Investment Directions

Fall 2005

COMPASS ADVISORS

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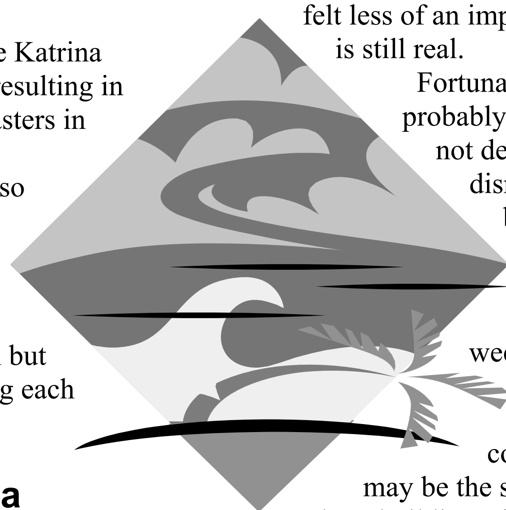
The Economic Impact of Hurricane Katrina

On August 29, hurricane Katrina barreled into the gulf coast resulting in one of the worst natural disasters in U.S. history. Katrina was a human tragedy but it may also have a powerful economic impact.

The full impact of the winds, storm surge and destruction is not yet known but our understanding is growing each day.



Pre-Katrina

To estimate the economic impact of Katrina we must start with the health of the economy before it struck. America was enjoying some positive economic news in mid summer:

- Economic growth (GDP) was up.
- Unemployment was under 5%.
- Profits at America's great companies were high.
- Inflation was running about 2.2%.

The economy still faced challenges such as the rising price of oil and a white-hot real estate market but before the storm the economy appeared healthy and strong.

The Impact

The impact of Katrina is notable in three areas: jobs, gas prices and construction.

First, Katrina caused perhaps a million workers to lose their jobs. Some will find work quickly but many may be unemployed for a prolonged period of time. This could push us back up over 5% unemployment and slow down economic growth in the months ahead.

Second, Katrina pushed gas prices up as refining and distribution processes were disrupted. Higher gas prices can translate into higher prices for other goods like food and clothing that need to be transported to our local stores. In the Northwest we have felt less of an impact but the pain at the pump is still real.

Fortunately, the problem will probably be temporary. Katrina did not destroy our oil supply; it just disrupted our delivery system a bit. Indeed we have seen prices drop significantly both for crude oil and for refined gasoline in the weeks since the storm.

The third big impact of Katrina is on the construction industry – this may be the silver lining in the storm. The rebuilding effect may turn out to be the strongest and longest-lasting economic effect of hurricane Katrina.

The Federal Government authorized more than $60 Billion in aid which works out to about $75,000 per affected household and private insurance will pay significant claims as well. All these dollars will provide a huge boost to the economy as families replace homes and everything in them. Companies will be making and selling roofing, refrigerators and rocking chairs in abundance.

Our Response

We mourn the human suffering caused by Katrina and recognize the pain that lingers for many families to this day. We hope the lasting legacy of Katrina will be positive. Lives were saved, families opened their homes to other families, individuals sacrificed for people whom they would never meet -- and we are all better for it.

America is great because of its people. We are caring and resilient. When challenges or even catastrophes come, we work together to overcome them. I believe we will rebuild after Katrina and America will be a stronger nation for the experience.

Source information from Putnam Investments, my thanks to the ideas of Dr. David Kelly, Sr. Economic Advisor.

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Compass Clippings

Actual Excerpts from Classified Sections of City Newspapers

3 year old teacher needed for pre-school. Experience preferred.

For sale: antique desk suitable for lady with thick legs and large drawers.

Dog for sale: eats anything and is fond of children.

Now is your chance to have your ears pierced and get an extra pair to take home, too.

Have several very old dresses from grandmother in beautiful condition.

Man wanted to work in dynamite factory. Must be willing to travel.

"I'm never having kids.
I hear they take nine months to download."

How Bill Learned 7% is not the same as 7%

Bill wanted to retire. He had a $500,000 nest egg, planned to draw 7% income and found an investment which would earn an average annual return of 7%. He invested his entire nest egg, reminded his wife how lucky she was to be married to him, then sat back and waited for the checks to arrive.

Bill didn't know it yet but his retirement plan had a serious flaw. His plan depended heavily on luck to work.

If Bill had read the fine print he would have known his annual returns would fluctuate between -7% and +21% as illustrated in the chart at right. This is not a real investment of course, the returns are hypothetical.

Bill ignored the volatility and confidently believed that if his account earned 7% per year on average he would be able to draw income of 7% each year forever. That is just simple math, right?

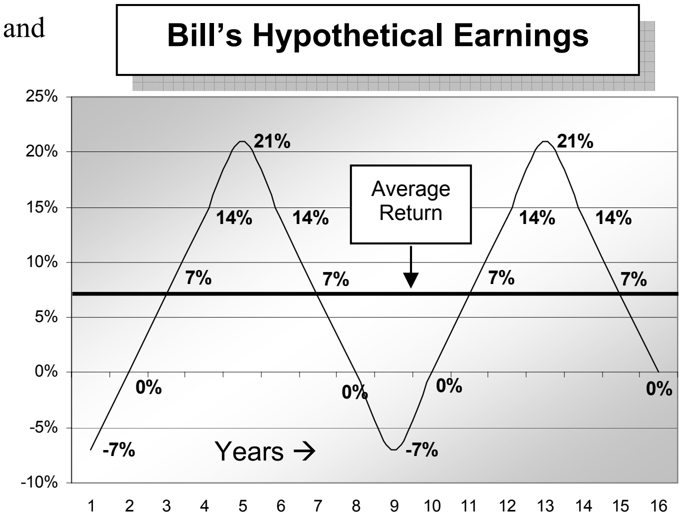
Well, no. Bill needed to make money early for his plan to succeed. If he lost money in the first year his plan could be sunk. Here is why:

Bill planned to take out $35,000 per year (7% of $500,000) but if he drew $35,000 and lost another $35,000 in investment performance in the same year he would be down $70,000. He would begin year two with $430,000 and Bill would be in deep trouble.

In order to get back to where he started, Bill would need to earn $70,000 to make up for year one and another $35,000 to cover his income for year two. That would require nearly a 25% return to catch up.

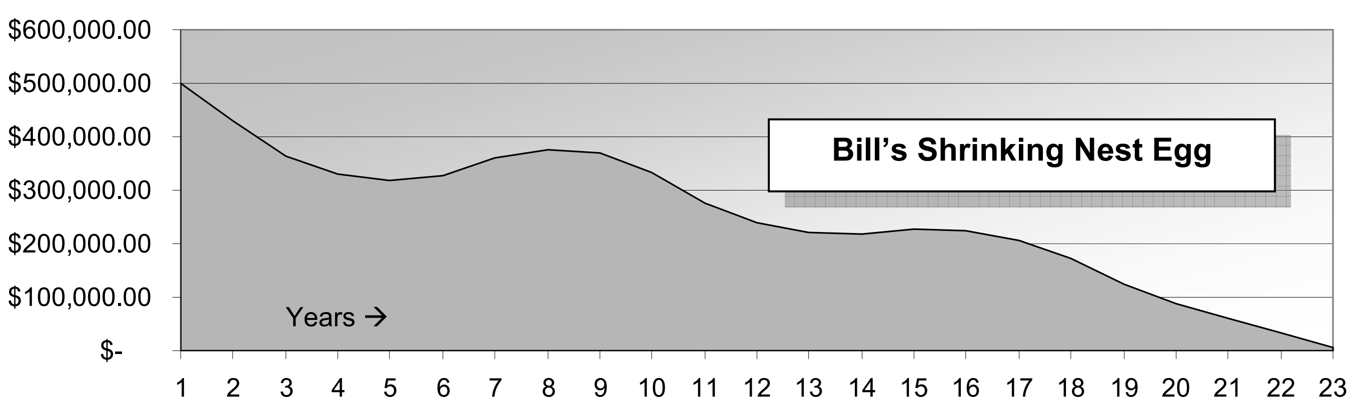
If Bill's account performs as we expect from the chart above, his account will earn nothing, will pay out another $35,000, and will fall to $395,000 after just two years. If no changes were made, Bill would run out of money as illustrated below.

It turns out retirement planning may not be as easy as it looks. Retiring comfortably requires careful planning and as Bill's hypothetical example illustrates, the pitfalls of poor planning can be unexpected and unpleasant.



What Did Bill Do Wrong?

- Bill was overconfident.
- Bill confused average returns with actual returns.
- Bill did not consult a professional for advice.
- Bill thought volatility did not matter much.
- Bill did not appreciate how upset his wife would get when his retirement plan did not work out as planned.



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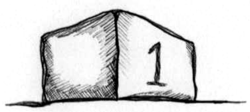
Four Cornerstones Of a Solid Investment Plan

Every building needs a solid foundation. Before the day of poured concrete foundations, builders relied on cornerstones to provide a square footprint and solid footings on which to build.

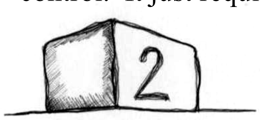
When investing, a solid foundation can also be invaluable. I would like to suggest four cornerstones for a solid investment plan. These are not complicated or fancy; they are more like simple but substantial quarried stones.



Save

Benjamin Franklin wrote "A penny saved is a penny earned." We know the importance of saving but few of us do it regularly. As a nation we have saved less as we have prospered. Our annual savings rate is now around 2% of our incomes which is much lower than a generation ago. Borrowing is way up, saving is way down – Ben Franklin would be dismayed.

Saving is the surest way to grow your portfolio – it does not rely on investment performance or factors outside of your control. It just requires you save.

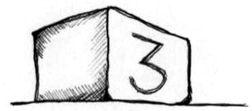


Diversify

Diversification does not assure against loss in down markets but it can reduce volatility if done right. Reducing losses in down markets is at least as important as capturing gains when markets move up.

Diversification works because different investments perform differently. By combining an investment that zigs with one that zags you can smooth out your investment results and have a better long-term experience.

Picking winners consistently is hard and I keep a crystal ball on my desk to remind me of the dangers of prognosticating. If you favor excitement you might consider Las Vegas or Emerald Downs, at least there you get some entertainment for your dollar. If you are serious about investing, you may find purposeful diversification to be more boring but also more reliable.

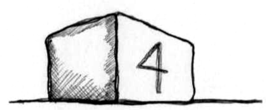


Rebalance

This is the cornerstone that brings discipline to diversification. Investing can be volatile, rebalancing can help you take profits from sectors which have performed well and add to sectors which are down in value.

Rebalancing requires advance planning which is why most people don't do it. It also requires ongoing care – you can't just "set it and forget it." When done right rebalancing can keep your investment plan on track and your portfolio out of unintended quagmires.

Rebalancing may be best done in retirement accounts where you can trade without worrying about tax consequences but it can be valuable in non-retirement accounts as well. It can keep your volatility in check and may cause you to buy low and sell high.



Time

Students just out of school may not have much money but they do have time which is a valuable commodity.

We have all heard about the magic of compound interest but few of us really believe it. Wealth is created by combining one part savings, one part investment returns and a load of time.

So, there are four cornerstones you can count on to provide a solid foundation for your investment portfolio. I recommend these to you as wise strategies you can use as you chart success, navigate life and arrive at your eventual destination.

My thanks to Jonathan Clements of the Wall Street Journal for inspiration on this article.