

THE COMPASS CHRONICLE

Highlighting important financial planning and investment issues

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Our financial advisory services include:

- ◆ Investment Management
- ◆ Retirement Planning
- ◆ Education Funding
- ◆ Family Budgeting

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COMPASS Investment Advisors, LLC is available to consult with individuals and families on their financial planning and investment advisory needs.

Is the Glass Half Full or Half Empty?

Economic Re-Cap

We believe the economy and stock market are in the midst of recovering from months of weakness, but stock market participants continue to collectively demonstrate their vacillation on the economy and corporate developments—some days the market rejoices when hopeful economic data is released and other days the market bemoans signs of economic weakness or the latest company facing corporate governance issues. The fact is the economy is improving, albeit unevenly and occasionally offering conflicting signals.

Officially, per the National Bureau of Economic Research, a private group of leading economists, the U.S. economy entered into a recession in March 2001, six months prior to the September 11th attacks. However, according to the conventional measure of an economic recession (that is, at least two consecutive quarters of negative, inflation-adjusted GDP growth), the U.S. economy is not in recession and has not been since 1990–1991. Nevertheless, an economic slowdown has materialized over the past year and one-half.

Despite recent weakness in consumer confidence and spending, it has been consumer economic activity that has kept the U.S. economy's growth from further deceleration. However, recent signs have emerged indicating that consumer confidence may be waning; in fact, consumer confidence has declined for five consecutive months to a 9-year low. Consequently, consumer spending is likely to decelerate in the months ahead. Of course, new terrorist attacks, corporate governance or accounting irregularities, or other event risks may further impact consumer confidence and spending. The basic fact remains that economic activity is improving and it is often at inflection points that economic data is most volatile.

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Is the Glass Half Full or Half Empty?

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Financial Market Response

Just as the stock market witnessed unprecedented gains in the late 1990's when the S&P 500 strung together five consecutive calendar years of 20% + gains (a feat never before accomplished!), the pain experienced over the past two and one-half years has been equally striking. Through September 30, 2002, the S&P 500 had suffered roughly a 47% decline since its peak 929 days prior, longer in duration than the infamous 1973–1974 bear market, but nearly identical in terms of severity. The third quarter ending September 30 was the S&P 500's worst quarterly performance in 15 years and 2002 is on course to be the third consecutive year of losses for the first time in 60 years. The performance of the general stock market has been disappointing to say the least—it has also been a reflection of an

overheated and speculative market in the late 1990's (remember those dot coms?), as well as a reflection of a deceleration in economic growth.

But all has not been lost by investors with well-diversified portfolios. Two areas in the U.S. stock market that have performed relatively well over the preceding 30 months ending September 30 are value-oriented stocks of smaller companies (up about 14% during this time frame) and mid-cap value-oriented stocks (up about 2%). Real estate investment trusts (REITs) have performed even better, supported by attractive dividend yields, rising a remarkable 45% over the prior 30 months. Bonds have performed well too, helped by a declining interest rate environment (see related story, ***Bonds at Risk?***). Over the past 2-1/2 years, U.S. bonds have generated annualized total returns of about 9% on average.

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Bonds at Risk?

Many investors see bonds as an investment with little risk—you receive coupon payments at regular intervals and, once a bond matures, you receive your initial investment back (the bond's par value). However, investing in bond mutual funds does involve risk, including default risk and interest rate risk, though many believe, incorrectly, that you cannot lose money.

Aside from default risk, or the chance that the issuer of the bond will be unable to pay the par value at maturity (usually due to bankruptcy), you also are subject to interest rate risk. Interest rate risk is the effect that interest rate movements have on the price of bonds. Bond prices move inversely to interest rates; that is, as interest rates decline (as they have for several years), bonds appreciate (their prices go up). Given that interest rates are at 40-year lows, the likelihood has increased that interest rates are more likely to move significantly up from current levels rather than continue their decline. Consequently, bond prices are at risk of falling and, depending on how much interest rates were to increase, could lead to a negative return (remember that even if bond prices were to fall, the bonds would still generate income from their coupon payments). To place this in perspective, if interest rates were to increase by more than 1%, a negative total return could result for the typical bond over a one-year period.

To mitigate the interest rate risk inherent in bond investing, we structure client portfolios without long-term bond funds because such funds are highly volatile and respond poorly to rising interest rates. Instead, our focus is on short- and intermediate-term bond funds, which are less likely to generate a negative return. In addition, we normally allocate a small percentage of a client's fixed income exposure to a high-yield bond fund, which invests in what are commonly known as "junk" bonds. Such funds tend to perform well with a strengthening economy and an improving stock market. They are also less susceptible to interest rate risk due to the higher proportion of their total return that is generated from the underlying bonds' coupon payments. (See our ***Portfolio Manager Insight: Janus High-Yield Bond Fund*** article for an analysis of our favorite high-yield bond fund.)

What's Next?

The decline in interest rates has had several beneficial effects, though seniors have been hurt by the lower income earned by their savings. With interest rates at 40-year lows, mortgage refinancings have been a boon to household pocketbooks since lower rates mean lower mortgage payments. This has freed up cash to be spent (or saved/invested) that support economic activity. If you currently carry a mortgage on your primary residence or vacation property and have not refinanced recently, you should consider refinancing given today's low interest rate environment.

Consumers with variable interest rates on their credit cards have also seen their debt servicing costs decline.

Given the unevenness of the economic recovery, we don't expect interest rates to gain significant upward traction any time soon. Bonds should continue to perform reasonably well near term, though their intermediate-term prospects (the next 1–3 years) are less stellar as we expect interest rates to move higher, thereby pushing bond prices down, within the next twelve months. As far as the U.S. stock market, we believe value-oriented stocks, those that are more sensitive to economic activity, such as industrial-related companies, will perform best over the next 12 months. Though small- and mid-cap value stocks have outperformed large-cap value stocks over the past 30 months, the latter may come into their own if recent weakness in the U.S. dollar continues. Larger companies tend to derive a greater proportion of revenues from international operations. The results of these foreign operations are supplemented by the positive currency

Portfolio Manager Insight: Janus High-Yield Bond Fund

Managing a fund that invests in the minefield of lower quality corporate bonds is no easy task, but manager Sandy Rufenacht has been successfully navigating Janus High-Yield Bond Fund for the past six years. As Morningstar states in a recent review, "it is the only fund that has ranked in the high-yield category's top half each of the last six years, and its three- and five-year trailing returns rank in the category's top decile." Morningstar gives Janus High-Yield a 5-star rating, its highest.

Not only has Janus High-Yield generated consistently superior returns relative to its peers, but it has done so with less risk (volatility). The fund's holdings are also spread across more than 140 different issues and are well-diversified by economic sector. Though the fund is focused on below investment grade issues, it is concentrated in the highest quality portion of the junk bond marketplace, thereby alleviating some of the default risk inherent in investing in high-yield debt. Another factor that has lessened the fund's default risk and helped it avoid problematic issues has been the depth of Janus's analytical resources.

We expect that with the manager's consistent and sensible approach to the high-yield marketplace, the future of Janus High-Yield Bond Fund is very bright indeed.

impact of a weak U.S. dollar. A weak U.S. dollar would also aid the returns of international investments held by U.S. investors from this same currency translation effect. Furthermore, international equity (stock) markets are more reasonably valued than the U.S. market. Finally, foreign companies have not gone through the extent of restructuring and cost cutting seen at U.S. companies, which provides opportunity for additional earnings gains.

Our Role

In this environment, like any environment, we will continue to monitor the asset allocation of our clients' portfolios to ensure that they are in line with their long-term plan. In addition, fund managers who fall short of our expectations will be replaced as part of our ongoing due diligence process. If you have questions regarding the market environment and its impact on your portfolio or personal financial situation, please do not hesitate to contact us.

IRA Contribution Limits Increased

We want to make sure that you are aware of the new, expanded IRA contribution limits that are available if you have not begun taking distributions from your IRA accounts. As a result of The Economic Growth and Tax Relief Reconciliation Act, beginning in 2002 the amount that you may contribute to an IRA has increased.

For a Traditional IRA, you may contribute up to \$3,000 as your 2002 tax year contribution up until April 15, 2003. If you are at least 50 years old, you may contribute an additional \$500. You must be less than 70-1/2 years old to contribute to a Traditional IRA. The annual contribution limit for the 2003 tax year will remain the same.

For a Roth IRA, the same contribution limits apply, but your adjusted gross income (AGI) must be \$95,000 or less as a single filer to make the full contribution and \$150,000 or less as a married individual, filing jointly. You are ineligible to make a contribution to a Roth IRA if your AGI is greater than \$110,000 (single filer) or \$160,000 (married, filing jointly).

For a SEP IRA, an employer may make an annual contribution of up to 25% of each eligible employee's compensation, up to \$40,000.

While we recommend contributing the maximum possible to your IRA(s) each year, we suggest you first maximize the contribution to those accounts where your contributions are made on a pre-tax basis, including 401(k), 403(b), and 457 plans (offered by corporate, non-profit, and government employers, respectively). Such contributions, limited to \$11,000 in 2002 (\$12,000 if you are at least 50 years old), not only help you save for your retirement, but have the added benefit of lowering your taxable income. In 2003, the maximum contribution increases to \$12,000 (\$14,000 if you are at least 50 years old).

If you have any questions regarding your retirement accounts, please do not hesitate to contact us.

