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Securing Your Portfolio

There are a number of ways you can protect your portfolio and your financial well being. Chief among them are insurance, estate planning and protection from identity theft. While nobody likes to talk about insurance (except, of course, those who sell it), some individuals should protect themselves with some basic policies. Here are a few examples.

It's a good idea to purchase a life insurance policy when you have a child. You'll want enough coverage to pay off the mortgage and get the kid(s) through college. Health insurance, of course, is a must. Many people jeopardize their retirement planning by not factoring in the cost of health insurance before Medicare kicks in. If you retire before age 65, be sure to investigate the costs. Disability insurance will help you get through an extended period of time without work. Long-term disability coverage typically provides 60% to 70% of your current income should you run into this unfortunate situation. Also, carrying the appropriate property and casualty insurance (homeowner's, auto, for example) can help you avoid liability lawsuits.

Once you have insurance covered, protect your estate. By neglecting the proper estate documents, you run the risk of damaging your assets. A simple will should suffice for many people. Failure to have a will in place upon your death can mean that your spouse or kids won't get what you intended for them. An attorney can put together a will for you or provide you with more information.

And remember: Always protect your identity. We all know how bad it can be to lose a wallet. Identity theft is even worse, and the number of incidents is unfortunately on the rise. A few simple steps can help prevent this from happening: Invest in a shredder and use it on financial papers, and get a copy of your credit report and verify the information on it.

Advisor Corner

Louis E. Conrad II, CFA
President

lconrad@compassinvest.com
(978) 828-5681
www.compassinvest.com

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.

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Downsizing Your Residence

By Louis E. Conrad II, CFA

- Downsizing your home is usually driven by lifestyle and financial factors.
- You may find that your current home is too large or requires too much maintenance as you grow older.
- From a financial perspective, downsizing reduces your monthly expenses and allows you to extract equity from your current residence, which can be invested in your portfolio. This excess equity can then supplement the assets that are available to meet your retirement needs.

I have found that as clients age, many begin to consider downsizing their homes—that is, moving to a smaller and/or less expensive home. Lifestyle and financial factors are usually behind such a decision, which are the subject of this article.

Some of the more lifestyle-oriented reasons for downsizing your home are: (1) your children have finally left the nest and you have more space than you care to have; (2) you no longer find the same sense of enjoyment or fulfillment in maintaining your home or its exterior landscape; (3) you are becoming physically less able to function within your home and access to a first floor bedroom or handicap accessibility may become necessary; and (4) you are seeking a different climate for your retirement years.

According to a recent report sponsored by the Society of Actuaries, 38% of retirees and 45% of pre-retirees have moved or expect to move to a smaller home or less expensive area to help meet their retirement needs. For most people, home equity comprises the majority of their total assets and, as retirees, they may find themselves house rich, but cash poor.

Between the decline in access to pension plans, the lack of savings in 401(k) plans, and the stock market's poor returns during the Great Recession, more retirees are likely to tap their home equity than they have historically. The growth of your home's equity, through a combination of long-term appreciation, capital improvements, and the payment of mortgage principal, which can be viewed as a type of forced savings, can have a powerful and positive impact on your net worth. Tapping that equity can help offset a shortfall in your retirement assets.

Instead of a reverse mortgage, which was written about previously, downsizing your home can be an effective means of redeploying your equity. The goal is to take your existing equity, purchase a less expensive home with some of the equity, and add the remaining equity to your portfolio. The trade-off is that you are using your excess home equity to supplement your investment portfolio, which may carry more risk, but also more return potential than leaving the excess equity tied up in your residence.

The other financial reason many consider downsizing is to reduce their monthly living expenses, such as a mortgage, real estate taxes, maintenance, water and sewer, utilities, and similar expenses. Both the cash infusion to a portfolio from excess equity and the reduction in monthly expenses can have a significant positive impact on how long your retirement portfolio will last.

From a tax perspective, the first $250,000 of capital gain on your residence is exempt from tax as a single filer. If you are married, filing jointly, you have up to a $500,000 exemption. With both filing statuses, you must have lived in your home for at least two of the past five years to receive the exemption. Your home's cost basis is the price you paid for it, increased by any capital improvements that have been made since its purchase.

One final factor that I incorporate into retirement planning analyses for clients is whether they will downsize within state or move out-of-state. This decision will impact the amount of state taxes a client will ultimately pay.

The decision to downsize is an important one from both a lifestyle perspective, as well as a financial perspective. Your home's untapped equity could be used to supplement your portfolio and help offset any shortfall you would otherwise have in meeting your retirement needs.

Monthly Market Commentary

April employment numbers were low, but auto sales were near record levels, housing data continued to improve, and retail sales are moving ahead at a slow but steady pace.

GDP: First-quarter real GDP growth slowed down to 2.2% from 3.0% in the fourth quarter last year. The number would have been much higher if government-defense and business-construction spending hadn't fallen significantly. In perspective, the drop in GDP growth is not such bad news given all the offsetting factors, and Morningstar economists estimate that we seem to be on track for 2.0%–2.5% growth in 2012 and 2013.

Employment: April's employment report was definitely bad news, with only 115,000 jobs added, a disappointingly low number when compared with the recovery high of 275,000 we saw back in January. If interpreted as a trend instead of as a number, this could mean more bad months ahead. However, weather, the auto industry, and seasonal factors can affect month-to-month employment data, making the bad news seem worse than it actually is. Examining the data year-over-year can strip out seasonality and eliminate month-to-month anomalies such as strikes or weather-related fluctuations. Year-over-year job growth has been steadily trending upward, from 0.8% in May 2011 to 1.6% in February 2012, then slightly down to 1.4% in April 2012.

Morningstar economists believe that, even though we shouldn't expect high numbers like in January anymore, employment growth will continue and will vary greatly by sector. So far, the manufacturing sector has been performing above average, while government has been experiencing a sharp decline. When comparing current job growth numbers with the ones observed during past recoveries, it becomes apparent that things are a little worse this time around (1.4% employment growth on an annualized basis versus a 1.9% average for the recoveries from the 1982, 1990, and 2001 recessions). Government is the sector with the worst shortfall.

Auto sales: In April, the auto industry experienced its second-best month of the recovery. Sales were not quite as strong as in February, but they were better than in any other month of the recovery since 2009. Strength in the auto sector was a main driver in the recovery, contributing 1.1% of the 2.2% increase in GDP during the first quarter of 2012.

Consumer spending: Inflation-adjusted consumer spending only increased by 0.1% in March, following 0.3% and 0.5% increases in January and February, respectively. However, warm weather and the reduced use of utilities may have played a role in keeping the March number low. On the other hand, year-over-year employment data suggests wage income is up only modestly (maybe 0.5% to 1.0% after inflation), while consumption is growing faster (about 2% after inflation).

Housing: Improvement in this sector has been steady and dramatic, as demonstrated by the Case Shiller 20 City Index, the Federal Housing Finance Administration Report, and pending home sales numbers. With mortgage rates back down, affordability back at record levels, and inventories in several markets near historic lows, the prognosis for further improvement is excellent.

When economies diverge: Can the U.S. economy keep improving if the rest of the world slows down? The Eurozone economy declined by 0.3% in the fourth quarter of 2011 and now appears poised to fall even faster in the first quarter. Inflation in Europe also seems to be on the rise, driven primarily by oil prices. As Europe is China's largest trade partner, a European slowdown may not bode well for China's economy. The U.S. derives less of its GDP from exports and a weakening in this area has so far been offset by a powerful auto industry, but the consensus is for the trade deficit to increase in the months ahead.

Reducing the IRS' Bite with Tax-Efficient Funds

- When investing the assets in clients' taxable accounts (e.g., trust, joint, and individual accounts), COMPASS takes great care to invest in the most tax-efficient manner possible.
- This approach involves the use of tax-managed and tax-efficient mutual funds, as well as maintaining a clients' bond exposure in their retirement accounts, when available, to avoid taxes on the interest income that would otherwise be due.

Handing over a portion of your investment earnings to the IRS is never pleasant. Fortunately, a specific category of mutual funds, called tax-efficient funds, might help you keep the amount you send to Uncle Sam to a minimum. Here's how tax-efficient funds work. Mutual funds must pay you almost all of the money they make from interest, dividends, or capital gains (money made from selling stock) in a year. That's called a taxable distribution (since you must pay taxes on that money). Tax-efficient funds keep their taxable distributions as small as possible, thus lowering the amount you have to pay in taxes. Tax-efficient funds can use several strategies to keep distributions low. They avoid stocks that pay dividends. They don't sell their stocks very often. When they do sell stocks, they might also try to sell some that have lost money to offset those that have made money. They could also hold stocks for more than one year before selling, since the profits are taxed at a lower long-term capital gains rate than short-term transactions. These methods, as well as some others, keep your tax bill lower.

While tax-efficient funds seem extremely attractive, there are a few drawbacks to note. First, there are only a handful of these funds available from which to choose (relative to other categories). Second, of the funds that do exist, few have long-term investment records that you can analyze. Finally, most tax-efficient funds stick mainly with large-company stocks and tax-free (municipal) bonds. That means you might have to look at non-tax-efficient funds to get exposure to other types of investments in an effort to build a diversified portfolio.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

2012 FIVE STAR PROFESSIONAL Wealth Manager

Louis E. Conrad II, CFA
President

COMPASS Wealth Management
Post Office Box 250
Lexington, Massachusetts 02420

lconrad@compassinvest.com
www.compassinvest.com

Tel:(978) 828-5681
Fax:(781) 862-7030