BCN ADVANTAGE: 2008 ANNUAL REPORT

January 2009	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	-8.61% [1 2 3]	-42.28% [1 2]	-19.88% [1 2]	2.53% [1 2]
Jan ' 97 = $100,000 [4]	$309,675	$176,281	$185,379	$152,100
Beta (2008):	0.25	1.00	0.50	0.00
Risk Adjusted Return:	-8.61%	-42.28%	-19.88%	2.53%

1 Performance results are based on the Federated Kaufmann Fund (-42.2% for 2008), the Vanguard Index 500 Fund (-37.0% for 2008), the Dodge & Cox International Fund (-46.7% for 2008) and an average money market return of 2.53%. 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 Inc. is the registered investment advisor. Performance from January 1997 to June 1998 was provided through Quest Securities as the registered investment advisor.

2008 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2008	25%	75%
2	04/01/2008	25%	75%
3	07/01/2008	25%	75%
4	10/01/2008	25%	75%
5	12/31/2008	25%	75%
	Present	25%	75%

A Year for the History Books

We hope the real lesson of 2008 is clear: “Buy-and-Hold” as a reliable strategy in every market does not work. Either you exited stocks early in 2008 – or wish you did. The former is practicing, the latter is aspiring, all are converts. Even Warren Buffett, America’s greatest investor, follows a timing strategy: “A simple rule dictates my buying,” Buffett declared in October 2008: “Be fearful when others are greedy, and be greedy when others are fearful.” Buffett goes on to state he cannot predict short-term movements of the stock market, but does believe “the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up.” He believes this based on his years of experience following market trends, and we cannot disagree. Our ability to predict is limited. Our ability to anticipate based on constantly repeating stock market patterns and trends is boundless.

The “Loss Decade”

“Losses kill the rate at which capital compounds. Defining risk as the attempt to avoid losses is materially different than trying to avoid underperforming a benchmark. The paradigm of relative returns might soon be perceived as a short blip or ideological error in the evolution of investment management.” (AIMA’s Roadmap to Hedge Funds, November 2008).

A hypothetical investment in the 100% Buy & Hold portfolio at the beginning of this decade has suffered a -35% LOSS over 9 years. A hypothetical investment in the BCN Advantage Actively Managed portfolio has enjoyed a +19% GAIN over the same period. The achievement is magnified when you consider the true ramifications of this “Loss Decade.” From the close on the last day of trading in December 1999, the DJIA has declined 2,721 points (-24%), the S&P 500 has declined 566 points (-39%), and the Nasdaq has declined 2,492 points (-61%). In 2009, just to return to those December 1999 levels, the DJIA must gain 31%, the S&P 500 must gain 63%, and the Nasdaq must gain 158%. There is little doubt this first decade of the new millennium will be the worst for stocks – by far – since the 1930s.

Repeating Patterns & Trends

“Earnings are mean reverting. They will fluctuate around the long-term trend line. And interestingly, that long-term trend line is nominal GDP. This has important implications for future values. Markets go from high valuations to low valuations and back over very long secular bull and bear markets which last anywhere from 13-20 years, or about 17 years on average. These cycles do not stop in the middle and reverse. That is why I could contend back in 2003 that we were not in some new long-term bull market. Valuations had not reached the levels from which bull markets are made. For comparison, note that in late 1974 valuations were still at about their long-term average. Buying then was not compelling from a valuation standpoint. But it was a "price" bottom. There was a great deal of volatility in the next eight years, and another recession at the end of the period, before valuations finally got down to extremely undervalued single-digit levels. Those years saw a rising stock market and ever-lower P/E ratios, as earnings grew faster than stocks prices. Investors, twice burned in the late '60s and early '70s, were reluctant to get back into the market. They were cautious. I think we may be in a reflection of that same period.” (John Mauldin, October 2008).

Employment + MEW = Consumer Spending = Earnings

The nation's unemployment rate grew to 7.2 percent in December 2008, the highest level in 16 years. For all of 2008, the economy lost 2.6 million jobs, the most since 1945. All told, 11.1 million people were unemployed. The average work week fell to 33.3 hours, the lowest level on records dating to 1964. In addition, 8 million people were working part time. The country is battling a housing collapse, a lending freeze and the worst financial crisis since the 1930s, making the current downturn especially dangerous. Even with new government stimulus and the Federal Reserve ratcheting rates down to nearly zero (an all-time low), unemployment is expected to hit 9 or 10 percent by the end of 2009. Even then, unemployment would just begin to match the levels seen in the last consumer-driven recession of 1980-82.

We doubt the TARP’s true aim was ever to get banks lending again. The real effort was to avoid “counterparty” defaults in the huge over-the-counter marketplace for debt derivatives. $62 trillion of credit-default swaps (at its height, compared with a $21 trillion U.S. residential real estate market), was too great to permit a domino effect. The Lehman Brother’s bankruptcy – the real catalyst for the cascading market decline that began in October 2008 – proved the banks and insurance companies were too big to fail.

Attempts to stabilize real estate have been largely unsuccessful. Too much air was contained in the over-inflated housing balloon. From 2004-2007, mortgage equity withdrawals (MEWs) exceeded $500 billion per year – money that was pumped directly into the economy, adding 2-3% to annual GDP. Residential real estate will stabilize when prices return to affordable levels – naturally. Until then, mortgage “work-outs” will continue to lead to re-default, and foreclosure moratoriums will be counter-productive. The housing bubble burst with unemployment at historically low levels (4.5%). Is there any wonder that defaults and foreclosures continue to skyrocket now that unemployment is soaring? We will know that housing has stabilized when the inventory of unsold homes falls below 6 months (supply is currently over 11 months). If we cannot stabilize housing – or more specifically, restore MEW to previous lofty levels – then attention must focus on job creation. This will be the essence of Obama’s economic stimulus plan – the adrenaline injection that will spark the next market rally, however short-lived.

The Strategy Going Forward

Likely we will go through at least one more cycle, the “Camel Hump,” that lasts from 4 to 6 years: First, we must endure the Q4 2008 earnings season to absorb what should be the worst quarter for earnings this decade. Second, we will see the market reaction to Obama’s economic plan: an 18 to 24 month rally that should take the indexes up 50% or more. Finally, we must be constantly on alert for the first signs of trouble, ready to exit stocks quickly – ahead of the crowd – before the inevitable decline that follows. Why is the decline inevitable? Because long-term secular bear markets do not end until P/E ratios for the major indexes compress below 10. With the S&P 500 at 900 and 2009 estimated earnings at 42, the P/E ratio is currently at 21. Despite the index’s 38.5% decline in 2008 (and 42.3% decline from the October 2007 market top), investors have yet to adequately price in the devastation we are seeing in corporate earnings. And ominously, initial public offerings, the life-blood of young bull markets, all but disappeared in 2008.

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 Inc. 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.