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# Investment Directions

Spring 2005

## Oil ... Well...

The first part of 2005 has seen the value of America's great companies drop a bit. The main cause of that drop may be the high cost of oil.

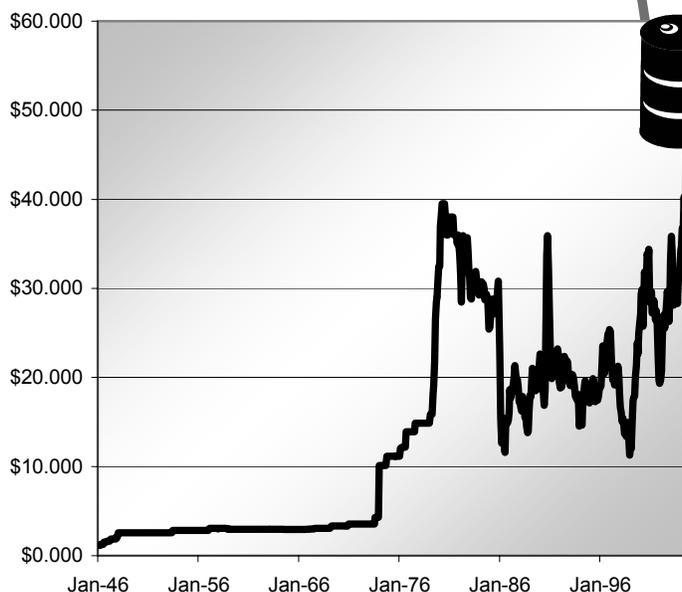
As recently as last August a barrel of oil was selling for under \$40. While the price of oil has shot up by over 25% since then, most American companies have held or increased their value. In the past few months oil has cost us at the gas pump and in our portfolios. I believe we will see improvement in both of those areas soon.

## Suds and Substance

The price of a barrel of oil depends on the fundamentals of supply and demand, then on a hefty dose of speculation. Speculators provide the suds; supply and demand provide the substance -- and all three favor lower oil prices. Let's look at them one at a time:

### Speculation

According to the Commodities Futures Trading Commission almost one-quarter of all oil transactions are speculative. I believe positive fundamentals are already beginning to pull oil prices back. If the speculators catch on,



they may help lower oil prices in the months ahead.

### Supply

The world supply of oil depends on decisions made by oil producing countries. OPEC, Russia and other oil exporting countries tend to pump more oil when prices are high; despite what they say in press releases. I expect increased supply to help lower oil prices in the months ahead.

### Demand

In addition to the usual demand for petroleum, the U.S. government has been adding to our strategic petroleum reserve. Japan, the European Union and China are also adding to their reserves. All this demand is temporary and may one day end. I expect reduced demand to help lower oil prices in the months ahead.

## A Prudent Response

In the long run the price of oil may exceed \$60, \$80 or even \$100 per barrel.

We all know oil is a limited resource and we are using it up day by day. Supply and demand seem to favor higher prices at some point in the future.

In the short term, however, I believe speculation and other factors may have caused a temporary spike in oil prices. I believe this rapid price rise has created a drag on stock prices which may also be temporary.

If your goals reach out ten years or more you may want to re-assess your asset mix. Prudent investing requires an occasional course adjustment as we chart success and navigate life.

Chart Source: Economic Research, Federal Reserve Bank of St. Louis. Monthly Spot Oil Price: West Texas Intermediate, Jan 1946-Feb 2005.



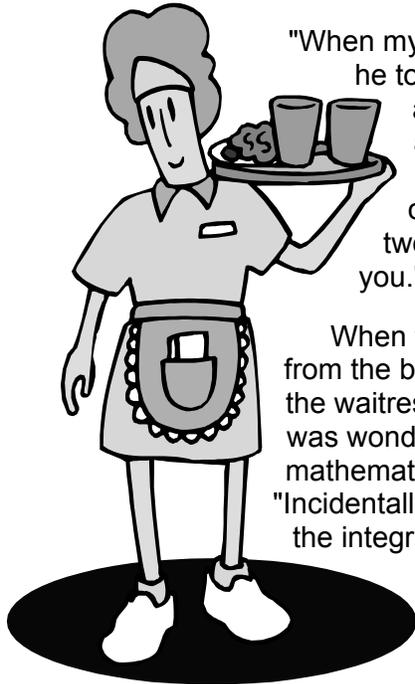
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## Common Knowledge

Two mathematicians were having dinner in a restaurant, arguing about the average mathematical knowledge of the American public. One mathematician claimed that this average was woefully inadequate; the other maintained that it was surprisingly high.

"I'll tell you what," said the cynic, "ask that waitress a simple math question. If she gets it right, I'll pick up dinner. If not, you do." He then excused himself to visit the men's room, and the other called the waitress over.



"When my friend comes back," he told her, "I'm going to ask you a question, and I want you to respond 'one third x cubed.' There's twenty bucks in it for you." She agreed.

When the cynic returned from the bathroom he called the waitress over. "The food was wonderful, thank you," the mathematician started. "Incidentally, do you know what the integral of x squared is?"



The waitress looked pensive; almost pained. She looked around the room, at her feet, made gurgling noises, and finally said, "Um, one third x cubed?"

So the cynic paid the check. The waitress wheeled around, walked a few paces away, looked back at the two men, and muttered under her breath, "...plus a constant."



## Congratulations to Kristal and Daniel!

Kristal, formerly Miller became Kristal Gerdes on March 5<sup>th</sup>, 2005 when she wed Daniel Gerdes in the LDS temple in Bellevue. We wish them all the happiness in the world.

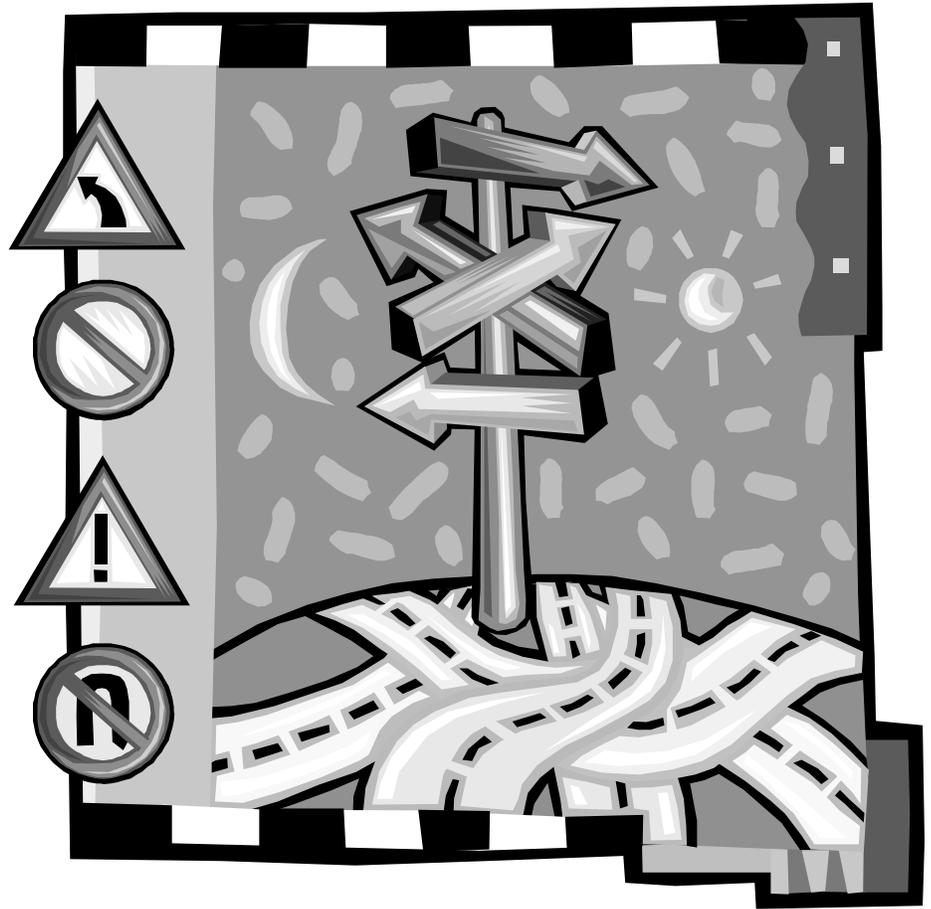
# The Alternative Minimum Tax

## How We Got Here

Back in 1967 Americans were outraged by a U.S. Treasury report showing that 155 individuals with annual incomes over \$200,000 paid no federal income tax. By 1969 Congress had enacted a “minimum tax” designed to ensure that high income individuals paid their fair share of taxes. Initially the tax rate was 10% and the number of people affected was quite small.

Today the “minimum tax” is known as the “alternative minimum tax” or AMT. The maximum tax rate has been raised to 28% and the number of people affected has risen to the millions.

You may be among those who face the possibility of AMT exposure. The tax is based on a complicated jumble of regulations; the box below lists some of the common items which may trigger the tax. Retirees with large proportions of “unearned” investment and pension income are particularly susceptible.



## What Can You Do?

Your first line of defense is a good CPA or qualified tax professional who may be able to help you avoid paying the AMT

altogether.

In addition to a good accountant you may also want to consider changing the timing of your income and deductions. If you think you may be subject to the tax in a given year you may be benefited by accelerating income or deferring deductions.

For example you may choose to put off exercising stock options or selling an investment at a gain. You may also elect to pre-pay property or other taxes, time elective medical expenses or avoid municipal bonds which pay interest subject to the AMT.

### **AMT Danger Signs- Items which may expose you to the tax:**

- A large number of exemptions for dependents.
- Large state and local tax deductions
- Interest on second mortgages, borrowings not used to buy, build or improve a home.
- Large miscellaneous itemized deductions.
- The exercise of incentive stock options or ISOs.
- Large proportional amounts of long-term capital gains.
- Significant interest from municipal bonds which is subject to the AMT.



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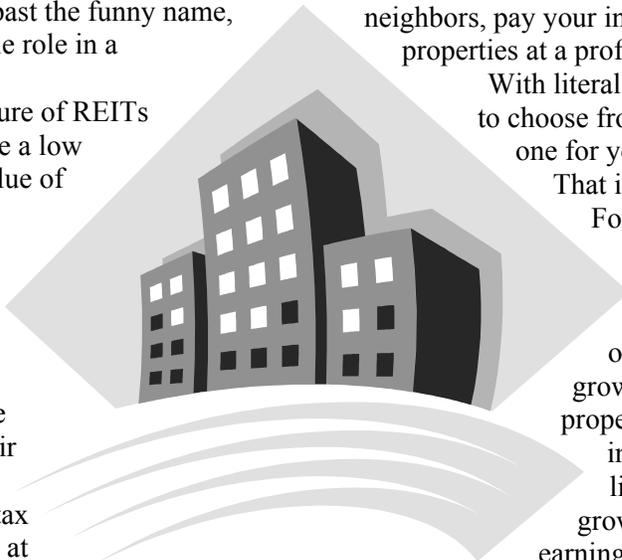
## Strategies You Can Use

### Real Estate Made Simple

Real Estate Investment Trusts or REITs are companies which invest only in real estate. If you can get past the funny name, they can play a valuable role in a diversified portfolio.<sup>1</sup>

One attractive feature of REITs is that they tend to have a low correlation with the value of America's great companies. The result is REITs may add balance to a portfolio which holds mostly stocks.

A second attractive feature of REITs is their income. REITs do not pay corporate income tax as long as they pay out at least 90% of their earnings as dividends to share owners. As a result the income could be attractive.



### Seeing the Big Picture

REITs fall into two major categories: Equity REITs which own actual real estate and Mortgage REITs which own real estate-backed mortgages. As you might imagine, the mortgage variety generally pay more income and the equity type generally experience more volatility and growth potential.

Now a word of caution: REITs as a group have performed exceptionally well in the past few years. Real estate prices in general have enjoyed quite a steep increase in many parts of the country and REITs have participated as well.

Some would say this is a bubble ready to pop. I would say do not let recent hot performance color your judgment. REITs may be considered as part of a balanced portfolio, not as an attempt to get rich quick.

### The Compass Contribution

Whether the properties in a REIT are run down apartment buildings or gleaming glass skyscrapers the business model is the same: try to get better rental income than your neighbors, pay your investors and sell the properties at a profit.

With literally hundreds of REITs to choose from, selecting the right one for you can be challenging. That is where we can help.

For income investors we look beyond the size of the dividend at adjusted funds from operations, dividend growth and the underlying properties. For growth investors we look for limited leverage, growing dividends and earnings and quality assets.

We are here to help you find just the right investment to meet your needs.

### Property Without the Pain

In summary... and I know some of you have skipped the paragraphs above to get to the summary... In summary, REITs may provide valuable diversification for growth investors and could show attractive income for income investors.

REITs enjoy tax preferences which allow them to pay healthy dividends and are built around a straight forward business model. REITs are not a hot new investment craze but a time tested approach to investing in real estate without the headaches of renters, repairs and recurring bills. If you think REITs sound attractive, give me a call and we will explore how they might work in your portfolio.

<sup>1</sup> Diversification does not assure against market loss.