

## BCN ADVANTAGE: 2004 ANNUAL REPORT

January 2005	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return: Jan ' 97 = \$100,000 <sup>4</sup>	15.58% <sup>1 2 3</sup> \$261,400	14.38% <sup>1 2</sup> \$203,991	7.79% <sup>1 2</sup> \$177,064	1.21% <sup>1 2</sup> \$131,012
Beta (2004): Risk Adjusted Return:	0.82 19.32%	1.00 14.38%	0.50 7.79%	0.00 1.21%

- 1 Performance results are based on the Federated Kaufmann Fund (14.3% for 2004), the Vanguard Index 500 Fund (10.7% for 2004), the Oppenheimer Global Fund (18.7% for 2004) and an average money market return of 1.21%. The results may not reflect the actual performance of BCN Advantage clients. Past performance does not guarantee future results.
- 2 Performance results show the year-over-year change to net asset values and do not include the reinvestment of dividends (if any) other than interest earned from the money market fund.
- 3 Performance results are net of BCN Financial management fees.
- 4 BCN Financial is the registered investment advisor. Performance from January 1997 to June 1998 was provided through Quest Securities as the registered investment advisor.

### 2004 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2004	60%	40%
2	01/06/2004	100%	0%
3	04/29/2004	40%	60%
4	10/04/2004	100%	0%
5	12/31/2004	100%	0%
	Present	100%	0%

### The Bull Market in Review

Measured from the October 2002 low, the current bull market is now 26 months old. How have BCN Advantage clients fared? First, it's important to remember our very accurate evaluation at the time: "Despite the looming war and dismal economic news, our confidence is growing. We believe the October 2002 lows will prove to be the bottom of this historic bear market." (BCN Advantage 2002 Annual Report) We translated that analysis into action, moving our clients 100% into the market in mid-August 2002. We moved to cash ahead of the war, but our indicators turned so strongly positive in mid-April 2003 that we moved 60% into the market BEFORE the end of "major military operations" and 100% into the market by the end of May, long before conventional wisdom recognized this current bull phase. The Nasdaq stood at 1472, the DJIA at 8454 and the S&P 500 at 916.

The first 9 months of 2004 were characterized for the most part by a consolidation phase (more about this in a moment), but the market did display some very disturbing behavior: the Nasdaq fell from its January 26<sup>th</sup> high of 2154 to its August 12<sup>th</sup> low of 1752, a decline of 19%. BCN Advantage clients were largely out of way, because we moved 60% to CASH on April 29<sup>th</sup>. Through late summer and early fall, the markets gave so many head-fakes and false signals that our October 4<sup>th</sup> move 100% into the market was greeted by several howls of protest. With the election still three weeks away (and too close to call, making a Florida repeat likely) and oil at \$55 a barrel, the emails and phone calls were non-stop. The Nasdaq stood at 1942, the DJIA at 10,192 and the S&P 500 at 1131.

### Outlook for 2005

Today's 2.2 year-old bull market compares with an average length of 2.6 years for the 15 bull markets that have occurred over the past 75 years. So one could hardly call this a "young" bull market, and we have to evaluate very carefully the key factors that could propel (or derail) this bull phase in the coming months.

The GOOD news... the amazing historical similarities between the current markets and the 5 years following the 1929 Crash: "A roaring bull market persisting for a decade, followed by a bursting of the bubble, and a frightening, multi-year decline... then a big recovery in prices for many months, followed by a prolonged correction and consolidation on generally light volume. As you might have guessed, we're describing the present – as well as the past. The DJIA went through much the same thing back at the end of the Roaring 1920s and through much of the 1930s. Since the Nasdaq topped out in January, we've been in the midst of a six-month consolidation phase – we've seen some short, scary declines, a couple of brief, exciting rallies, but all in all, we're not much changed from the start of the year. This slogging, sideways-type action is much like the Dow's consolidation phase in 1934. Finally, sometime in early 1935, the Dow broke out of this sideways pattern, on the upside. That kicked off a meteoric rise that persisted for the next two years. If the pattern holds, the next major move should be up." (Cabot Market Letter, August 2004)

The MIXED news... Oil. "So far, the October top in oil has been bullish for stocks and fits into the idea of a fourth quarter rally lasting into the start of next year. The longer-term picture is still in doubt... if oil starts to rise again next year from \$40 (as I suspect it will), the stock market could run into trouble. In case you're wondering if oil really has an impact on stocks, note that the peak in oil during March 2003 (at the start of the second Iraq war) coincided exactly with a major bottom in the S&P 500. The second peak this October helped launch the latest S&P 500 up leg." (John Murphy, Chart Watchers, December 2004)

The BAD news... Higher Interest Rates. The Fed began its current round of rate increases on June 30, 2004, and to date has completed 5 "measured" rate hikes of ¼ point each, bringing the federal funds rate to 2.25%. Historically, interest rate hikes take six months to sink their teeth into corporate earnings and precipitate a market decline... just about where we are right now. But remember, we are coming off the lowest interest rates since 1961. The Fed moves – so far – have brought short term rates roughly even with annual inflation (a neutral stance) and have barely budged 5 and 10 year rates.

Oil above \$40 a barrel will remain a drag on the economy and could severely limit stock market gains during 2005. On the other hand, high oil prices, because they impact the economy in much the same way as high interest rates, could provide the Fed with the justification to keep interest rates low – or at least to keep future rate hikes "measured." Keep in mind that market breakouts and big new up trends NEVER begin in perfect, worry-free environments. Oil speculation and concern over future interest rates have all the hallmarks of the "wall-of-worry" that markets like to CLIMB.

### **The Importance of Global Investing**

2004 provided a reminder of the importance of global diversification. Of the 23 stock markets around the globe, the United States lagged all but four. Factoring in currency gains, the U.S. market came in dead last, because of the declining dollar. Your return in foreign stock funds is made up of two things: the performance of the funds, plus or minus currency gains or losses. Since its peak in January 2002, the dollar has fallen an average of 30 percent against the currencies of its major trading partners. Should the dollar continue to weaken, U.S. investors will see currency gains in most foreign investments. If the dollar strengthens, they will see currency losses. The exceptions are investments in countries that link their currencies to the dollar, such as Hong Kong, Malaysia and China.

### **Understanding the BCN Advantage Index**

We occasionally change the mutual funds that comprise the performance index. We ALWAYS select funds that accurately represent our predominant market allocation, currently: (1) mid-cap growth, (2) large cap value / blend, and (3) global / international. We substitute a particular fund whenever its performance that year is not typical of most funds in its category. This year we replaced the T. Rowe Mid-Cap Fund (+18.4 for 2004), because the fund (though held by many BCN Advantage clients) significantly OUTPERFORMED. The Federated Kaufmann fund (+14.3 for 2004) was more typical of its category. Note also that the money market rate of 1.21% only partially reflects the high usage of "stable value" funds, many of which paid well over 3% in 2004.

As always, we look forward with great optimism. We appreciate your faith and confidence. And we are eager to apply the lessons learned for your benefit.

**BCN Financial is the Registered Investment Advisor**

We are required to offer Form ADV Part 2 to our clients each year. Contact BCN Financial for a copy.