COMPASS ADVISORS

Investment Directions

SUMMER 2016

A Hobbit Market

In J.R.R. Tolkien's children's book The Hobbit, Bilbo Baggins is swept away into an adventure with dwarves, elves and trolls. He fights a dragon, finds a ring and other treasures and after the adventure he returns home where he started. He was wiser and more experienced, but still a humble hobbit living a simple life.

This is a lot like the U.S. stock market over the past year. From the start of July 2015 until the end of June 2016, the S&P 500 went on a wild ride and ended about 1% higher than where it started[1]. I see a pattern that may be with us for a while: low growth with high volatility.

Our Journey Over and Under the Mountain

You may recall the dip late last summer when the major U.S. stock indexes dropped a little over 10% from July to September. After rebounding in the Fall, the indexes dropped again a similar amount in January and February of this year.[2]

In June when Great Britain voted to leave the European Union we had a mini dip, the drop only lasted a couple of days and reached half of the earlier two[3]. Since that time, we have rebounded to reach new all-time highs.

Some would call this a flat market; I prefer to describe it as a Hobbit market: full of adventure and ultimately ending back where we started.

What is an investor to do? My advice is to take advantage of opportunities as they arise. Here are three ideas:

Looking for Treasures

Consider capturing losses for tax purposes when the market drops. One opportunity which may arise is the chance to harvest capital losses to offset capital gains.

Consider converting traditional IRA assets to a Roth IRA. Since the conversion is a taxable event, doing it when values have dropped may save you some tax dollars if you are looking for the opportunity.[4]

Consider rebalancing when values move dramatically. Whether prices go up or down, rebalancing may help you buy low and sell high. The act of returning your portfolio to your intended targets may prove beneficial in the long run.

Roads go ever, ever on, Over rock and under tree,
By caves where never sun has shone, By streams that never find the sea;
Over snow by winter sown, And through the merry flowers of June,
Over grass and over stone, And under mountains of the moon.
J.R.R. Tolkien

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[1] *Closing prices of 2077 7/1/15 to 2099 at the close on 6/30/16, a change of 1.03%. Source: finance.yahoo.com*

[2] *S&P 500 closing prices of 2127 on 7/17/15 to 1884 on 9/29/15, a drop of 11.42%. 2078 on 12/29/15 to 1847 on 2/11/16, a drop of 11.12%. ibid.*

[3] *S&P 500 closing prices of 2113 on 6/23/16 to 2000 on 6/27/16, a drop of 5.35%. ibid.*

[4] *Please consult a tax professional before taking action, I cannot give tax or legal advice.*

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Rebalancing a portfolio may cause investors to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Traditional IRA account owners should consider the tax ramifications, age and income restrictions in regards to executing a conversion from a Traditional IRA to a Roth IRA. The converted amount is generally subject to income taxation.

National Park Service Turns 100!

The U.S. National Park Service celebrates its 100th anniversary in August of 2016. In honor of the centennial, here are a few facts you might find interesting. We are grateful for the many beautiful national parks across the country.

- President Woodrow Wilson signed into law an act that established the National Park Service on August 25, 1916. At the time, there were 35 national parks and monuments in their charge.
- The National Park Service now manages 411 sites but of those, only 59 are national parks. The remaining sites include national memorials, seashores, historic sites and battlefields.
- In 1872, 44 years before the establishment of the National Park Service, Yellowstone was named the first national park with the cavalry placed in charge of its care.
- Decades before that, in 1832, the federal government declared what is now Hot Springs National Park to be a protected federal reservation. That land in Arkansas is now the smallest national park.
- Several former prisons are under the management of the National Park Service, including Alcatraz, Andersonville, Fort McHenry and Dry Tortugas.
- The president lives in a National Park! The White House is part of President's Park, managed by the Park Service.
- In 1951, the familiar NPS arrowhead was designated as the system's official emblem. It includes the sequoia tree and bison to represent vegetation and wildlife, the mountains and water to represent scenic and recreational values, and the arrowhead itself represents historical and archaeological values.

NPS facts source: Alamo.com travel guide

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RETIREMENT INCOME STRATEGIES

Benefits of Boring

After decades of working, taking the step out the door and into retirement can be a giant leap in your life. Your preparation will be critical. How can you increase the odds you will be happy in your retirement years?

One way is to plan to avoid surprises. Nothing is more dispiriting than to have your plans dashed by an unexpected downturn in your income or investments.

You may be able to avoid such surprises by going in with your eyes open. Understanding the real world impact of volatility is crucial.

The Arithmetic of Loss

To illustrate this real world impact, imagine a purely hypothetical example. Imagine a person invested $1,000 hoping to earn 5% per year. Further imagine that person was successful for the first three years.

As the chart below shows, the original $1,000 would have grown to $1,158. So far so good, the average annual return for the first three years is 5%. Now imagine in year 4 the investment loses 5% in value. The value of the investment would drop to $1,042 resulting in an average annual return of 1.03% per year for the first four years.

Mathematically we need to get to $1,276 in order to achieve a 5-year average annual return of 5%. This brings us to the big question: What would our hypothetical person have to earn on their hypothetical investment in year 5 to reach that? The answer is a whopping 22.5%!

Since few conservative investments could be expected to provide that kind of return in one year, our hypothetical investor faces a dilemma. Live with the loss and adjust his/her expectations, or take on more risk in hopes of making up the loss.

One way to avoid this dilemma is to avoid the event in the first place. This illustrates the wisdom of being more conservative in retirement. Once you have retired you may choose to work and find it satisfying but being forced to work in retirement to pay your bills can be discouraging.

Opting for Balance

Most folks retire at a point in their lives when there is less time to make up for unpleasant surprises. The key to lower volatility in retirement is to try to avoid an unexpected financial downdraft.

Stability is a valuable asset in retirement. For some this may mean fewer stocks and more bonds and cash in their portfolios. For others a traditional pension or other stable income source may provide a base of income stability.

The Goal: Happiness

In my experience it is not the size of your nest egg that brings happiness but your wealth relative to your expectations. As you plan for retirement I recommend you set realistic expectations. Choose your neighbors carefully and adopt a lifestyle you can realistically afford. You don't want to feel like you are the only one on the block who didn't get to Europe this year.

Family, good friends and a modest lifestyle can be more rewarding than a holiday in Holland. If you want to be happy, a good plan can help you get there.

Here is the Math:
(for illustration purposes only)

	Annual Return	Balance	Average Annual Return
Beginning		$ 1,000	-
Year 1	5%	$ 1,050	5%
Year 2	5%	$ 1,103	5%
Year 3	5%	$ 1,158	5%
Year 4	-5%	$ 1,042	1.03%
Year 5	??%	$ 1,276	5%

Based on simple annual compounding and rounded to the nearest dollar. This is a hypothetical illustration, no specific investment is implied, your returns may vary.

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New Tools for New Times

Be Prepared

I like the Boy Scouts of America. They camp, they build things and they teach valuable life lessons. All four of my boys participated and became Eagle Scouts. The motto of the Boy Scouts is "Be Prepared."

For investors, being prepared means having a well-defined investment plan tailored to your goals. Being prepared means managing your expectations. Being prepared means keeping your focus on your goals and sticking to your plan despite unexpected events.

Having a Plan

Defining a plan that is right for you requires mentally drawing a line between where you are now and where you want to be at some point in the future. This can be painful – both facing the reality of your current situation and accepting what is possible in the future. This is where you separate reasonable expectations from pipe dreams. It is also where playing the lottery is dismissed as a form of financial planning.

Understand, Accept, Commit

In business management terms we are talking about the process of "understand, accept and commit." To define a financial plan tailored to your goals implies you *understand* where you are and what is reasonably possible in the future, you *accept* your personal situation as it is and not as you wish it were, and you *commit* to a path that has a reasonable likelihood of success.

Navigating Life

That is a great start but then life happens … and it is nothing like what you planned. In the face of surprises, you may be tempted to abandon your plan; you may think you can beat the odds, take on more risk without negative consequences or trade your way out of the hole you have fallen into. In the words of the American Philosopher Meghan Trainor: "You need to let it go. You need to let it go. Nah to the ah to the, no, no, no." Bad ideas don't get better in times of stress.

Most of the time the better response is to stick to your plan. Occasionally plans need to be reworked but that is rare. Downturns tend to be temporary, if you are having a hard time seeing them that way, perhaps a rework is in order.

Beware, less volatile investments may provide a smoother ride in the near term but less return in the long run. Finding the right balance for you will make it easier to hold to your plan when surprises arise.

A wise scout leader once told me when you pick up one end of a stick you get the other end also. You may wish the itty-bitty risk stick had great big reward on the other end but that has not been my experience.

To sum up, be prepared: have a plan, realistic expectations and patience.