gross Returns

Positive Quarters 33 (66%)  
Negative Quarters 17 (34%)

Alpha: Measures the return added by the manager. It is the excess return over the benchmark return, adjusted for volatility.

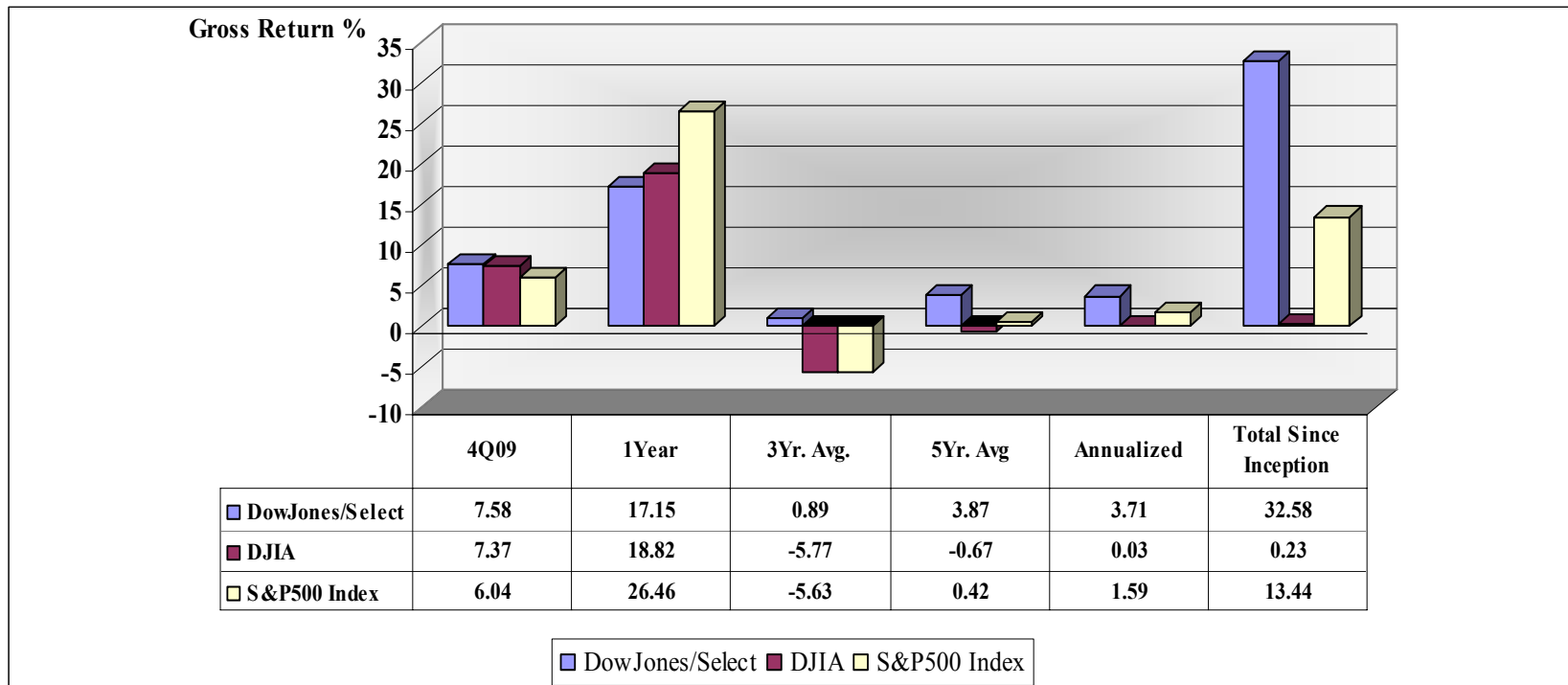
Information Ratio: The return added by the manager for each 1% of risk added.



# PERFORMANCE VS BENCHMARK

While we accept the use of index benchmarks for performance comparisons, not all stocks or sectors within the index will contribute to positive performance. Therefore, in the absence of benchmark risk controls such as replicating stock and sector weightings to the index, superior stock selection and the capture of growth potential results in significant positive performance divergence from the index. However, risk of under-performance is highest with this process when the market is transitioning from a Bear Market to a Bull Market as lower quality stocks with negative, or no, profits tend to outperform the higher quality growth stocks that we own. The following chart represents gross returns.

Period Ending: December 31, 2009



# STYLE ANALYSIS

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Our growth strategy is actually a **blend of traditional growth and value** stocks, but each stock is showing a positive change in its internal growth potential. Many value stocks eventually become growth stocks and we prefer to own them prior to that “style” transition which also produces a price transition. Therefore we use the **S&P500 Index** as a style comparison.

As can be seen in the table below, the DowJones/*Select* has similar characteristics of growth stocks, yet we uncharacteristically have a **79% greater dividend yield**. It's the best of both worlds.

## DowJones/*Select* vs. Growth Benchmark

### **Growth Characteristics:**

	<b>DowJones/<i>Select</i></b>	<b>Russell 1000® Growth</b>
<b>P/E Ratio</b>	20.1	19.5
<b>P/Book</b>	4.4	3.6
<b>ROE</b>	23.3	19
<b>Div. Yield</b>	2.78%	1.5%
<b>Market Cap(\$Bln)</b>	\$120.3	\$78.2

### **Portfolio Constraints:**

- (1) **Default to cash.**
- (2) **No shorting** of stocks.
- (3) **No options** or futures.
- (4) **No market timing.**

# COMPETITIVE EDGE / Q.E.P. INDEX

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## Internal Growth Potential:

Allocations of capital are the most important decisions management will make. These decisions reflect their view of the future, whether to get defensive or stimulate growth, and are first observable through changes in key balance sheet items before they impact on earnings.

Consequently, these **balance sheet variables have predictive characteristics** regarding the direction of growth potential. When new quarterly financial data is released a **temporary lag** occurs between a change in this accounting-based measure of internal growth potential and the **market's reaction to it**.

## Market Pricing Anomaly:

This market mispricing is corrected in two stages, with the first being related to expectations from prior period information and is corrected rapidly once the new data becomes available. The second pricing anomaly is known as "post earnings announcement drift" which is associated with future periods and is normally corrected over the next several weeks. Beyond this, if the positive trend in growth potential continues there exists an opportunity for a concentration of abnormal returns in quarters after the mispricing exists. Plus, the direction and magnitude of these abnormal returns should be consistent with the direction and magnitude of the predictable bias revealed by the previous quarterly changes to the balance sheet variables.

## Capitalizing on Mispriced Stocks:

To capture this growth potential before market participants adjust to the new data Beacon Street Capital combines these predictive balance sheet variables into a summary measure called the *Quantitative Earnings Power (Q.E.P.) Index*. A change in the Index is used as a unique buy/sell indicator to **minimize market emotion** and **produce more consistent and reliable excess returns**.

# COMPETITIVE EDGE / Q.E.P. INDEX (cont'd.)

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## Q.E.P. Index:

The Q.E.P. Index is an earnings leverage model. It looks at the rates of change in sales and earnings relative to the rates of change in capital investment items (which impact the various line items in the balance sheet) in the business. The relevant basic capital investment categories are Shareholder's Equity, Long-Term Debt and Working Capital. The basic sales and earnings categories are Revenues, Operating Expenses and Dividends.

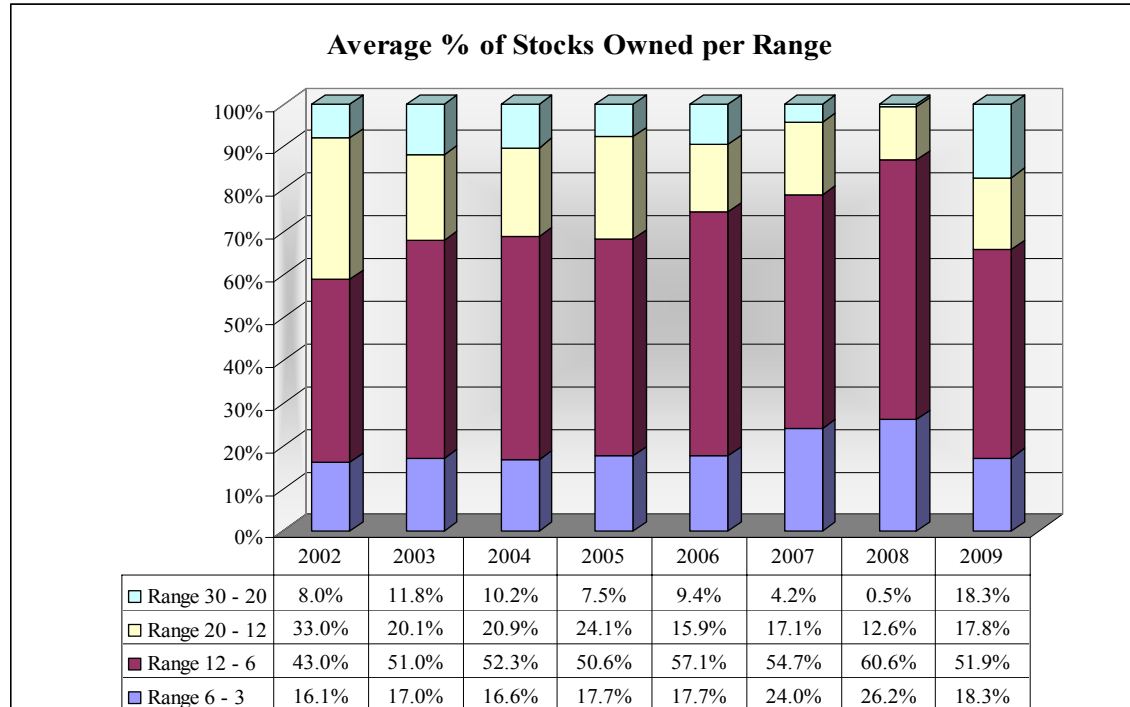
$$\text{Q.E.P. Index} = f\{\text{SHE, LTD, WC, REV, OP EXP, DIV}\}$$

Within the Working Capital component, additional weight is given to changes in inventories as well as to the trends and levels of receivables and payables. The Index is configured as a reverse indicator which trends lower as growth potential improves, with the company's stock price following in the opposite direction over time.

As the trend moves lower the stability of growth potential also improves which diminishes the impact of market volatility, or systematic risk. Stocks with the most stable growth potential are those with an Index that ranges between 30 at the high end and 3 at the low end. Above 30 growth potential is less defined, thus price is influenced more by market factors. Below 3 competitive equilibrium sets in and growth potential eventually turns negative.

Within these boundaries and as the Q.E.P. Index moves down, growth potential is influenced less by earnings and more by capital allocation, which is controlled by management. Therefore, growth potential becomes more clearly defined to market participants who can then make better judgments as to the current change in value which, in turn, makes that value less influenced by market volatility. Consequently, all stocks we purchase are in this 30-3 comfort zone, with the majority being in the mid-range of 20-6, which produces excess returns with a low standard deviation.

# COMPETITIVE EDGE / Q.E.P. INDEX (cont'd.)



## Qualitative Judgment Overlay:

While the firm's quantitative algorithm provides a **strict, disciplined** framework for **buy/sell decisions**, a qualitative judgment overlay is used to select stocks that meet our fundamental guidelines. No Wall Street research or third party sources for data gathering are used. Specific accounting line items needed to compute growth potential are acquired directly from SEC company filings. The qualitative aspects represent 20% of the decision to buy, sell or hold and are based on the management team's extensive experience in understanding the companies we select and the market's relationship to the change in their internal growth potential.

# INVESTMENT PROCESS

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**Stock Screening:** A universe of large-cap stocks (both growth and value) are screened from the Dow Jones Industrial Average Index to identify those that are **financially sound, profitable** and have **positive cash flow**. (1) Return-on-Equity  $\geq 12\%$  (2) Cash Return-on-Equity  $\geq 8\%$  (3) Net Profit Margin  $\geq 4\%$

**Fundamental Review:** Of those candidates that remain, the investment team conducts a line item review of quarterly changes in their balance sheet and income statement to verify consistency. Those with accelerating growth in R-O-E and Net Profit Margins are selected for further analysis.

**Quantify Growth Potential:** A proprietary algorithm (Q.E.P. Index) based on **key balance sheet** changes is applied to determine the strength and trend of each candidate's internal growth potential. This provides a **more significant and reliable buy/sell mechanism** than analyst expectations. **The result:** An equally weighted diversified portfolio of 4-16 high quality growth stocks.

## **Portfolio Management:**

### **(1) Buy Decision**

- Positive Trend in Growth Potential as Measured by their Q.E.P. Index
- Accelerating Returns-On-Equity and Expanding Net Profit Margins
- **Let Profits Run** Until Change in Trend

### **(2) Sell Decision**

- Opposite Buy Decision – Negative Trend in Growth Potential as Measured by their Q.E.P. Index
- Decelerating Returns-On-Equity and Contracting Net Profit Margins
- Existence of accounting irregularities or negative government action
- **Profits Harvested and Losses Cut Early** When Trend Changes

# INVESTMENT PROCESS (cont'd.)

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The investment process generates **excess returns that are enhanced during Bear Markets** (i.e., see 2002 and 2008 in the chart below), and with less volatility (or low tracking error). Furthermore, it provides the **added benefit of higher dividends** and the **financial strength** of large cap **Blue Chip** stocks.

For periods ending December 31, 2009

DowJones/Select vs. S&P 500 Index			
Avg.	Alpha	Tracking Error	Information Ratio
3yr	3.66	9.28	0.73
4yr	2.73	8.35	0.52
5yr	2.51	7.95	0.46

Source: Informa Investment Solutions

Alpha: Excess return over the benchmark return adjusted for volatility.

Tracking Error: The standard deviation of excess returns. The lower the error the lower the risk.

Information Ratio: The return added by the manager for each 1% of risk added.

# PERIOD COMPARISONS

There have been two bear market and one bull market cycles since this strategy began in 2002. Below is a comparison of this products “gross” return performance during each cycle and we can only assume the comparisons will continue into the future, although past performance is no indication of future performance.

a. Period 04-3-0 (inception) to 3-31-03

Bear Market		Excess
DowJones/Select	-11.11	+8.54
Dow Jones Ind. Avg.	-19.65	

b. Period 4-01-03 to 10-31-07

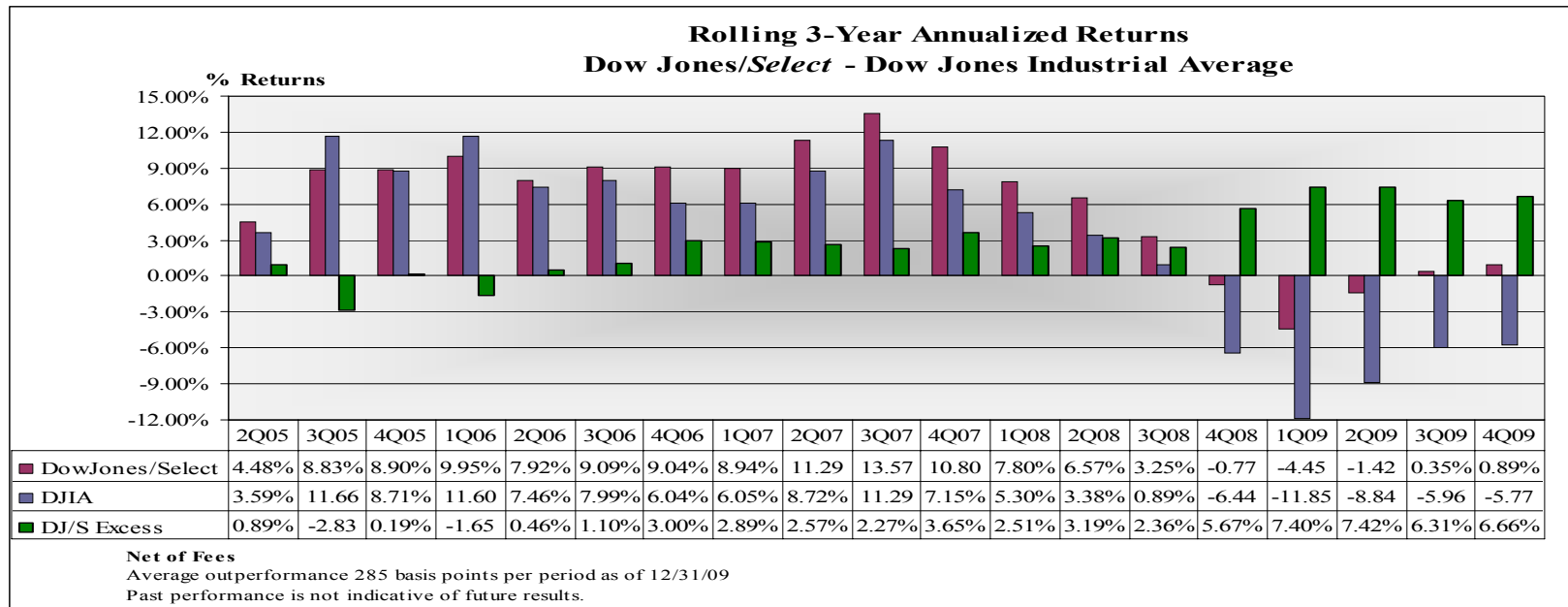
Bull Market		Excess
DowJones/Select	69.38	-4.92
Dow Jones Ind. Avg.	74.30	

c. Period 11-01-07 to 3-31-09

Bear Market		Excess
DowJones/Select	-31.53	+13.85
Dow Jones Ind. Avg.	-45.38	

d. Period 4-01-09 to 12-31-09

? Market		Excess
DowJones/Select	28.63	-8.42
Dow Jones Ind. Avg.	37.05	



# PORTFOLIO RISK CONTROLS

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**Company Specific & Valuation Risk:** We view the stock market as a market of individual stocks, all of which perform differently. Within an index of stocks generally only 20% are strong performers and those members rotate through various economic and industry life cycles. Our objective is to capture those 20% top performers without over-paying and without adding to the risk that exists by being in the market. To accomplish this, risk controls in stock selection and portfolio construction emphasize the following:

**(1) Company-specific risk, centered on business risk or the chance of failure.**

- Companies selected have positive internal growth potential, are profitable, financially sound and have positive cash flow.
- Maximum 8% allocated per stock when purchased. Stocks are trimmed when allocation exceeds 15%.
- Maximum 30% allocated to one sector – average allocation <15%.
- Portfolio allocation is 4 to 16 stocks, with balance invested in cash.

**(2) Valuation risk or the risk of paying too much for growth potential.**

- Capture growth potential at a discount due to a market mispricing anomaly.
- Market value increases due to “post earnings announcement drift” from consensus building among analyst.
- Retain captured growth potential by selling before the market can price it out.
- Avoid setting price targets – prefer to let profits run as growth potential improves and cut losses early when growth potential turns negative.

**Market (Volatility) Risk:** Whether the growth premium that is priced into a stock is maintained in a volatile market depends on the quality of its growth potential. The **Q.E.P. Index identifies the quality, and** by extension the **stability**, of that potential from the position of the Index within a certain range.

- Higher the quality more reliable the growth potential and greater the price stability relative to the market.
- Lower the quality the more external forces influence price which creates greater price volatility.
- Stocks outside their Index comfort range are excluded from the portfolio.

# RISK COMPARISON

The following tables and chart summarize the **value we add** to our clients' investments in terms of risk and reward. Our strategy has generated a five year average of **500 basis points of excess return** over the S&P 500 Index with **25% less risk** (or volatility as measured by the Standard Deviation).

*Five Year Period Ending 12/31/09*

## DowJones/Select vs. S&P 500 Index

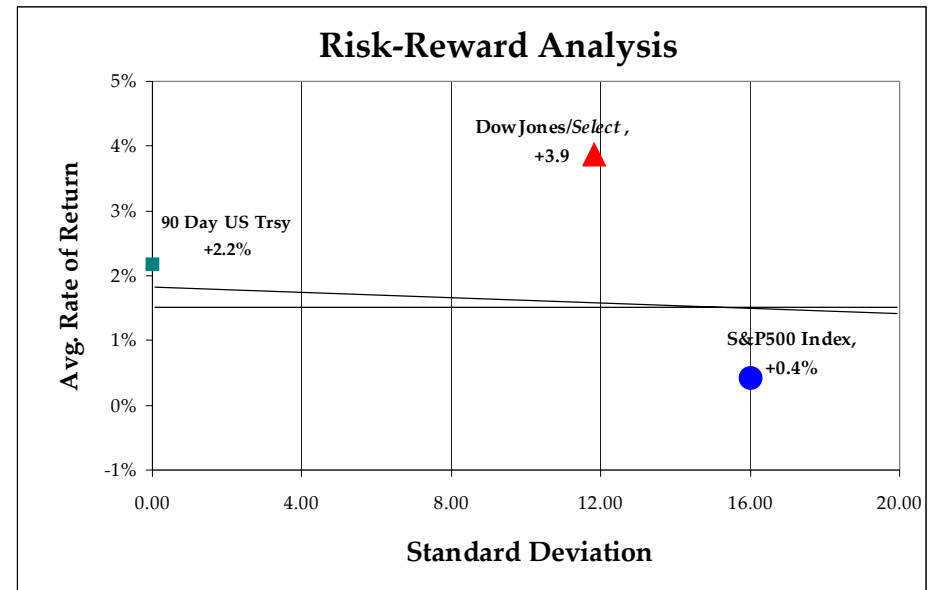
### Volatility/Correlation

	Average Return	Standard Deviation
DowJones/Select	3.87	11.81
S&P 500 Index	0.42	16.04
90-Day T-Bill Rate	2.17	0

### Average Active Risk

	Average Excess Return	Alpha	Tracking Error	R <sup>2</sup>
DowJones/Select	3.45	2.29	7.95	0.84

Source: Informa Investment Solutions



\*Total Risk-Reward for Five Year Period Ending 12/31/2009

▲ **DowJones/Select**

● **Russell 1000® Growth**

# WHY BEACON STREET CAPITAL?

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- **Team Approach**
  - Experienced
  - Informed Judgment
- **Disciplined Investment Process**
  - Bottom-up Stock Screening
  - Fundamental Accounting Review
  - Create Alpha by Selecting Stocks with Positive Internal Growth Potential
  - Boost Alpha by Capturing Pricing Inefficiencies
  - Positive Growth Potential & High Quality Stocks Lower Volatility
- **Quantitative Trading System**
  - Clearly Defined Buy & Sell Mechanism
  - Consistent & Repeatable Results
  - High Correlation to Benchmark
- **Service Oriented / Client Focused**

# THE FIRM / MANAGEMENT TEAM

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## The Firm:

- Beacon Street Capital, LLC, is a registered investment advisor located in Atlanta, GA.
- **Co-founded** by Terry Burke and Herron Weems, who **have their own capital invested in the company and alongside clients** in the investment products.
- **No affiliation** with any financial institutions.
- **Independent: Founders own 93%** of the firm and work closely together on a daily basis. Both are committed to providing their clients with a better way to invest in large cap stocks.
- **All portfolio and administrative decisions are made jointly.**

## Management Team:

- **Terry Burke, CEO**, provides the quantitative analysis of each stock covered. Mr. Burke created the **accounting-based algorithm** from his experience at **DataBase Research Corporation**, a company he founded in 1977 to provide financial consulting to public and privately held companies. Mr. Burke received a B.A. degree in 1970 from the **University of Florida** with a double major in Finance and Business Administration, and did post baccalaureate work there in accounting.
- **Herron Weems, Managing Director**, provides external research on those same stocks as well as compliance and client communication. Mr. Weems has over 23 years experience in the securities industries with Salomon Brothers, which he joined in 1977 and with **Salomon Smith Barney** after the merger of Salomon Brothers and Smith Barney. In 1980 he joined the fledgling mortgage department of Salomon Brothers under **Lewis Ranieri** and helped to build the department into a leadership position on Wall Street. Mr. Weems received a B.A. in 1975 from **Vanderbilt University** with a double major in Economics and Business Administration, and earned an MBA in 1977 from the **University of Chicago Graduate School of Business** with concentrations in Finance and Accounting. He is a member of the Leadership Atlanta Class of 1998 and currently serves on the Advisory Board of Literacy Action. Inc.

**Experienced. Capable. Consistent.**

# FEE & MINIMUM ACCOUNT SIZE

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➤ **Fee Schedule for Investment Management Services:**

- 1.25% For amounts less than \$1 million
- 1.00% For amounts greater than \$1 million but less than \$5 million
- 0.90% For amounts greater than \$5 million but less than \$10 million
- 0.85% For amounts greater than \$10 million

➤ **Minimum Account Size:**

- Dow Jones/*Select*                      \$500,000

*Achieve Significant Excess Returns  
with Low Volatility*

# BEACON STREET CAPITAL, LLC

INVESTMENT MANAGEMENT

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