THE COMPASS CHRONICLE

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COMPASS Update

In addition to its direct work with clients, COMPASS Wealth Management, LLC has been active in the investment and financial planning community.

National Speakers Bureau

Louis E. Conrad II, CFA, COMPASS' president, was recently added to the national speakers bureau of the American Association of Individual Investors (AAII). AAII is a non-profit organization of 150,000 members dedicated to educating individuals on investment-related topics. Lou is the immediate past president of the Boston Chapter of AAII.

Lou will be traveling to Florida in February 2012 to make five presentations before AAII groups. He will be presenting "Behind the Curtain," his exposé of the mutual fund industry and the inherent conflicts between mutual fund companies and their shareholders. As a former mutual fund manager, Lou has special insight into the challenges facing mutual fund investors.

In September, Lou traveled to Westport, CT to present "Behind the Curtain" before AAII members. In the past year, Lou also made two presentations to the Retirement Investing group of the Boston Chapter of AAII. He presented "Behind the Curtain," but also "Retirement Reality," a review of the challenges confronting those preparing for or living in retirement.

Putnam RIA Advisory Council

Lou was recently asked by Putnam Investments to join its RIA Advisory Council, a group of six registered investment advisors (RIAs) created to exchange ideas on ways for Putnam to enhance its services to RIAs and their clients. Lou has been a member of Fidelity Institutional Wealth Services' Advisor Council, which serves a similar purpose.

COMPASS Wealth Management

MORNINGSTAR

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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.

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

Managing Risk through Diversification

By Louis E. Conrad II

- One of the simplest methods of reducing risk in a fully invested portfolio is through diversification.
- A diversified portfolio benefits from holding assets that respond differently to market influences--the returns of holdings are not perfectly correlated.

With the stock market's wild gyrations in recent weeks, you may be wondering how you can reduce the risk in your portfolio. If you react emotionally to market volatility, odds are you will violate the market adage of "buy low, sell high."

Diversification

Structuring your portfolio to be diversified helps to manage its risk. Diversification is the combination of assets that respond differently to changes in the investment environment. For example, oil and airline stocks normally react in opposite directions to significant movements in the price of oil—an increase improves the revenue outlook of oil companies, yet raises the operating costs of airline companies. As a result, a rise in the price of oil can help oil stocks, but hurt airline stocks.

Correlation

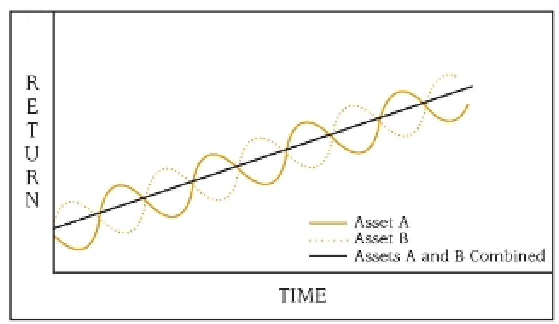
As the correlation of returns among assets declines, such as with oil and airline stocks, the benefit of diversification increases. That is, investments that do not move in lockstep with each other reduce the volatility (risk) of an investor's overall portfolio. Diversification's goal is not to enhance returns—in fact, it does not even guarantee a profit—but to reduce risk.

For example, see the accompanying graph. The basic case of two assets that respond completely differently to external events is presented. However, when these perfectly uncorrelated assets are combined into one portfolio, the returns are much more consistent and stable (less risky).

In the short term, the benefit of diversification can be obscured by volatile markets. Correlations between different types of investments are not static and can change dramatically, which occurred during the financial crisis of 2008 – 2009.

In order to structure a diversified portfolio, you should use a combination of investments covering domestic stocks, including representation of large and small companies, value and growth-oriented stocks, as well as international stocks, including those of developed and developing countries. In the bond arena you should consider investing in domestic and international bonds of varying sensitivities to interest rate changes. Depending on your income level and the mix of your retirement and non-retirement assets, you may want to consider municipal, government, or corporate bonds.

Your overall asset allocation (another commonly used investment term that refers to the mix of stocks, bonds, cash, and other investments in a portfolio) and diversification strategy is dependent upon your individual goals, investment time horizon, risk tolerance, and related factors. These are the types of decisions we assist our clients with in structuring their portfolios.



Government Health-Care Spending: Medicare

- This article, written by Morningstar, outlines the establishment and growth of the Medicare program.
- The different parts that comprise this federal health insurance program are also reviewed.

It is a well-known fact that the United States spends much more than other developed countries on health care, both in absolute dollars and as a percentage of GDP. Two enormous, complicated programs, Medicare and Medicaid, account for the majority of government health-care spending in the U.S. Both programs have been growing rapidly, which is expected to continue in the coming years.

Medicare and Medicaid were both created in the mid-1960's as part of Lyndon Johnson's Great Society agenda. As of 1970, 62% of total health-care spending was still private, with out-of-pocket spending the single most significant source. During the subsequent forty years, however, Medicare and Medicaid each expanded by more than 11% annually due to benefit expansions and demographic change, pushing public-sector spending up to nearly 50% of total health-care expenditures. During the same time, private-sector spending also grew at a robust 8.7% annually, as employer-sponsored insurance became the predominant conduit of health-care spending.

Looking forward, the Centers for Medicare & Medicaid Services (CMS) project 6.5% annual health-care spending growth over the next decade. Public sector growth is again expected to outpace private spending growth, with a 6.9% growth rate compared to 6% for the private sector. Combined, Medicare and Medicaid are expected to account for 39% of U.S. health-care spending in 2019, up from 37% in 2010 and 17% in 1970.

Medicare is a federal government program that provides health insurance to people over age 65, and people with certain disabilities. In 2009, more than 43 million people received health insurance benefits through Medicare at a total cost of approximately $510 billion. Medicare benefits are divided into three parts: Part A Hospital Insurance, Part B Medical Insurance, and Part D Prescription Drug Insurance. Part C created a private version of Medicare, now called Medicare Advantage. More details about these benefits can be found in the attached table.

Original Medicare's relatively high cost-sharing provisions and lack of a limit on out-of-pocket spending can leave beneficiaries exposed to potentially devastating expenses in the case of a serious adverse health event. For this reason, most Medicare beneficiaries also carry supplemental insurance. Employer-sponsored retiree health plans, though becoming less common, still cover approximately 30% of the Medicare population. 20% of Medicare beneficiaries purchase individual supplemental policies, also called Medigap policies. Medicaid helps pay Medicare's premiums and cost-sharing for another 20% of the Medicare population. Only about 10% of Medicare beneficiaries are estimated to be completely without supplemental coverage.

Medicare Benefits Breakdown

Benefit	Approx. % of Spending	What Does It Cover?	What Does It Cost Beneficiaries?
Part A	39	Inpatient hospital care, skilled nursing facilities, and in some cases hospice or home care.	Generally no monthly premium as long as the beneficiary paid sufficient payroll taxes while working. Deductible and co-insurance for hospital stays exceeding 60 days.
Part B	26	Physician services, outpatient care, and in some cases physical or occupational therapy and home health care.	Monthly premium, deductible, and 20% co-insurance after the deductible is met.
Part C	23	Same benefits as Part A, Part B, and often Part D. Medicare Advantage plans are offered by private insurance companies as an alternative to original government-run Medicare.	Monthly premium, deductibles, co-pays, and co-insurance.
Part D	11	Prescription drugs.	Part D benefits are only offered through private insurance companies, which charge a premium in addition to deductibles, co-pays, and co-insurance.

Source: Kaiser Family Foundation and Medicare.gov

Government Health-Care Spending: Medicaid

- Also written by Morningstar, the Medicaid health insurance program is reviewed in this article.
- The impact of the recently passed Patient Protection and Affordable Care Act (also known as "Obamacare") on the Medicaid program is discussed as well.

It is a well-known fact that the United States spends much more than other developed countries on health care, both in absolute dollars and as a percentage of GDP. Two enormous, complicated programs, Medicare and Medicaid, account for the majority of govern¬ment health-care spending in the U.S. Both programs have been growing rapidly, which is expected to continue in the coming years. As illustrated in the image, Medicare and Medicaid are expected to account for 39% of U.S. health-care spending in 2019, up from 37% in 2010.

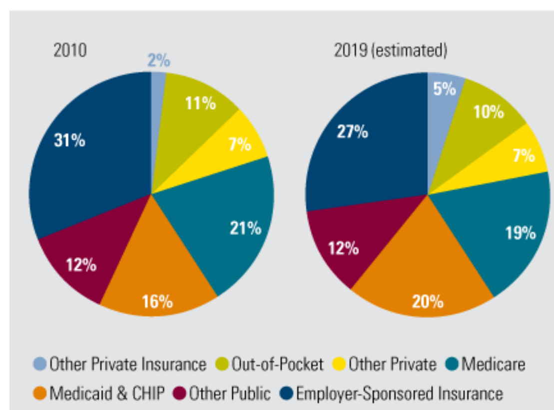
Medicaid is a joint federal-state program that provides health insurance to low-income people. Each state runs its own program and has discretion over benefits and eligibility within federal guidelines. A related program, the State Children's Health Insurance Program (SCHIP or CHIP), covers children from families who make too much to qualify for Medicaid but not enough to afford private insurance.

In 2007, on average 49.1 million people received health benefits from Medicaid. However, 61.9 million people received benefits at some point during the year, as varying economic circumstances led people to transition into or out of Medicaid. Medicaid cost $390 billion in 2009, with about two-thirds of that money coming from the federal government and the remainder from the states. The federal share of costs—called the Federal Medical Assistance Percentage (FMAP)—de¬pends on income levels in the states but is at least 50%. As part of the 2009 stimulus package (the American Recovery and Reinvestment Act), the FMAP was temporarily increased on condition that states accepting the increase could not reduce their Medicaid eligibility levels.

Medicaid beneficiaries are very diverse with widely varying health-care needs. Although children, their parents, and pregnant women accounted for around 75% of Medicaid enrollees in 2007, they only accounted for 32% of Medicaid spending. Aged, blind, and disabled members are gener¬ally much more expensive. Approximately eight million Medicaid enrollees also receive Medicare benefits, and are known as "dual eligibles." Medicaid does not require beneficiaries to pay premiums, and cost sharing is generally very limited, making Medicaid the nation's most important payer of long-term care services.

Medicaid will experience some of the most radical changes under the Patient Protection and Afford¬able Care Act. Starting in 2014, the program will be expanded to cover nearly anyone under age 65 with income up to 133% of the federal poverty level, including adults without dependent children. This is expected to result in 16 million new Medicaid beneficiaries, representing half of the health-reform-related increase in the number of people with insurance. The federal government will pay for 100% of the costs of newly-eligible Medicaid beneficiaries from 2014-2016, phasing down to 90% by 2020.

U.S. Health-care Spending by Source in 2010 and 2019



Source: CMS National Health Expenditure Data

Staying in Style

- This article, when read in conjunction with "Managing Risk through Diversification," helps clarify the concepts of asset allocation, diversification, and style.
- COMPASS constructs portfolios for clients with an appropriate asset allocation and a diversified mix of assets. Mutual funds are then painstakingly selected that offer the best combination of reward for the risk undertaken.
- A fund's style purity is one of the key factors COMPASS considers in its due diligence process to control risk exposures in client portfolios.

Most financial professionals agree that the asset-allocation decision is one of the most important factors in determining both the risk and the return of an investment portfolio. Asset allocation is the process of combining asset classes such as stocks, bonds, and cash into a portfolio that will meet your goals. Taking this process a step further means selecting mutual funds to represent a certain segment or style for your overall portfolio (large stocks vs. small stocks, growth stocks vs. value stocks, etc.).

This can be a challenging task, and once the process is complete and the portfolio of mutual funds built, you'll need to consider something else: style drift. Style drift occurs when actively-managed mutual funds deviate from a particular investment style over time in an effort to potentially improve performance. While improved performance might not seem like a bad thing, a shift in style can be hazardous because it alters your risk exposure and return profile.

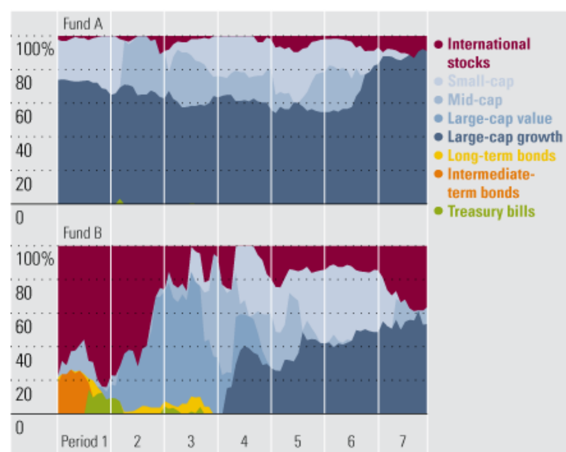
For example, let's say you held a large percentage of your portfolio in a large-cap stock fund. Now, at a certain point in time, this fund's manager got convinced that small stocks would benefit due to certain market conditions. Acting on this belief, he shifted the strategy of what was supposed to be a large-cap stock fund by buying an unusual amount of small stocks. This not only unnecessarily increased the risk of your overall portfolio, but also potentially set you up for large losses if small stocks were not going to behave the way this manager expected.

Style analysis is a technique used to understand investment style and identify the behavioral characteristics of a fund. It matches the returns of a fund to a mix of asset-class benchmarks that best describe the fund's behavior. This process can aid investors and advisors in the selection of funds to assemble a diversified portfolio.

The graph shows the rolling style analysis over time of two hypothetical mutual funds with the same stated objective. Although these two funds have the same objective, their style and consistency differ greatly. Look at international stocks, for example: In Period 1 and Period 2, Fund B had a much higher exposure to international stocks than Fund A. Such style drift can indicate that your manager is not following the fund's stated objective.

If you notice your fund manager jumping on the bandwagon of past trends, he may be trying to save his own hide. Remember, the goal is to buy low and sell high, not jump in late and hope for the best. It takes real discipline to stick to a set of stated investment objectives. So always keep an eye on your investments and evaluate funds periodically to make sure they fit your asset allocation appropriately.

Understanding Fund Behavior: Some Funds Do Not Behave as Advertised



The percentages illustrated in the image are based on each hypothetical fund's returns-based style analysis results using 36-month rolling periods. Style analysis represents the best combination of benchmarks that match the variation in fund returns over the time period. It does not represent actual holdings.

Monthly Market Commentary

August saw market participants reacting wildly to any economic news, good or bad. As new worries in Europe, compounded by a European slowdown in second-quarter GDP growth, developed, investors were concerned that it would be more difficult for Europe to deal with its intractable debt crisis. On the other hand, factory orders, home prices, and consumer spending looked positive, and equity markets followed the news flow. Markets collapsed on the Friday before Labor Day long weekend because the overall economic news was bad, but not bad enough for Bernanke to reconsider another round of quantitative easing.

GDP: Second-quarter GDP was revised downward to 1.0% from 1.3%. The reduction was mainly because of changes in export data and inventory adjustments caused by slowing inventory growth. While a lower GDP growth number is never good news, consumption and business spending actually improved, setting us up for a better third quarter. Growth of 2.5%–3% is generally considered normal growth for the U.S. economy, indicating that we’ve so far had a lackluster recovery in the first half of 2011.

Employment: August reported no job growth, although the report was distorted by the 45,000 striking Verizon Communications employees who were considered unemployed. The government sector continued to contract, and that was offset by growth in the private sector—led by health-care and business services in August. Hourly wages and hours worked were down, partially because of falling inflation and summer vacations. Unemployment remained flat at 9.1%.

Housing: After a yearlong decline, housing industry prices began to turn upward in the second quarter and in June specifically. With fewer homes entering the foreclosure process, higher rents and a low interest-rate environment could combine with stabilizing home prices, and the construction market may see improvements as early as 2012 given small (165,000 units) new-home inventories and the 110 million or so existing households.

Manufacturing: The ISM Manufacturing Index fell in August, although to a lesser degree than expected, which indicated continued monthly expansion albeit at a very slow rate. One of the causes of concern was a drop in exports, which were a major driver of our economic recovery earlier on in the year. The anemic manufacturing industry also depressed manufacturing employment.

Consumers: Retail consumption continued at a healthy pace in August, led by luxury goods and wholesale clubs, despite Hurricane Irene. Despite Hurricane Irene, supply problems from Honda and Toyota, and weak consumer confidence, August auto sales remained remarkably resilient and stayed flat, though up almost 8% compared with last August. Inflation continued to decline with cheaper gasoline and cheaper cars, indicating stronger inflation-adjusted consumption numbers in the months ahead.

Domestic News: Fed chairman Ben Bernanke’s speech at Jackson Hole, Wyo., where the annual global central banking conference was held, resulted in no immediate third round of quantitative easing but a reaffirmation that low policy rates will be maintained until mid 2013. It was also announced that the Federal Open Market Committee meeting in September will be extended from one to two days, indicating a more thorough discussion in evaluating if further measures will be necessary to help the U.S. economy. Market participants initially reacted negatively to the quantitative easing announcement but later took some solace with the announcement of the no-interest-rate-increase-until-mid 2013 pledge, allowing for a continued cheaper cost of borrowing in the next two years.

A Quick Guide to Home Equity Loans

- Home equity loans and lines of credit are contrasted here.
- COMPASS cautions clients against the use of home equity products to fund their living expenses, pay for extravagant travel, etc.
- If the use of home equity is not tied to the purchase or improvement of an asset (e.g., home remodeling), you may want to reconsider increasing the liability side of your personal balance sheet.

If you as a consumer need an additional line of credit, a home equity loan, also known as a second mortgage where your home serves as collateral, is one of several options that you can choose from. There are two major advantages of home equity loans. First, the interest rate on home equity loans is usually lower than credit cards and other consumer loans. Second, you can usually deduct the interest on home equity loans, unlike other loans. There are two types of home equity loans—fixed-rate loans and lines of credit.

A fixed-rate loan provides a single, lump-sum payment to the borrower, and is repaid over a fixed period of time at a pre-determined interest rate. This is useful if you know how much you would need and when you would be able to pay off the loan.

A home equity line of credit (HELOC) is a variable rate loan that works like a credit card. Borrowers are pre-approved for a specific spending limit and can withdraw money when needed via a credit card or special checks. Similar to a fixed-rate loan, the outstanding loan amount must be repaid in full at the end of the term. However, unlike a fixed-rate loan, HELOC interest rates float up or down, generally adjusted based on the current prime rate. A HELOC is a convenient way to cover short-term, recurring costs, such as quarterly tuition for a four-year college degree.

Although home equity loans do provide attractive rates of financing, we caution consumers to think twice about the reasons why one would need an additional line of credit. If you are thinking about using a home equity loan for day-to-day expenses, one should examine whether you are overspending and possibly sinking deeper into debt. If you end up taking out more money than your house is worth, the interest paid on the loan above the value of the home is not tax deductible.

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