

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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A Disciplined Approach To Investing

Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing. As much as anything else, successful investing requires something perhaps even more rare: the ability to identify and overcome one's own psychological weaknesses.

– Warren Buffet

[Warren Buffet is a highly regarded investor and chairman of Berkshire Hathaway]

Emotionally-based investment decisions tend to lead an investor away from the old Wall Street adage of *buy low, sell high*. Instead, during periods of market turmoil and weakness, investors who let their emotions dictate their actions respond by selling their riskier positions after the market has already sold off, thereby missing the inevitable rebound. In addition, selling out of an asset class, while thought to be a means of reducing risk, actually increases a portfolio's risk due to its reduced diversification (see page 3 for an article on the concept of diversification).

As Warren Buffet suggests, investors are challenged in making sound investment decisions by their own emotions. In fact, a study conducted by Dalbar, which provides research on the financial services industry, found that the average investor dramatically underperforms broad stock and bond indices. As Dalbar stated,

investors continue to chase investment returns to the detriment of their pocket books. Motivated by fear and greed, investors pour money into equity [stock] funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than [the rate of] inflation.

A slew of psychological challenges face each investor. We review some of the more prevalent challenges below and then review how COMPASS Wealth Management manages client portfolios to avoid these psychological investment traps.

Rearview Mirror Investing

This is my unscientific, but descriptive phrase of what behavioral finance calls “anchoring” and “recency bias”. Too many investors expect that what has most recently occurred will continue to occur. For example, in the late 1990's, many investors expected the dot-com and Internet-related stocks would continue their parabolic ascent, though many such companies were likely years away from turning a profit. Investors were, in effect, looking in the “rearview mirror” and optimistically expecting that past stock appreciation, though consistent with a bubble, would continue indefinitely.

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A Disciplined Approach To Investing

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One consequence of investors extrapolating the market's contemporary experience into the future is that they tend to overweight the asset classes, sectors, and individual securities that have performed well, rather than looking prospectively and making a sound judgment as to what will outperform in the future.

Confirmation Bias

Confirmation bias was also evident during the dot-com bubble. Related to anchoring, confirmation bias is placing greater weight on information that supports what you already believe (or want to believe), as well as discounting information that does not support your view. Many investors were easily taken by the prospects of dot-com stocks, rather than critically evaluating their prospects based on realistic growth and valuation metrics.

Return Asymmetry

One of the more interesting perspectives that some investors have is that they would like to enjoy the upside of stock investing, but are unwilling to accept the potential downside of such investing. Unfortunately, to obtain the greater returns offered by stocks, you need to accept the greater risks that accompany them—security returns are not asymmetric! We can use tools to alter the asymmetric returns of securities, such as placing stop loss orders on stocks or exchange-traded funds, but these tools do not alter the traits of the underlying securities.

Loss Aversion

No one prefers to lose money and, not surprisingly, investors avoid losses like the plague. Yet losses are part of the normal investing experience, though you obviously expect your gains to occur more frequently and with greater magnitude than your losses. Many investors habitually focus more on their money-losing holdings than on their holdings that have performed well. Certainly you should review underperforming holdings, but many investors are unable to distinguish between a bad decision and a bad outcome. Often a reasoned decision was made initially, but a bad outcome may still result. Such is the life of an investor!

THE COMPASS APPROACH

COMPASS Wealth Management's approach runs counter to an emotionally reactive one. Our disciplined approach is devoid of emotions.

Risk Evaluation

Our process begins by first evaluating risk, or how much volatility a client is willing to subject their portfolio to, from two different perspectives. The first is from

a client's perspective and attempts to determine from an emotional or psychological level their willingness to undertake risk in order to achieve returns. The second perspective on risk is our own—given a client's circumstances, how much risk do we think they should be willing to bear from an objective standpoint. We examine any differences between the two views on risk and, in discussions with our client, incorporate the client's risk tolerance and our assessment of their risk capacity into our recommendation for their portfolio structure.

Portfolio Structure

Once we have determined where on the return-risk continuum a client lies, we create a portfolio structure that is appropriate for their needs. This structure is specific to their individual goals, investment time horizon, and risk tolerance and capacity. This customized approach can incorporate a client's multiple financial goals and objectives, whether it is having sufficient assets for retirement, saving for a child's college education, etc.

Depending on the market environment, we may adjust a client's exposure to various underlying asset types within preestablished ranges to take advantage of market opportunities. However, our disciplined strategy maintains diversification in order to control risk. Our belief is that by consistently following a disciplined process, clients have the best opportunity to create the wealth necessary to meet their financial goals.

Investment Policy Statement

All of these factors are then included in an investment policy statement, which outlines a client's financial circumstances and recommends a specific portfolio structure based on their needs. This document acts as a road map that is adjusted over time as a client's circumstances change.

The investment policy statement incorporates our recommendations for establishing an appropriate asset allocation and diversification strategy. We regularly review the asset allocation of our clients' portfolios and rebalance them whenever necessary to maintain alignment with long-term targets. This rebalancing process reduces exposure to asset classes or sectors that have performed above trend line and increases the weighting of recent laggards (consistent with the *buy low, sell high* adage referenced earlier).

SUMMARY

Our approach of crafting an appropriate portfolio structure for each client's needs and our policy of regularly rebalancing each portfolio to maintain diversification limits the deleterious impact that emotions can play in preventing successful investment decisions.

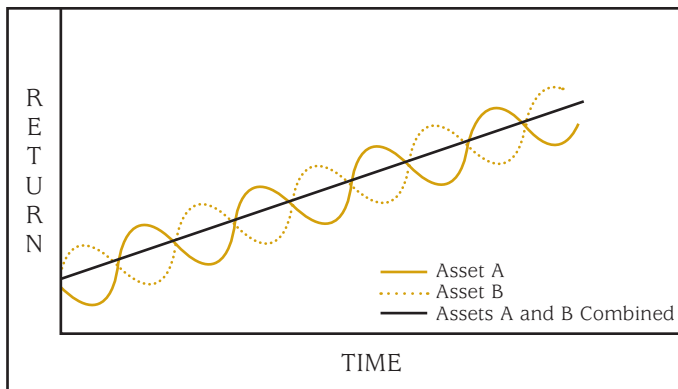
The Concept Of Diversification

The ubiquitous investment term, diversification, although widely used, is too often misused or confused with other investment concepts.

Diversification is the combination of assets that respond differently to changes in the investment environment. For example, energy and airline stocks normally react in opposite directions to significant movements in the price of oil—an increase improves the revenue outlook of energy companies, yet raises the operating costs of airline companies. As a result, a rise in the price of oil will help energy stocks, but hurt airline stocks.

As the correlation of returns among assets declines, such as with energy and airline stocks, the benefit of diversification increases. That is, investments that do not move in lockstep with each other reduce the volatility (risk) of an investor's overall portfolio.

For example, see the graph below. We present the basic case of two assets that respond completely differently to external events. Either asset alone would produce a highly variable return stream. However, when these perfectly uncorrelated assets are combined into one portfolio, the returns are much more consistent and stable (less risky).



In order to structure a diversified portfolio for each of our clients, we use a combination of investments covering domestic large-, mid-, and small-cap stocks, value and growth stocks, domestic bonds, as well as international stocks and bonds. A client's overall asset allocation (the mix of stocks and bonds) and diversification strategy is dependent upon their individual goals, investment time horizon, risk tolerance, and related factors.

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

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When you overhear a friend discuss their latest success with an emerging markets fund over cocktails, your bragging rights over maintaining a diversified portfolio may seem less than satisfying. However, keep in mind that over the long term, a well-structured, diversified portfolio can reduce your overall investment risk and create greater wealth. This approach requires regular rebalancing of your portfolio to maintain predetermined asset allocation and diversification targets. Such a dedicated approach serves our clients well.

Did You Know... A Penny Costs 1.7 Cents

We have all heard about the rising price of commodities over the past few years, including oil and gold, but during the last fiscal year, it cost the U.S. Mint 1.7 cents to produce and distribute each penny, while a nickel cost 9.5 cents! Consequently, "with each new penny and nickel we issue, we also increase the national debt by almost as much as the coin is worth, and these losses are rapidly mounting," according to Edmund Moy, the director of the U.S. Mint, in his testimony before Congress in March.

To reduce the manufacturing and distribution costs of pennies and nickels, the U.S. Mint is considering altering the metal composition and weight of coins. The penny is made of copper and zinc, while the nickel is made of copper and, well, nickel. In the past five years, the cost of copper has risen 440%, zinc is up 260%, and nickel has increased by 310%.

Lou Conrad Named AAIL Boston Chapter President

Louis E. Conrad II, CFA, COMPASS Wealth Management's founder and president, was recently named president of the American Association of Individual Investors' (AAIL) Boston Chapter. AAIL is a national non-profit organization devoted to the unbiased education of individual investors.

Retirement Account Contribution Limits For 2008

Employer-Sponsored Accounts

The amount that you may contribute to an employer-sponsored retirement account did not increase for 2008. 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 remains at \$15,500 for 2008. If you will be 50 years of age or older by December 31, 2008, you may contribute an additional \$5,000 in 2008 (no change versus 2007; also known as the “catch-up” provision).

Contributions to your employer-sponsored retirement account, when 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

Although you may not be able to contribute more in 2008 than in 2007 to an employer-sponsored retirement account, the contribution level did increase for Traditional and Roth IRAs.

For a Traditional IRA, you may contribute up to \$5,000 as your 2008 tax year contribution up until April 15, 2009. If you are at least 50 years old at any time during 2008, 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 (MAGI) must be \$101,000 or less as a single filer to make the full contribution and \$159,000 or less as a married individual, filing jointly. Consequently, if your income level prevents you from funding a Roth IRA during 2008, you may still contribute to a Traditional IRA.

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