Investment Directions

FALL 2017

Handling Cycles in Life

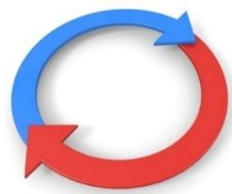
Since we published last, much has happened. We have all endured terrible news stories: severe weather, escalating international tension and tragedy -- these events are unsettling to all of us. Add to that the current political climate of contention – and feelings of peace, unity or prosperity may seem unattainable.

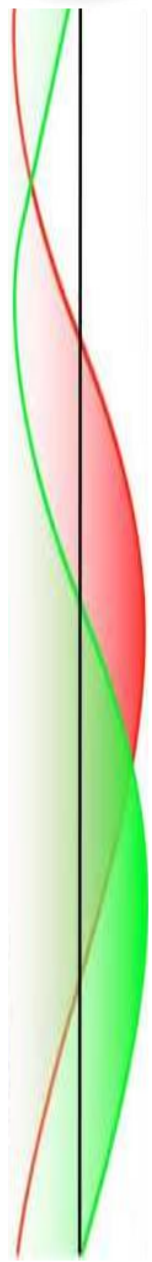
In such a time as this, I recommend focusing on the uplifting stories which seldom make the front page. The relief supplies and volunteers that flew in after the hurricanes. The many acts of heroism and sacrifice in Las Vegas and elsewhere. These stories can balance the negative headlines and give us hope.

Focus on Fundamentals

In a similar way, economic news can also be unsettling. We may feel concerned by negative news and be tempted to make decisions based on emotion. I recommend you instead look to trusted economic and market indicators for perspective. In other words, focus on fundamentals.

For example, some may see reason to worry when stock prices hit all-time highs, concerned that a fall is immanent. By focusing on fundamental facts and data, one might allay those fears. For example, company profits, the health of the economy or other factors might provide a different perspective.





Investment markets tend to be cyclical. There is no single data point for predicting recessions and bear markets, every cycle is different, but by looking to several data points we may glean some perspective.

Forecasting the Cycle

Here are five indicators, or data points to consider for perspective when assessing our current economic cycle.

First is the Treasury Yield Curve. In our view the current interest rate environment looks positive.

Second are Leading Economic Indicators. As we look at changes year over year we again see reason for optimism.

Third is Market Breadth. This is a fancy way of asking whether many companies are participating in this market rise or just a few. Once again, we do not see reason to worry.

Fourth is Market Valuation. Here we see reason for caution. If earnings do not continue to rise, prices may be impacted.

Fifth is Purchasing Managers' Sentiment. This is a test of industrial optimism which is currently positive.

When we consider the future and particularly our investments I recommend we focus on fundamentals. From where I stand, the fundamentals look good.

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Random Acts of Brilliant Vandalism

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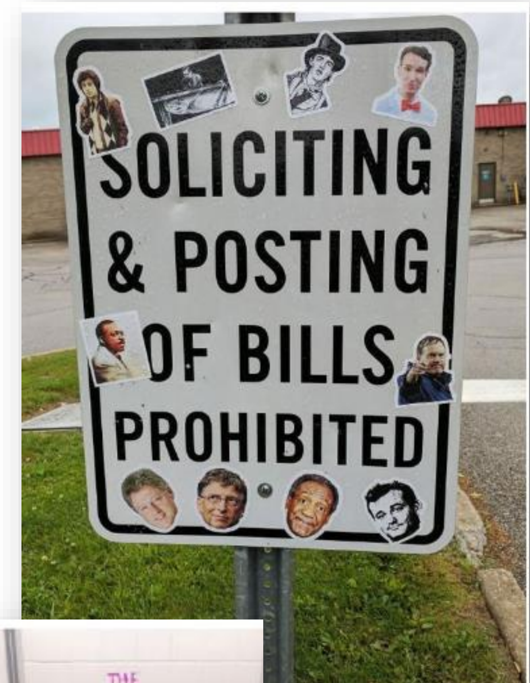
Compass Advisors is changing with the times! We have a new location, an updated logo and soon we will be launching our new website.

If you haven't been in to see our new office yet we invite you to come. We also have a new service assistant, Kendra Alexson, whom you will find to be smart, capable and easy to work with. Kendra is efficient, effervescent and fun.

In addition, we have new online reporting capabilities, technological tools and resources all to better serve you.



Wizard of Id Comic Strip © John L. Hart FLP, printed with permission. www.johnhartstudios.com

Potential Impact of Tax Reform

Recent tax proposals being discussed by Congress seem to be having an impact on the value of America's Great Companies. Despite Congress' recent difficulty in passing high-profile legislation, the investment markets are acting as if something significant may get done.

Clearly, the stock market is a complex critter and any rise can have many causes. That is surely true of our recent experience but one of those many causes may be potential tax reform. In my opinion, a tax deal in the next few months has become more likely.

Why This Time May Be Different

Key Republicans, some not with the president on previous legislation, have voiced support for the general goals the president has outlined. The lack of details makes this natural in the early stages but the coalition will be tested as actual legislation nears completion.

The framework, circulating for more than a month now, seems to have enough support to provide hope of passage. As we move beyond broad concepts to more specifics, trial balloons – leaks of what might or might not be included in the final package – have clearly identified who will holler at which ideas. So far, the objections have not been so loud as to dampen my optimism.

What might be done

There seem to be three broad areas being discussed: First is a reduction of the corporate tax rate. This was championed by the president on the campaign trail and seems to be a priority. Second is a reduction or re-working of tax rates on individuals. We are being told it will be focused on the middle class to spur economic growth but we shall see. Finally, is tax reform. This implies simplification or other broad changes to how taxes are levied.

Of the three, tax reform is the toughest to do and has the potential to gore the most prized bulls so if the going gets tough, this point may be dropped. If the goal is to drain the swamp, you can count on stiff resistance from the creatures who swim there.

Why it Matters

Each of these proposals has the potential to impact investors so it is worth watching. Once again, we are speculating here, if anything gets signed into law it may look nothing like what we now expect. But in the spirit of being prepared, it might be prudent to consider the impact of potential changes.

A reduction in corporate tax rate has the potential to favorably impact corporate profits. Dollars not sent to the government may fall to the bottom line and where there are more profits we might see higher stock prices. Beware on this point, as I mentioned at the start, the markets may already have this baked into current prices. If corporate tax rates don't drop, stock prices might.

A reduction in personal tax rates, especially if given to the middle class, may result in more saving or spending per family. Both of those things are generally bullish. Whether a person adds more to their 401k or buys a shiny flat screen TV, the effect on stock prices is potentially positive.

Tax reform is less well defined so its impact is harder to anticipate. On one extreme, tax reform could mean simplification to the point of putting all those expensive accountants and tax lawyers out of work. The efficiency boost to the economy could be huge (dare I say "Yuuuge")… unless of course you are one of those accountants or lawyers … but that seems unlikely. More likely is minor tinkering affecting a few but barely nudging the economic needle.

So, stay tuned! If legislation gets passed you will be on top of it. If not, let's hope the spectacle is entertaining.

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New Tools for New Times

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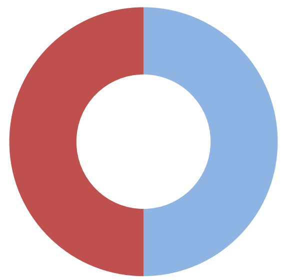
Rebalancing Strategies

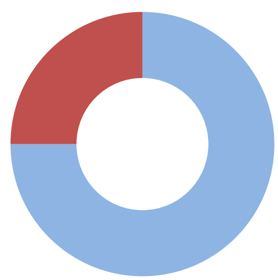
Adopting a systematic and well-thought-out rebalancing strategy can aid in your search for investment success. Systematic rebalancing can provide a mechanism that removes emotion from investment decisions. The benefits of systematic rebalancing include:

Portfolio A



1- **Portfolio discipline**. Rebalancing portfolios systematically employs a "buy low, sell high" policy by reducing allocations to relative outperformers and increasing allocation to relative underperformers.
2- **Maintain Diversification**. Systematic rebalancing also reduces concentration risk, as any position will be reduced when it becomes a much larger allocation in the portfolio than originally intended.
3- **Consistency with investment objective.** Systematic rebalancing maintains adherence to an investment policy and portfolio goals. This helps ensure that the risk and return profile of the portfolio remains consistent with its original design.

Portfolio B



Portfolio Drift

Assuming a person creates a portfolio designed with a specific investment objective in mind, portfolio drift is what happens when one investment outperforms another.

For example, imagine a hypothetical portfolio created with a mix of two equally weighted investments. Further imagine investment 1 outperforms investment 2 until it makes up 75% of the portfolio. The result is a shift from Portfolio A to Portfolio B – this is the definition of portfolio drift.[1]

Rebalancing in Action

If rebalancing strategies are systematic and determined long before any trades are placed, both emotion and market timing would be removed from buy and sell decisions. Here are two such strategies to consider:

Rebalancing by Calendar

A simple way to enact a rebalancing strategy is to examine portfolio weights at predetermined times of a year. Portfolios would be rebalanced on a frequency that fits an investor's drift tolerance.

Rebalancing by Weightings

Another strategy is to rebalance based on how much investments vary from their initial target weights. Based on your risk tolerance, a threshold is set and a trade is triggered when an investment crosses the threshold.

The benefits of rebalancing need to be tempered by the costs: trading costs, tax costs and opportunity costs should all be considered. For this reason, portfolio rebalancing needs to be tailored to each investor. I believe systematic rebalancing, if used properly, can provide tangible benefits for many investors.[2]

1. *This is a hypothetical example and is not representative of any specific investment. Your results may vary.*
2. *Source material from: LPL Research, Portfolio strategy series, Balancing Rebalancing Strategies, July 2016.*