

THE COMPASS CHRONICLE

Highlighting important wealth management issues

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COMPASS Wealth Management, LLC



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A client-focused wealth management firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our wealth management services include:

- ◆ Investment Management and Consulting
- ◆ Retirement Planning
- ◆ Education Funding
- ◆ Gift Planning

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How Much Do You Need For Retirement?

A Few Rules Of Thumb

While we use sophisticated software tools to assist us in determining how much a client needs to *save* for retirement and then how much they can *spend* in retirement, several rules of thumb can also provide guidance to answering these questions. Remember that these are only generalizations and may not be accurate given your circumstances. Retirement plans that we create for clients incorporate their specific set of facts to provide a customized analysis.

Two general rules of thumb are applied to retirement planning:

1. your pre-retirement savings rate, and
2. your post-retirement spending level.

Ultimately, how much you save for retirement and how much you spend in retirement depend upon many factors, including some that are completely unknown, such as your life span and the return generated by your investments. We will take each of these rules of thumb in turn.

PRE-RETIREMENT SAVINGS RATE

The earlier that you begin saving for retirement, the less you will need to save. By contributing to your retirement accounts as early in your career as possible, you allow time to work for you through the power of compounding. The later you wait, the less benefit you will receive from compounding (and the less time you will have to weather a poor market).

According to data published by The Vanguard Group, if your current income is \$100,000 and you had not yet begun to save for retirement, you would need to save 13% of your income for 40 years in order to replace 75% of your pre-retirement income (we will discuss this concept in more detail in the next section). If you wait 10 years so that you only have 30 years to invest prior to retirement, you will need to save 21% of your income each year. And if you only have 20 years prior to retirement, you will need to save a staggering 36% of your annual income.

Obviously, your contribution could be lower than these levels to meet your retirement needs if, for example:

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1. your employer matches your contribution to an employer-based plan (then your combined contributions would need to meet the levels cited above), or
2. you receive a corporate pension.

Unfortunately, only about 20% of workers in the corporate sector are covered by a company pension plan and this proportion has been declining over time as companies phase out this costly benefit.

The contribution rates above assume you receive Social Security retirement benefits, that your retirement lasts 25 years, and that your portfolio's asset allocation gradually becomes more conservative as you age. If your current income is greater than \$100,000 annually, then you will need to save an even greater percentage of your income for retirement, whereas if you earn less than \$100,000, you can save a lesser percentage.

POST-RETIREMENT SPENDING LEVEL

Your post-retirement spending level can be characterized as a percentage of your:

1. pre-retirement income, or
2. overall investment assets.

Pre-Retirement Income

Conventional wisdom states that in retirement you will spend at least 75 – 80% of your pre-retirement income to maintain your standard of living. For example, if in your last year of employment you earn \$100,000, then you could expect to spend at least \$75,000 in your first year of retirement (adjusted for inflation thereafter).

The obvious difficulty with this rule of thumb is knowing what your terminal income will be and whether a 75 – 80% spending level is appropriate for you. For example, while you may be able to plan whether your mortgage will be paid off prior to reaching retirement, how do you

know whether you will incur significant uninsured medical costs during your retirement?

Overall Investment Assets

Another approach is to determine how much you may withdraw from your investment assets each year without completely depleting your portfolio by the time you pass away. This is often referred to as your withdrawal rate. Here too it depends on how long your retirement will last and the returns your portfolio will generate. Given a reasonably allocated portfolio, an annual withdrawal rate of 4% or less is unlikely to deplete your investment assets during your lifetime. For example, if you determined that you needed \$80,000 from your portfolio each year to meet your retirement expenses, then you would need a portfolio worth at least \$2 million once you reached retirement.

In practice, you first need to determine how much income you will need from your portfolio in addition to the income that you expect to receive from Social Security and any pensions. Then take that required annual portfolio income figure and multiply it by 25 to calculate the required size of your retirement nest egg.

While the rules of thumb outlined above should be considered only retirement planning guidelines, they can provide you with an indication of how well you are positioned for retirement. For a more thorough and complete review, contact us to have a retirement planning analysis performed as part of our service offering, Wealth Management Solutions.

“Investing requires patience....nervous energy is a great destroyer of wealth.”

Fayez Sarofim

(Founded Fayez Sarofim & Co., an institutional investment management firm, in 1958)

Our New Name

In late March we formally changed our name from COMPASS Investment Advisors, LLC to COMPASS Wealth Management, LLC to better reflect our comprehensive suite of wealth management services. Note that our mailing address has also changed.

Common Investment Mistakes

In a recent survey, the CFA Institute, which administers the highly regarded Chartered Financial Analyst (CFA) Program worldwide, asked its members for their views on the most common mistakes made by individual investors. Among the most common mistakes cited were:

1. **No investment strategy:** Too often individual investors invest without first establishing a formalized investment strategy that incorporates their financial goals and objectives, investment time horizon, risk tolerance, and other relevant factors.

At COMPASS Wealth Management, we create an Investment Policy Statement for each client that establishes a customized set of guidelines and parameters for their portfolio.

2. **Buying high and selling low:** Although a fundamental investment principle is to buy low and sell high, emotional decisions often result in buying high and selling low. Many investors are tempted to invest in a stock, mutual fund, or an area of the market that has performed well, assuming that it will continue its recent trend. These “performance chasers” are frequently disappointed when the latest investment fad comes crashing back to earth.

Our approach, on the other hand, is to maintain a prudent and disciplined asset allocation and diversification strategy. This approach can weather all types of market environments and avoids the temptation of falling for the latest fashionable investment.

3. **Frequent trading:** The temptation to trade can be a costly one. Based on academic studies, investors who actively trade their portfolio tend to underperform the returns generated by investors who follow a buy-and-hold strategy. Why? Active traders suffer from higher transaction costs and incur greater taxes, as well as the drawback of trading on emotion instead of pursuing a disciplined approach.

We adhere to a buy-and-hold strategy when investing on behalf of our clients. While we certainly do not trade frequently, we do monitor developments that affect each of our clients’ investments and make changes when warranted; these changes are communicated to clients in advance. In addition, we rebalance client portfolios to maintain compliance with the investment parameters that were established in each client’s Investment Policy Statement.

Saving For College

According to the Social Security Administration, Jacob and Emily were the most popular baby names in 2005, the most recent year for which data has been compiled. In fact, Jacob has been the most popular boy name for the past 7 years, while Emily has been the most popular girl name for the past 10 years. To fully meet the total projected costs of college 17 years from now, Jacob and Emily’s parents have quite a bill ahead of them. Assuming an annual inflation rate of 6%, attending a four-year public university, which costs \$16,357 on average this school year, will require more than \$192,000 for four years of education. Similarly, attending a four-year private university, which costs \$33,301 on average this school year, will require an additional \$200,000, or over \$392,000 for four years of education.

Fortunately, Section 529 and Coverdell accounts are available to help save for educational costs. In fact, last August the federal tax exemption for Section 529 plans was made permanent with the passage of the Pension Protection Act of 2006. Consequently, withdrawals from Section 529 accounts to pay for qualified educational expenses will be federally tax-free into the future. Previously, the federal tax-free nature of distributions was set to expire at the end of 2010. If you could benefit from our education funding expertise, please do not hesitate to contact us.

Written and edited by Louis E. Conrad II, CFA.

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Retirement Account Contribution Limits For 2007

Employer-Sponsored Accounts

The amount that you may contribute to an employer-sponsored retirement account has increased for 2007. For 401(k), 403(b), and 457 plans, offered by corporate, non-profit, and government employers, respectively, the maximum you may contribute via payroll deduction to such plans is \$15,500 for 2007, up from \$15,000 in 2006. If you will be 50 years of age or older by December 31, 2007, you may contribute an additional \$5,000 in 2007 (no change versus 2006; also known as the “catch-up” provision). Contributions to your employer-sponsored retirement account, which are made on a pre-tax basis, have the benefit of lowering your taxable income (and thus your taxes), as well as assisting you in saving for your retirement.

IRA Accounts

The amount that you are able to contribute toward Traditional and Roth IRAs has not increased for 2007. For a Traditional IRA, you may contribute up to \$4,000 as your 2007 tax year contribution up until April 15, 2008. If you are at least 50 years old at any time during 2007, you may contribute an additional \$1,000. You must be less than 70½ years old to contribute to a Traditional IRA.

For a Roth IRA, the same contribution limits apply, but your modified adjusted gross income must be \$99,000 or less as a single filer to make the full contribution and \$156,000 or less as a married individual, filing jointly. Consequently, if your income level prevents you from funding a Roth IRA during 2007, you may still contribute toward a Traditional IRA.



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