# The COMPASS Chronicle

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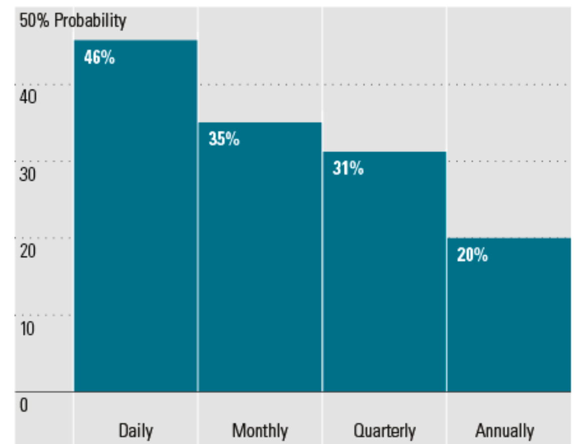
## Short-Term Focus: Coping with Near-Term Fluctuations

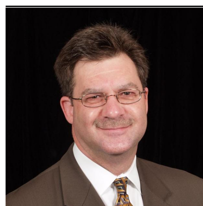
- COMPASS counsels its clients to focus on meeting their long-term goals with long-term investment plans. A key ingredient for a successful investment strategy is to not allow short-term noise to alter this focus.
- When looking at a diversified portfolio comprised of 60% stocks and 40% bonds, there has been no 10-year period over the past 100 years that experienced a negative return.

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1994–2013




Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.



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### More about COMPASS Wealth Management, LLC

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.

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

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

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# ETFs Versus Actively Managed Funds

- Think of ETFs as index funds that offer intraday tradability.
- They are generally low cost, which is important, and can be relatively tax efficient.
- However, COMPASS has found its approach of carefully constructing a portfolio of actively managed mutual funds can provide its clients with enhanced returns and reduced risk than can be found by passive investing alone.

Do we have a winner? Ever since passively-managed funds like exchange-traded funds (ETFs) came into being, there has been much debate about active management versus passive management. Research published by industry professionals presents different arguments. Some studies show that only a fraction of active funds beat their respective benchmarks. Other studies show that, while active funds have failed to beat their benchmarks, they do provide added-value when a disciplined approach is adopted over longer periods.

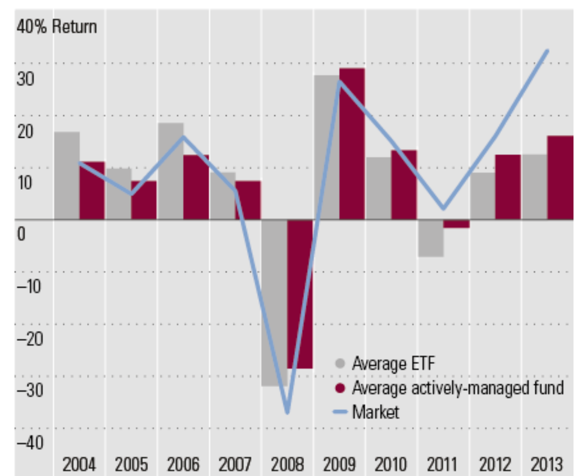
An exchange-traded fund strives to achieve a return similar to a particular market index. The ETF will invest in either all or a representative sample of the securities included in the index that it is seeking to imitate. ETFs provide passive diversification, are tax-efficient investment vehicles and have cost advantages. However, the return on an ETF is capped by the return of the index it tracks. Active managers, on the other hand, attempt to pick the best investments in the market and, if well executed, their performance is not limited by the return on an index. However, active funds are prone to style drift—the tendency of a fund to deviate from a particular investment style over time to improve performance. These modifications in investment style may be attributed to changing trends in the market environment.

Let's take a look at how the "average" ETF and "average" active fund performed over the last decade. The image compares the performance of the "average" ETF with the "average" actively managed mutual fund during the past 10 years. As evident from the image, in periods of poor market performance (2008 and 2011) when the market experienced negative or very low returns, the "average" actively managed mutual fund performed better than its passive counterpart. When the market experienced strong positive performance, ETFs fared better in some years (2004 to 2007, for example). In other years, actively-managed funds performed better (2012 and 2013).

Why is this, you may ask? One reason for this behavior is the underlying structure of active and passive funds. Passive funds like ETFs are designed to track a particular index or benchmark. This means that when the benchmark experiences poor performance, the ETF also fares badly. On the other hand, active managers may be able to quickly adjust their portfolios depending on the underlying market conditions. This may be one reason for better performance in down markets.

Making a choice between active and passive investing isn't an easy one. When deciding which style of management is better for you, it is important to take into account several factors, such as costs, style, risk, transparency of investments, manager performance, and tax implications. Consult your financial advisor to learn more about investing in ETFs and actively managed funds.

## Performance Over the Past 10 Years




This information is for illustrative purposes only and not indicative of any investment. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Investors should read the prospectus and consider this information carefully before investing. ETFs are subject to similar investment risks as common stocks. An ETF's performance may not be exactly that of its underlying index. Past performance is not a guarantee of future results; holding a portfolio of securities for the long term does not ensure a profitable outcome. Investing in securities always involves risk of loss. An invested cannot be made directly in an index.

Source: The market is represented by the Standard & Poor's 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Average ETF and average mutual fund performance from Morningstar's open-end database.

# Monthly Market Commentary

Even though the U.S. market lost 3.5% in January, investors still seemed hopeful about continued low interest rates (now more likely, given soft economic activity) and about the potential for slower Fed tapering of bond purchases. (However, interest rates continue to decline even as the Fed tapers.)

Speaking of soft economic activity, recent auto sales, manufacturing data, trade data, construction spending, and employment all fell well below plan. About the only good news was that the U.S. government's fiscal situation continues to improve, with forecasts of declining budget deficits reiterated again this week. Bad weather in the Midwest and Northeast isn't helping the overall economic picture, but it probably isn’t the entire reason for the poor data reports that now stretch across several months and many data points.

Employment: Total nonfarm payroll employment rose by 113,000 in January, and the unemployment rate was little changed at 6.6%. Sectors that saw improvement included construction, manufacturing, wholesale trade, and mining. Health care and education added almost no jobs for the second month in a row, after being the bulwark of job growth for a large part of the economic recovery. Cost controls and fear of Affordable Care Act provisions seem to have really kept a lid on health-care hiring, and unless health-care employment turns the corner, it will be a major impediment to employment growth in 2014.

GDP: The first run of the GDP report for a given quarter comes out one month after the end of the quarter and is revised twice based on new or revised data. Much of the actual data released the first week of February for inventories, net exports, and construction data contradicted previous estimates. When all these potential revisions are added together, Morningstar economists caution they could take as much as 0.9% off of the original GDP estimate, meaning the economy potentially grew a slower 2.3% in the fourth quarter of 2013, instead of the 3.2% originally reported.

Trade: The headline trade deficit widened markedly in December to $38.7 billion, up from $34.6 billion in November, which was unusually good. However, it wasn't far off of the average for all of 2013 of $39.3 billion. (A smaller trade deficit is positive for the economy.) That full-year average represents a huge improvement from $46.4 billion in 2012 and $44.6 billion in 2011. During an economic recovery, the trade deficit almost always widens as exports and imports usually grow at relatively similar rates, and imports are far larger than exports. Decreased oil imports and oil-related exports are clearly making a difference. However, it's not just about oil; imports across the board have increased, as they often do in a recovery. Still, exports of non-oil-related goods have done even better.

Consumer Spending: Over the third quarter of 2013, income growth (as measured by real disposable income) exceeded consumption growth in each individual month of the quarter. That situation exactly reversed itself in the fourth quarter when consumption growth far exceeded income growth in every month.

Housing: Pending home sales continued to fall in December, hitting their lowest level since 2011. Although higher rates and stronger home prices have plagued this data point since May, this month was likely affected by poor weather conditions. But even averaging the data and looking year over year, the trend in pending home sales has been abysmal. Pending home sales are important because they are a leading indicator of closed existing-home sales. It is those closed deals that generate remodeling, moving, furniture buying, and mortgage activity that is helpful to the economy. Judging by the gap between the pending sales index and the existing-home sales index, existing-home sales are likely to fall even more in the early months of 2014.

# The Cost of Taking a Cash Distribution

- COMPASS advises its clients that pursuing option 4 in this article, taking a cash distribution from an employer-sponsored retirement plan, is "expensive money".
- Such an action will subject the distribution to your marginal federal and state income tax rates, plus a 10% penalty if you are under 59 1/2. A distribution could also push you into a higher federal income tax bracket.

Deciding what to do with your 401(k) balance when you leave a job does not have to be difficult. It is something that almost everyone will have to do at some point. The best approach is to look at the various options, understand the differences, and figure out how your decision will impact your ability to save for retirement. In general, here are the options available: 1. Keep your savings in your previous employer's 401(k) plan (typically allowed if you have a balance of $5,000 or more); 2. Transfer your savings to your new employer's 401(k) plan; 3. Transfer your savings to a Rollover IRA; 4. Take a cash distribution.

Let's look at a hypothetical example of an individual with $20,000 in a 401(k) who has left his or her job. This person now has to choose between the options above. Let's assume a hypothetical 8% annual return over a 20-year period. If the money was kept in a 401(k) plan or rolled into a traditional IRA, it would have grown to $93,219 over 20 years. Alternatively, you could spend the $20,000 or put it into a taxable account, but these options do not provide the benefits of tax deferral. Furthermore, the tax consequences and early withdrawal penalties involved with the cash distribution would greatly reduce the actual amount of cash received.* While cashing out from your retirement plan when you leave a job may seem like an attractive option, even the smallest withdrawal may have more sizeable financial consequences than you realize.

* Withdrawals from tax-deferred accounts will be taxed at then-current rates. Early withdrawals may be subject to surrender fees, and withdrawals made prior to age 59½ may be subject to a 10% IRS penalty tax. Past performance is no guarantee of future results. You should consult your tax advisor as to the consequences of a particular investment.

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