THE COMPASS CHRONICLE

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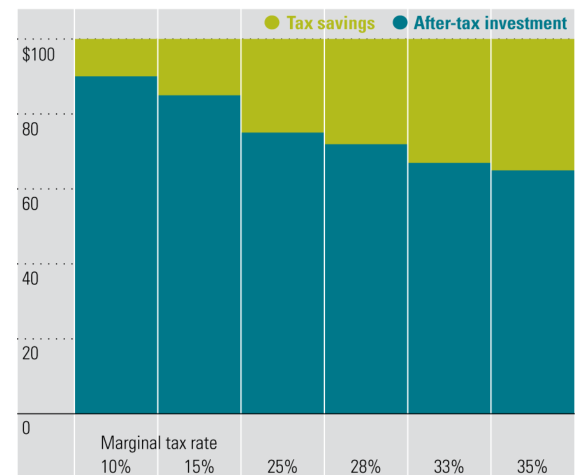
401k Contributions and Tax Savings

A commonly-overlooked benefit of 401k investing is that contributions can be made pre-tax, so that even a small contribution can go a long way. In this situation, 401k contributions are not taxed until you retire. Therefore, the more you contribute to your retirement account, the smaller your taxable income becomes, and the more federal taxes you are able to defer.

The image presents the tax savings (reduction in tax liability) achieved by a 401k contribution of $100 for six marginal tax rates. For example, if you are subject to a 35% marginal tax rate and you choose not to contribute, you will pay $35 in taxes and only have $65 available to invest in another account. If, however, you invest pre-tax in your 401k, you will have $100 that is yours and can grow tax-deferred until you retire.

Tax Savings from Investing in a 401k Plan



This is for illustrative purposes only and should not be viewed as tax advice. Be sure to consult with a financial advisor or tax professional for the latest rules and regulations.

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Advisor Corner

I pride myself in offering you expert financial advice along with personalized service. Assisting you in reaching your financial goals is my business and I take that responsibility very seriously.

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

COMPASS Wealth Management, LLC is a client-focused wealth management firm dedicated to providing superior advice to individuals, families, and corporate retirement plans.

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

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For details on the selection criteria used to determine the recipients of the 2011 FIVE STAR Wealth Manager award, please visit our web site.

Monthly Market Commentary

The market's primary focus during April was corporate earnings, which were generally positive. The technology and manufacturing sectors produced exceptional results while consumer spending, inflation, manufacturing, and the Chinese economy continued on their strong upward trajectories.

Earnings: The technology sector showed promise as both Apple and Intel reported stellar results. Besides robust tech earnings, results in the manufacturing sector were also encouraging. Organic growth (versus acquisition-driven growth), auto-related data, and capital goods were positive. Earnings from the banking sector however, weren't as strong. New loan growth at many firms including J.P. Morgan Chase was almost non-existent. Overall, J.P. Morgan Chase revenues declined 9% while profits increased about 67%. Rising commodity prices were the main reason for mixed earnings in consumer-oriented firms. At McDonald's, revenue increased but the stock fell about 1.9%.

Housing: According to the federal government report, home prices were down 1.6% from January to February. Existing home sales increased 3.7%, reaching the 5.1 million unit mark. During the housing boom in 2005, the annualized number of existing home sales was as high as 7.4 million units. Outside the couple of odd months near the expiration of the two housing credits, the lowest sales number was about 4.5 million units.

Inflation: Inflation reports from around the world were higher than expected. Year-over-year inflation accelerated to 5.4% in China in March 2011. In the euro zone, month-to-month inflation (annualized) accelerated to 2.7% in March up from 2.4% in February. Inflation continues to accelerate around the world despite attempts by central bankers worldwide to tighten rates and boost reserve requirements. During March, the U.S. producer price index and the consumer price index moved up 0.7% and 0.5%, respectively.

GDP: The recent GDP report suggested a growth rate of 1.8%, in line with expectations but well below the fourth quarter number of 3.1%. This slowing was largely due to shifts in government defense spending and weather-related construction spending. The U.S. consumer spending growth came in at 2.7%, higher than the expected growth of 1% to 2%. Business investment spending grew 11% during the first quarter, while government spending (which comprises about 20% of GDP) fell 5%.

Auto sales: Motor vehicle sales typically tend to be good indicators of consumer spending. The recent motor vehicle sales report indicated no change in the mix between domestic and import brands, which appears to be a sign that Japanese supply issues weren't holding back sales.

Unemployment: The recent unemployment report revealed a 43,000 surge with claims for unemployment rising to 474,000, the highest level in eight months. The report suggested that the adjustment timing for a spring break in New York State followed by a new emergency benefit plan in Oregon were the main reasons for this surge.

Employment: Employers added 244,000 jobs in April, which came in much higher than analysts' estimates for the month. Goods-producing and service-providing sectors experienced the most job growth while government jobs posted a decline. On a year-over-year basis, overall payroll job growth increased 1%.

According to Morningstar economists, auto sales figures, employment, production and manufacturing statistics, will remain key indicators of future economic health in the weeks ahead.

Investing Without Emotion

By Louis E. Conrad II

- According to Warren Buffet, the highly regarded investor and chairman of Berkshire Hathaway, "success in investing doesn't correlate with IQ....Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing....successful investing requires something perhaps even more rare: the ability to identify and overcome one's own psychological weaknesses."

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.

As Warren Buffet suggests, investors are challenged by their own emotions in making good investment decisions. In fact, a study conducted by Dalbar, a provider of financial services industry research, found that the average investor dramatically underperforms broad stock and bond indices, with stock returns lower than the rate of inflation.

A slew of psychological challenges face each investor.

Rearview Mirror

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 the past stock appreciation, though consistent with a bubble, would continue indefinitely.

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

Confirmation Bias

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 downside potential of such investing. Unfortunately, to obtain the greater returns offered by stocks, you need to accept the greater risks that accompany them—stock returns are not asymmetric!

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!

To avoid being overrun by emotions, COMPASS Wealth Management designs portfolios with a structure that incorporates a client's goals, investment time horizon, etc. By consistently following a disciplined process, the chances of creating the wealth necessary to meet a client's financial goals are improved.

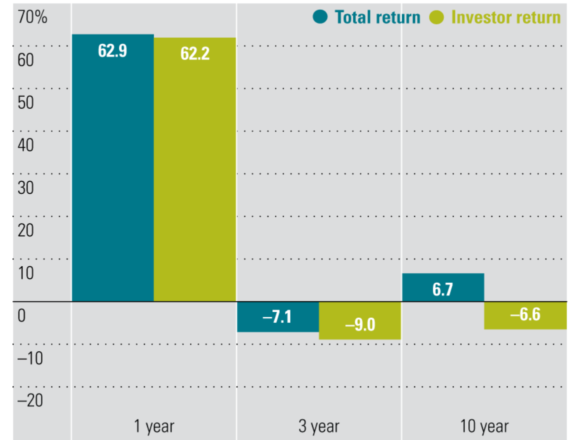
Chasing Performance

- In the prior article, "Investing Without Emotion," we outlined how investors too often make emotional decisions that negatively impact their portfolio returns.
- This article provides data calculated by Morningstar that differentiates between the returns generated by a mutual fund and the reduced returns enjoyed by the average investor in the fund due their poor timing decisions.

Investors often endure poor timing and planning as many chase past performance. They buy into funds that are performing well and initiate a selling spree following a decline. This becomes evident when evaluating a fund's total return compared with the investor return. Overall, the investor return translates to the average investor's experience as measured by the timing decisions of all investors in the fund.

The image illustrates the investor return relative to the total return for a given fund. Over the short term, both the total and investor returns were positive, with the investor return ending slightly lower. Over a 10-year period, however, total return greatly exceeded investor return. Investors who attempted to time the market ran the risk of missing periods of exceptional returns.

Comparison of a Fund's Return Performance Over Time



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Returns and principal invested in stocks are not guaranteed. Morningstar investor returns measure how the typical investor in that fund fared over time, incorporating the impact of cash inflows and outflows from purchases and sales. It is not one specific investor's experience, but rather a measure of the return earned collectively by all the investors in the fund. Total return measures the percentage change in price for a fund, assuming the investor buys and holds the fund over the time period, reinvests distributions, and does not make any additional purchases or sales. Investor returns are not a substitute for total returns but can be used in combination with them. Data as of February 2010.

Source: The fund illustrated in this example was selected from Morningstar's open-end database.

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