

# BEACON STREET CAPITAL, LLC

INVESTMENT MANAGEMENT

## *Institutional-level Money Management for Individuals*

October 1, 2007

### Highlights

- Assets under management exceed \$25 million from new clients and asset appreciation.
- Our DowJones/Select strategy has outperformed the DJIA by 328 basis points year-to-date.
- Volatility for our portfolios remains significantly less than their benchmark indices. This dramatically improves the impact of compounding on long-term returns.

### Third Quarter 2007 Newsletter

A market correction was the primary theme for the third quarter, putting a damper on the strong upward trend that the equity markets have enjoyed year-to-date. Despite the fear it generated, the DJIA (+3.63%) and the S&P500 Index (+2.03%) recovered and ended on the plus side. Our portfolios also ended with positive results as our Dow Jones/Select strategy increased +5.45%, out performing the DJIA by 182 basis points and the Russell 1000© Growth Index by 124 basis points. Our S&P500/Select strategy performed better than the S&P500 Index (+3.38%) by 135 basis points but underperformed the Russell 1000© Growth Index. For the first three quarters of the year our Dow Jones/Select (+14.77%) and S&P500/Select (+14.26%) strategies have beaten the Russell 1000© Growth by 209 and 158 basis points, respectively.

There was very little turnover in either portfolio as growth potential remained positive for most stocks, but cash levels rose a bit more in the Dow Jones/Select strategy due to the sale of two stocks, the purchase of one and position trimming in others. Regardless of the positive growth potential we see, recessionary fears still loom in the background and the market continues to climb a “wall of worry” due to the housing market downturn and its related credit problems, so we look once again to the upcoming financial reporting period for clues to market strength. In the meantime the global economy appears to continue its upward momentum and this will benefit large cap U.S. stocks that receive much of their revenues from the global markets.

Best Regards,

*BEACON STREET CAPITAL, LLC*

<sup>1</sup>All results are un-audited and net of fees. Composite returns began January 2002 for the S&P500/Select and April 2002 for the DowJones/Select, are asset weighted and net of fees. Returns prior to November 2001 and March 2002 are total returns for model portfolios managed by Beacon Street Research, Inc., an affiliated company, on a real-time basis using the same methodology and manager, with stocks selected from those comprising the Standard & Poor’s 500-Stock Index and Dow Jones Industrial Average. **Past performance is no indication or guarantee of future performance.**

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Investor emotions moved all over the map in the just completed third quarter as the positive sentiments from the second quarter carried over and the wave of private equity driven corporate buyouts reached almost frenzied proportions. Although the housing and housing finance markets continued to show significant weakness the deal driven market in corporate buyouts helped push the equity markets to new heights in the first few weeks of the quarter as speculation increased as to which publicly traded company would be the next to be taken “private.” However, when the music stopped many players were left standing with no place to sit.

**Exhibit 1:**  
**DowJones/Select**  
**Top Ten Holdings**

Boeing Co.	9.0%
Honeywell Int'l	8.9%
Caterpillar Inc.	8.8%
McDonalds	8.4%
IBM	8.2%
AT & T	7.9%
Procter & Gamble	7.8%
American Int'l Grp.	7.8%
Intel	7.7%
Microsoft	7.2%

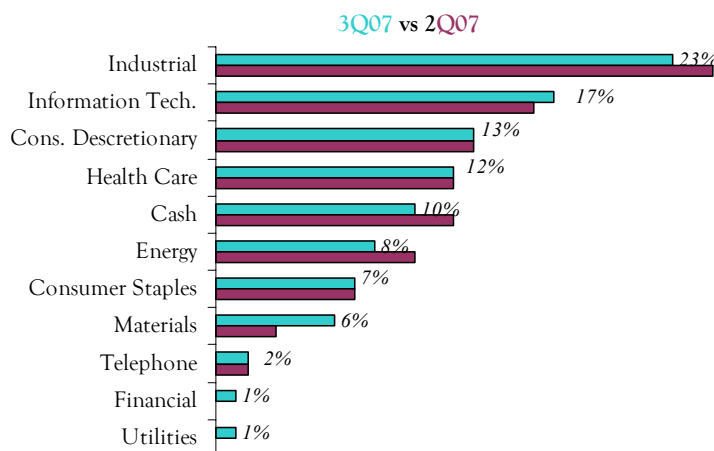
**Exhibit 2:**  
**S&P500/Select**  
**Top Ten Holdings**

National Oilwell Varco	2.6%
Apple Inc	2.4%
Monsanto	2.2%
Cisco	2.0%
Lockheed Martin	1.9%
Praxair	1.9%
McDonalds Corp	1.9%
Caterpillar Inc.	1.8%
Gilead Sciences	1.7%
Honeywell Int'l	1.7%

Credit markets seized up and numerous committed private equity deals were no longer able to raise leverage financing to complete the transactions. From record highs set on July 19, public equity markets fell over the next four weeks including an intra-day decline on August 16 that took the major indexes to as much as 12 ½% below their previous month highs into official “correction” territory before closing that day 9 ½% below the prior records. The following day the Federal Reserve cut the Discount Rate for banks to 5 ¾% from 6 ¼% and the stock markets were up by 2 ½% within minutes of the opening of trading. Stocks never looked back as they rose through the end of the quarter to close within a whisper of the previous closing highs set in July. The Fed’s statement with the Discount Rate cut was especially telling as the language shifted from a neutral stance to an easing bias. The statement stressed the “downside risks to growth” and never once mentioned inflation, and this only 10 days following the most recent FOMC meeting. The FOMC appears to now be more worried about a hard landing for the economy than rising inflation.

Another interesting aspect to the market was the marked increase in volatility in the recently ended quarter. According to a report in the *Wall Street Journal*, between July 19 and the end of the quarter roughly half the trading days experienced swings in the S&P 500 of greater than 1%. In comparison, in all of 2005 and 2006 combined there were fewer than 60 trading days with price swings of greater than 1%. The increased volatility hurts the stocks of smaller

**Exhibit 3: S&P500/Select Sector Weighting**



companies more than larger household name companies like the ones we own from the DJIA and the S&P 500. These larger companies perform better in a slow-growth economy and also do better in the current weak dollar environment due to their large percentage of sales and profits generated overseas.

Looking forward many analysts now put the odds of a recession in the U.S. in the near future at near 50/50. All recent reports coming from the housing industry have been abysmal. However, historically housing accounts for a relatively small percentage of the economy, estimated at about 5% of U.S. gross domestic product. But housing is the most important investment of many households and weakness in residential investment typically precedes weakness in GDP. Non-residential investment is a much larger component of GDP than residential investment and so far we have not witnessed a downturn in non-residential investment. Recessions generally occur when both residential and non-residential investment turn down together, so the level and direction of non-residential investment merits watching.

Another leading indicator worth watching is the trend in quantifiable growth potential that we track each quarter for the companies in our investment universe. If economic weakness is approaching it should appear first through negative changes in growth potential for a large number of companies. This will provide the signals to reduce our exposure to equities and build up cash levels in advance of any market downturn driven by a weaker economy. Many investors felt the third quarter volatility marked the beginning of a recession and major market decline, but our disciplined strategy of focusing on internal growth potential allowed us to maintain our composure while others were losing theirs. The result is that our returns have out-paced the market year-to-date with lower volatility for markedly better risk-adjusted returns for our clients.

*Herron P. Weems  
Managing Director*

## **Performance Summary**

The stock market swooned mid-way through the third quarter, but we continued to maintain our disciplined approach which dictated the sale of several stocks and the purchase of a few others.

**DowJones/Select:** During the quarter we sold Walt Disney (DIS) and tendered our position in Home Depot (HD) to the company as part of their recapitalization plan, and sold a portion of our United Technologies (UTX) position. The internal growth profile for DIS and HD turned negative with their latest SEC filings and we sold some of the UTX position as it had continued to perform well and we wished to not have it become too large a percentage of the overall portfolio.

We believe that Home Depot's stock is attractive from a historical valuation perspective and considered over-riding our discipline and holding the stock, but with the change to a negative growth profile and the continuing turmoil in the housing and mortgage sectors, we decided the downturn for HD could be

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extended and extensive and felt we should be able to find more attractive areas for investment as we wait for the housing and home improvement markets to recover over the next few years. At the end of the quarter Home Depot became the largest decliner in the DJIA losing -17.6% of its value but our tender of the stock allowed us to minimize that loss at -6%.

The lone purchase we made in the quarter was American International Group (AIG). Although AIG declined -3.4% for the quarter, we were fortunate to have purchased it mid-quarter near its low point and actually recorded a gain of +9.7% from our purchase date to quarter end. After these changes we currently own 14 stocks and are still relatively heavily invested with cash representing 9.7%. Of the top performing stocks in the Dow Jones Industrial Average this quarter, we owned the top three, Proctor & Gamble (+15%), United Technologies (+13.5%) and IBM (+11.9%). In addition to these our winners included Boeing (+9.2%), Intel (+8.8%), McDonald's (+7.3%), Johnson & Johnson (+6.6%), Honeywell (+5.7%), and AT&T (+2%). Caterpillar and Microsoft were essentially flat for the quarter and Wal-Mart Stores (-9.3%) was our lone major loser.

The third quarter and longer-term performance can be seen in Exhibits 4, 5 and 6.

<b>Exhibit 4: DowJones/Select Net Return versus Benchmark</b>					
	<b>3Q07</b>	<b>YTD</b>	<b>1Year</b>	<b>3Yr. Avg.</b>	<b>Inception</b>
<b>DowJones/Select</b>	5.45%	14.77%	21.22%	12.45%	14.38%
<b>Dow Jones Ind. Avg.</b>	3.63%	11.49%	18.98%	11.29%	5.97%
<b>Russell 1000® Growth Index</b>	4.21%	12.68%	19.35%	12.20%	4.70%

**Exhibit 5: Value of \$100 Invested July 1, 1997 to September 30, 1997**

## Beacon Street Capital - Dow Jones/Select

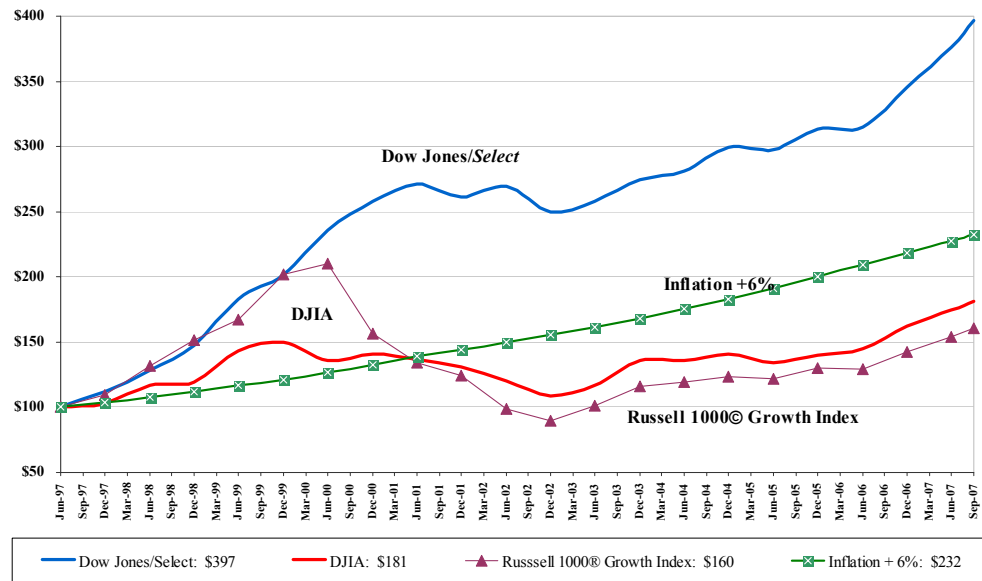


Exhibit 6: Growth and Volatility July 1, 1997 – September 30, 2007			
	Growth of \$100	Variability of Returns (Std Dev)	Percentage of Months at a Loss
<b>DowJones/Select</b>	\$397	11.22	39%
<b>Dow Jones Ind. Avg</b>	\$181	14.87	42%
<b>Russell 1000® Growth Index</b>	\$160	18.79	45%

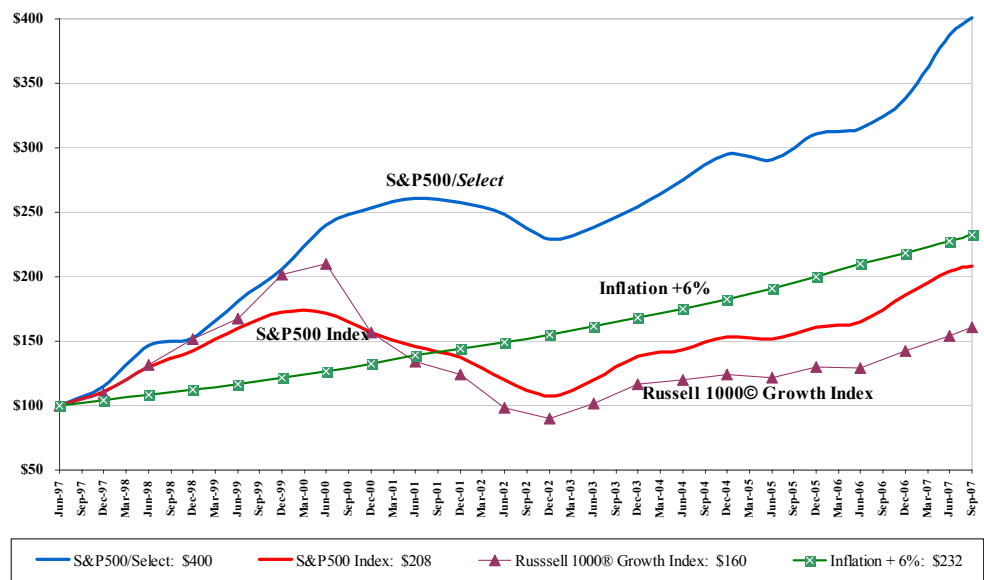
**S&P500/Select:** During the third quarter we purchased six new stocks and sold five for this strategy, leaving a total of 61 stocks in the portfolio. This decreased our cash position to 10% from 12% and gave us new positions in utilities and financials, plus a higher allocation in technology and materials stocks. Of the new purchases in the quarter American International Group (AIG, +9.6%), Schering Plough (SGP, +9.4%), Ecolab (ECL, +7.3%) and Zimmer Holdings (ZMH, +5.1%) performed the best from the date of purchase through the end of the quarter while General Mills (GIS) was essentially flat and Kohls (KSS, -5.1%) under performed.

The third quarter and longer-term performance can be seen in Exhibits 7, 8 and 9.

Exhibit 7: S&P500/Select Net Return versus Benchmark					
	3Q07	YTD	1Year	3Yr. Avg.	Inception
<b>S&amp;P500/Select</b>	3.38%	14.26%	20.38%	12.26%	14.11%
<b>S&amp;P500 Index</b>	2.03%	9.13%	16.44%	13.14%	7.16%
<b>Russell 1000® Growth Index</b>	4.21%	12.68%	19.35%	12.20%	4.70%

Exhibit 8: Value of \$100 Invested July 1, 1997 to September 30, 2007

Beacon Street Capital - S&P500/Select



<b>Exhibit 9: Growth and Volatility June 30, 1997 – September 30, 2007</b>			
	<b>Growth of \$100</b>	<b>Variability of Returns (Std Dev)</b>	<b>Percentage of Months at a Loss</b>
<b>S&amp;P500/Select</b>	\$400	11.17	35%
<b>S&amp;P500 Index</b>	\$208	14.95	38%
<b>Russell 1000® Growth Index</b>	\$160	18.79	45%

**Portfolio Risk:** Market risk, or volatility, is another factor that has a major impact on the compounding of returns. Exhibit 10 compares the risk and reward characteristics for the past five years of our DowJones/*Select* and S&P500/*Select* composites with the Russell 1000© Growth Index. This information is provided by Informa Investment Solutions, Inc. and is available through Fidelity Investment's manager search application.

<b>Exhibit 10: Risk Statistics</b>	<b>DowJones/ Select</b>	<b>S&amp;P500/ Select</b>	<b>Russell 1000© Growth</b>
Annualized Std. Deviation (5 Yr.) <sup>1</sup>	6.25	6.47	10.32
Sharpe Ratio (5 Yr.) <sup>2</sup>	1.29	1.47	1.08
Information Ratio (5 Yr.)	-.43	-.27	N/A
Beta <sup>4</sup>	0.42	0.48	1.00
Alpha (5 Yr. Average) <sup>5</sup>	3.39%	3.99%	N/A
R-Square <sup>6</sup>	.43	.52	N/A
Tracking Error <sup>7</sup>	7.32	6.71	N/A
Annual Turnover (5 Yr. Average)	31%	54%	N/A

## About the Firm

Beacon Street Capital provides affluent individuals and business professionals in the Southeast with a conservative, consistent, long-term approach to managing money that has generated excess returns with reduced volatility. Our strategy reflects sound investing principles, delivered with a sophisticated level of financial services. We believe our clients deserve nothing less.

We select for our clients individual equity securities that show positive internal growth potential and financial strength. These securities are held and actively monitored in a separately managed account held by an independent custodian, and we provide detailed quarterly updates.

Whether growing assets for retirement or building a family estate, we believe that wealth properly managed is wealth with a future. Please contact us to explore how we can help you with this process.

*Terry E. Burke*  
Chief Executive Officer

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### Definitions:

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<sup>1</sup> *Standard Deviation*: A measure of volatility, or the range of a portfolio's performance. The more an investment's return varies from its average, the higher the standard deviation. Unlike *beta*, which measures volatility relative to the market, standard deviation is a measure of total risk, or the total variation of the return. The lower the standard deviation the lower the risk, or volatility of the portfolio.

<sup>2</sup> *Sharpe Ratio*: A measure of risk-adjusted return. The Sharpe Ratio incorporates the standard deviation and the excess returns over 90-day Treasury bills to measure the reward per unit of risk. The higher the ratio over 0.0 the better the investment's historical risk-adjusted performance.

<sup>3</sup> *Information Ratio*: One of the most important tools for measuring the performance of an active manager against an appropriate benchmark. It is the ratio of excess returns to standard deviation of excess returns of the portfolio, and is used to estimate the return added by the manager for each 1% of risk added by the manager. A 5-year average *Information Ratio* over 0.50 is considered "good", over 0.75 "very good", and over 1.00 "exceptional".

<sup>4</sup> *Beta*: Measures volatility in relation to the benchmark (or market). A portfolio with a *beta* of 1.5 means that the portfolio return is expected to move 1.5 times the benchmark return. If the benchmark return is 10%, the portfolio return is expected to be 15%. If the benchmark return is -10%, the portfolio return is expected to be -15%. A low *beta* represents lower volatility, which is often associated with low returns; a high *beta* represents higher volatility, which is often associated with high returns. It is unusual to have a combination of high returns and low volatility. However, a good manager picking outstanding stocks can provide excess returns without adding excess risk. This is call "adding *alpha*".

<sup>5</sup> *Alpha*: Measures the return added by the manager. It is the excess return over the benchmark return, adjusted for volatility.

<sup>6</sup> *R-Square*: Measures the correlation between the portfolio return and the benchmark return, or how well they fit from a statistical standpoint. A correlation of a 1.00 means a perfect fit and any number over .70 means the *Alpha* and *Beta* measurements are meaningful.

<sup>7</sup> *Tracking Error*: The standard deviation of the excess returns. The lower the tracking error the lower the risk.

<sup>8</sup> *Russell-1000® Growth Index*: This Index is more representative of the overall large capitalization market and thus more representative of our investment style. It is also widely used by institutional consultants, such as *Informa Investment Solutions Inc.*, which tracks and reports our performance through its *PNS Manager Database*, when seeking investment managers for their clients.