THE COMPASS CHRONICLE

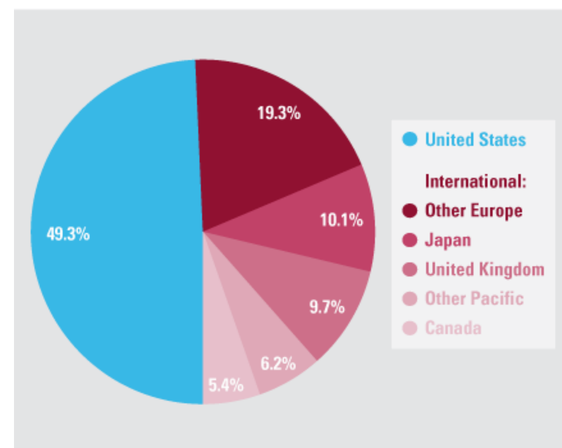
February 2011 | Vol. 1 No. 2 | Wealth Management Update

A World of Opportunity

As trade barriers continue to break down, the world economy has become a small neighborhood. Should investors seek to participate in this wave of globalization, or are they getting all they need here at home?

Historically, foreign investments have acted in a significantly different way from domestic investments. When the U.S. market slumped, various opportunities abroad have prospered. An American investor who put some money into foreign markets may have reduced risk while still attaining attractive returns. With the spread of globalization, this benefit decreases as companies across the globe are acting more like each other. However, as the image illustrates, an investor who doesn't take advantage of options outside of the United States is missing out on roughly half of the investable developed stock market opportunities in the world.

World Stock Market Capitalization
Year-End 2010



International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Source: World Market Capitalization by Country is from the Morgan Stanley Capital International Blue Book℠. The data is expressed in U.S. dollars.

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Advisor Corner

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As an objective and independent fee-only wealth manager, my sole interest is to ensure my recommendations meet your financial goals.

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Our wealth management services include investment management, retirement and gift planning, education funding, and other advisory services.

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Investing in Emerging Markets

- COMPASS has long recommended exposure to emerging market stocks due to the underlying growth prospects of their economies relative to the developed world.
- More recently, COMPASS began introducing emerging market bonds to some client porfolios because, in part, of the financial strength of many of these countries.

Emerging-market economies offer tempting rewards and are becoming more standard among investors willing to take on additional risk. Commonly called developing-market economies, they are in transition but are beginning to see a substantial increase in living standards and income, rapid economic growth and a relatively stable currency. They can be small or large economies and can be found all over the globe. Examples include China, India, Korea and Thailand in Asia; Poland, Egypt, and Turkey in Europe and the Middle East; and Brazil, Chile and Mexico in Latin America. As of May 2010, MSCI Barra identified 21 emerging countries worldwide.

Since these economies are still developing, the risk of an emerging-market investment is higher when compared with a developed market. Some of these risks include currency fluctuations, foreign taxation and political, social, and economic upheaval. However, such added risk comes with the potential for higher returns.

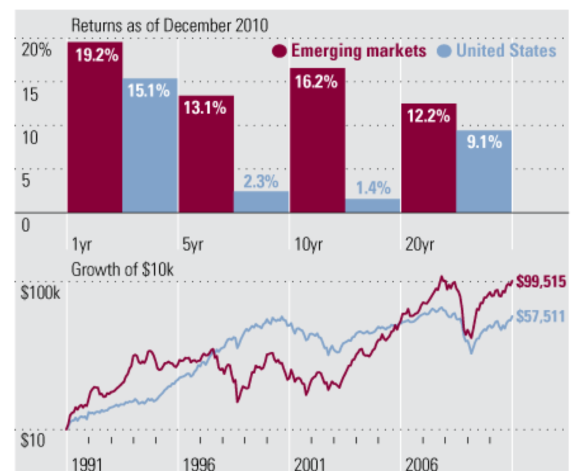
Perhaps the easiest way to include emerging markets in a portfolio is to buy an emerging-markets mutual fund. This is a mutual fund that holds various investments in emerging countries, bringing you the added benefit of diversification. Make sure to read the mutual fund's prospectus very carefully before investing or sending any money.

Another way to invest in emerging markets would be to buy stocks of foreign companies directly—much more difficult and risky to do on your own. You may also hear the term ADR connected with international investing. It stands for American Depositary Receipt, and it is an instrument allowing the stock of a foreign company to trade on a U.S. exchange. However, no matter how you decide to invest, always keep in mind the risks associated with international and emerging-market investments.

The graph illustrates the historical short- and long-term performance of emerging markets compared with U.S. markets. Emerging markets posted very respectable returns, beating those of the U.S. market in every time period. However, these returns came with additional risk, as shown by the volatility of the line graph. A hypothetical $10,000 invested in emerging markets would have grown to $99,515 over this 20-year time frame, compared with $57,511 for domestic investments.

While the emerging markets' ending wealth value easily surpassed that of the U.S. investment, it accumulated over a rather long time horizon. Note that emerging markets can experience a much greater upside and often a deeper downside in any particular year (2008, for example). Consequently, this type of investment is more appropriate for long-term investors who can handle potentially large fluctuations in returns.

Undeveloped Opportunities: 1991–2010



International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Emerging-market investments are riskier than developed-market investments. Liquidity is typically lower in emerging markets than in developed markets. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed.

Source: U.S. stocks are represented by the Standard & Poor's 500® index, which is an unmanaged group of securities and considered to be representative of the stock market in general. Emerging markets are represented by the Morgan Stanley Capital International Emerging Markets Index.

Monthly Market Commentary

Geopolitical news out of Egypt took stage and dwarfed recent economic news and earnings reports. Unrest in the Middle East tends to result in higher oil prices, which created problems for the economy.

GDP: Because of an inventory adjustment, the 3.2% fourth-quarter GDP growth appeared to disappoint investors. GDP growth did accelerate, however, from 2.6% in the third quarter of 2010. On the positive side, GDP has now officially recaptured all that was lost during the 18-month recessionary period. According to Morningstar economists, rock-bottom inventories and the payroll tax cut should lead to higher GDP growth rates in the first quarter of 2011. Export growth remained strong thanks to strong emerging-markets and agricultural categories, contributing about 1% to GDP growth. Business spending was also a small contributor to growth while government spending fell 0.6%, resulting in a small negative impact on GDP. To summarize, consumer goods and services, exports, and imports had a positive impact on GDP, while change in private inventories negatively impacted GDP.

Earnings: Technology and manufacturing sectors showed positive results, while retailers and financial institutions have had a hard time meeting expectations. Companies such as Ford Motors and Amazon revealed disappointing results.

Consumer spending: The savings rate declined to 5.4% in the fourth quarter of 2010 from 5.9% in the previous quarter. This decline may suggest that purchases were made from stock market profits and, possibly, in anticipation of the 2011 payroll tax cut. Consumer spending growth accelerated to 4.4%, the fastest growth rate in consumer spending in more than five years.

Durable goods: December orders for durable goods dropped by 2.5% from November on a seasonally adjusted basis. Recent data suggests a 7% increase above last year's result. However, if the volatile transportation sector is excluded, annual growth could be estimated at 11.5%.

House prices: The Case-Schiller 20-city price index fell by 1% at the end of November 2010. On a year-over-year basis house prices were down 1.6%. However, house prices are up 3.3% compared with the lows of 2009. Morningstar's housing team notes that the rate of decline in markets slowed in November. The real-time listing database has showed signs of improvement, which should start to show in the delayed Case-Schiller statistics in the months ahead.

Home sales: New home sales jumped by 17.5% in December 2010 to reach 330,000. However, this number appeared inflated by an upcoming change in California building code, which makes new homes more expensive and may have caused a sales acceleration in the Western region report. Pending home sales increased by 2%, and the index has moved up during five out of the past six months. Data on the existing home sales indicates an increase to 5.28 million units in a six-month period from the homebuyer-credit-expiration bottom of 3.8 million units.

Employment: Initial jobless claims fell by 42,000, to 415,000. Alabama, Georgia, North Carolina, and South Carolina posted the biggest declines after the four states posted large increases in the prior week because of snow effects. The unemployment rate fell to 9% from 9.4% in December 2010. The most recent employment report suggested that, on a year-ago basis, overall payroll job growth rose to up 0.8% in January from up 0.7% in December. Overall payroll employment increased a meager 36,000 in January, which fell well short of analyst's estimates. Data from ADP, the company that prints payroll checks, indicated that the job market is doing better than the employment report suggests. ADP data suggests that payrolls grew by 247,000 in December and 187,000 in January. According to Morningstar economists, the recent economic data appears positive, and the payroll tax cut should keep the economy humming for a few more months.

The Many Faces of Inflation

- COMPASS continues to believe that general inflationary pressures in the U.S. are currently subdued. Inflation should remain muted as long as the unemployment rate and capacity utilization remain near current levels.
- That said, some commodities have shown recent strength, such as gold and oil.

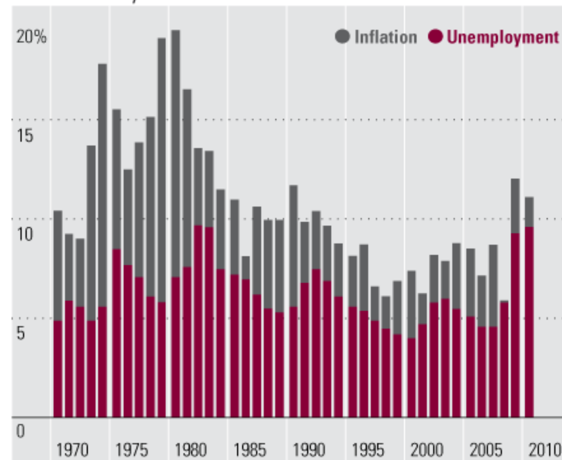
During the recent 2007–2009 recession, it seems all we've seen and heard about the economy was bad news: the housing market collapsing, 401(k)s suddenly being worth much less than before, a lifetime of savings almost disappearing in a few months, rising unemployment, and fluctuating prices. Now that the recession has officially ended in June 2009 and we're on the road to recovery, inflation may become a concern once again. In this uncertain economic climate, it may be helpful to learn about the different types of inflation and their immediate effects.

Inflation: Inflation is defined as a continuing rise in the general prices of goods and services. Simply put, if prices, on average, are going up in an economy, then you've got inflation. With a set amount of money in an inflationary environment, consumers are able to buy less and less over time. High rates of inflation can generate uncertainty, lower productivity and discourage investment. The leading measure of inflation in the United States is the Consumer Price Index (CPI). The government can change its monetary policy to control the money supply and keep inflation in check, although this is not the only variable affecting inflation. In November 2010, the Federal Reserve announced it would buy back long-term Treasuries in order to inject money into the economy, a policy called quantitative easing, which can trigger higher inflation.

Hyperinflation: Hyperinflation is extremely high, out of control inflation, caused by a steep increase in the money supply without a corresponding increase in the output of goods and services. Well-known examples include the German hyperinflation after World War I and the hyperinflation in Hungary after World War II. It appears that such an extreme phenomenon occurs mainly as a result of radical changes and prolonged economic instability.

Deflation: Deflation is the opposite case: a general decline in the prices of goods and services. In the U.S., deflation occurred as recently as 2008 and 2009: The change in CPI was negative in the third and fourth quarters of 2008 and in the fourth quarter of 2009, a clear indicator of deflation. The obvious positive effect here is lower prices—many argue that deflationary periods are good times to buy. The problem with deflation, though, is that consumers reduce spending and businesses stop growing, which is not good for the economy.

Stagflation: This is the worst-case scenario: high inflation and slow growth simultaneously. Normally, there is an inverse relationship between inflation and unemployment; if the economy is able to tolerate a higher rate of inflation, lower unemployment can be achieved, and vice versa. But during a stagflation period, both inflation and unemployment go up. An interesting measure for stagflation is the misery index, which, as illustrated in the image, combines the unemployment and inflation rates. The U.S. experienced severe stagflation in the 1970s, when unemployment and inflation reached a combined high of almost 20%. There has been talk of stagflation during the recent crisis as well, but the potentially encouraging news is that the misery index is not nearly as high now as it has been in the past.



Source: Inflation is represented by the Consumer Price Index, and unemployment by the national unemployment rate, not seasonally adjusted, from the Bureau of Labor Statistics.

Insuring for Long-Term Care

By Louis E. Conrad II, CFA

- As the article highlights, costs associated with long-term care can quickly deplete your assets, thereby jeopardizing your financial security.
- However, long-term care insurance can be purchased to help defray potential long-term care costs.

Long-term care costs can be one of the biggest risks to a retiree's nest egg. Long-term care refers to a broad range of services designed to provide ongoing care for people with chronic challenges who have lost the ability to function independently. The need for care arises when physical or mental impairments prevent an individual from performing certain basic activities (called ADLs), such as bathing, continence, dressing, eating, toileting, and transferring. Long-term care services may be provided in a variety of settings, such as the home, adult day care centers, assisted living facilities, or nursing homes.

Probability and Duration of Care

Based on data originally published in 2004 by the National Bureau of Economic Research, roughly two-thirds of 65-year olds will enter a nursing home. Twelve percent of men and 22 percent of women will have a stay of greater than three years, while one in eight women will actually reside in a nursing home for more than five years. These figures do not reflect the probability that an individual may need in-home health care, assisted living, or other community-based, long-term care services.

Costs of Care

The costs of long-term care add up quickly. According to the Genworth 2010 Cost of Care Survey, in Massachusetts the median daily rate was $321 for a private room in a skilled nursing home or $117,000 per year. This type of expense can quickly drain your retirement savings that took years to build. Home health care can be costly too. According to the same survey, the median hourly rate was $24 for a licensed home health aide in Massachusetts or $70,000 per year with eight hours of coverage each day.

Medicare and Medicaid

A common misconception exists that these costs are paid for by Medicare, the federal medical insurance program designed for people at least 65 years of age or the disabled. Medicare will only pay up to 100 days in a nursing home if you qualify at all, and will only cover certain types of skilled care in your home. In addition, if you purchase a Medicare Supplemental (Medigap) plan or participate in a Medicare HMO plan, these plans will typically not cover long-term care services that are not paid by Medicare.

On the other hand, Medicaid does cover long-term care, but it is a welfare program. To qualify, patients must have limited assets and those who might consider transferring assets for the purpose of qualifying for Medicaid should realize that legal restrictions exist.

Long-Term Care Insurance

You work a lifetime to build your assets—incorporating long-term care insurance (LTCI) into your retirement plan as an asset protection strategy may make sense.

LTCI contractually pays a selected dollar amount per day for a stated period of time for care in nursing homes and other settings, such as home health care. Other services may be included, such as adult day care, adult foster care, chore care, homemaker services, and respite care. Services will be covered if they are either medically necessary or if the policyholder needs assistance with at least two or three ADLs.

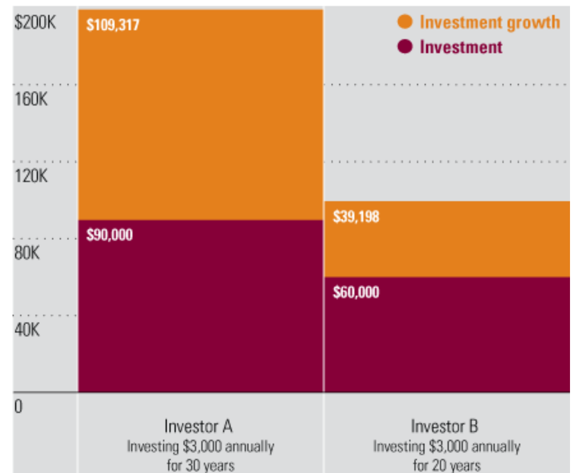
LTCI can be costly for individuals who are insurable. Depending on your age at application and the coverage selected, annual premiums can range from $1,000 to $10,000 or more. Despite the cost of annual premiums, LTCI should be a consideration for many individuals to help protect their wealth from potential and significant long-term care costs.

The Costs of Financial Procrastination

Retirement usually doesn't start until you're in your 60s but there is a good reason to start saving much sooner. The earlier you contribute to your nest egg, the more time your portfolio will have to grow in value.

The image illustrates the ending wealth values and effects of compounding of two investment portfolios. Consider two hypothetical investors who begin investing $3,000 at an average annual rate of return of 5%. Investor A invests $3,000 for a 30-year period, which results in an ending wealth value of $199,317. On the other hand, investor B invests $3,000 for a 20-year period, which results in an ending wealth value of $99,198. Investor A invested an additional $30,000 compared to Investor B. However, a large difference in the ending wealth value can be attributed to the compounding effect of the $30,000 for the additional 10 years. In other words, your dollars saved now will be worth a lot more than your dollars saved in retirement.

The Effect of Compounding



Source: This is for illustrative purposes only and not indicative of any investment. The image represents a hypothetical rate of return of 5%. The values represented do not account for inflation or taxes. Past performance is not a guarantee of future results. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment advice. Please consult with your financial professional regarding such services.

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