COMPASS ADVISORS

INVESTMENT DIRECTIONS

Winter 2014

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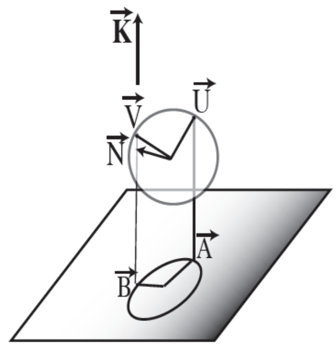
Investing is not like Flipping a Coin



2013 was a wonderful year for America's great companies. Despite all of the shenanigans at home and abroad, Wall Street remained optimistic and the value of most companies went up more than expected.

After such performance you might be wondering: Is the outlook for 2014 just a flip of the coin? While it is possible for anything to happen, I believe investing is not a game of chance. Based on my best research, I expect good news in America, less good news overseas and a better than average year for U.S. stocks. Here is why:

Government Impact

The Federal Reserve has now begun its long anticipated "taper" which means they are buying fewer treasury bonds. This was expected and seeing it finally start is positive.

Fiscal battles loom in Washington D.C. but I do not expect a partisan bloodbath. It is, after all, another election year (cynical implication intended). I think a government shut-down this year is unlikely and this too is positive.

Another factor is foreign government action and potential impacts on the inter-connected global economy. I see troubles diminishing in Europe and although smaller countries may struggle I anticipate ripples on our shores, not a tsunami. In short, I expect the impact of 2014 government policies to be positive.

Investor Confidence

The resilience, reliability and sustainability of our markets will likely foster optimism. I expect investor confidence to remain high and even increase. I expect U.S. economic growth to break out from the sluggish 2% mire and move up to perhaps 3% or more in 2014. This could mean better than average returns for America's great companies, perhaps in the 10% - 15% range for the year.

With that growth we may see higher inflation and interest rates. This would mean income investors may be challenged to find investments that work for them; my ideas on that front are on page 3.

As a result of increased investor confidence we may hear news reports of major stock market indexes setting new all-time highs in 2014. This does not worry me. In a healthy economy a growing stock market should be expected.

Potential Potholes In the Road

There is another side to this coin, events which may make 2014 a difficult one for investors. Economic growth may sputter, profits may evaporate and company prices may go down.

We have unrest in the Middle East, potential for war in North Korea and we could experience a trust-shattering scandal in our financial institutions. The risks are many and we are not ignorant of them.

Despite all of this I remain convinced America is the greatest nation on earth and perhaps the greatest in history. Our freedoms, democratic institutions and stability are the envy of the world. Based on this and the factors above, I believe investment success is not as random as a flip of a coin and in 2014 I expect a better than average year for U.S. stocks.

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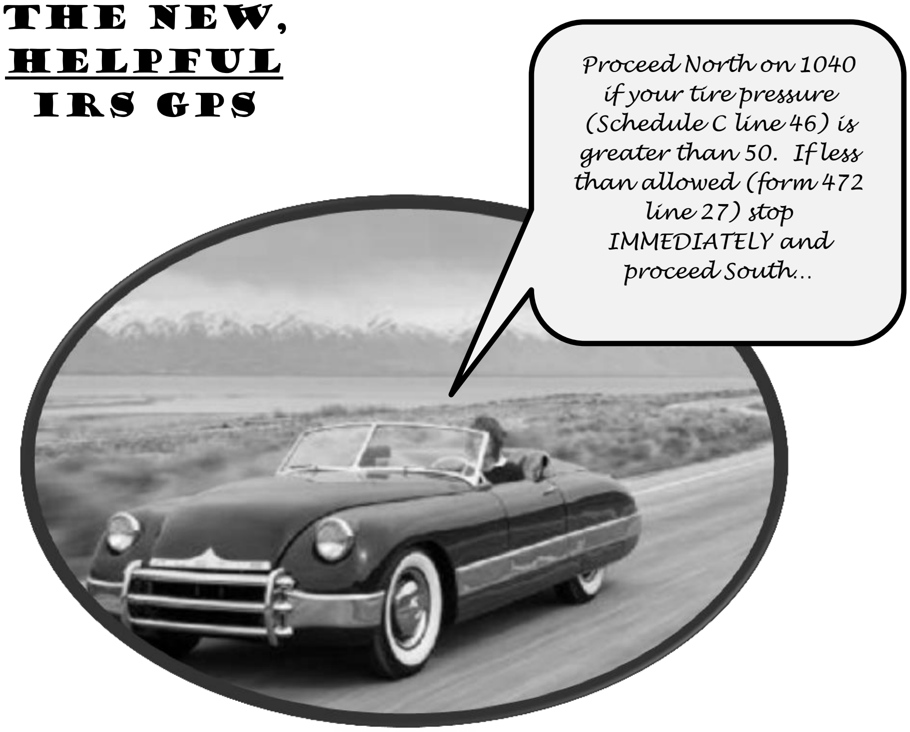
Will Rogers on Taxes

"The income tax has made more liars out of the American people than golf has."

"The difference between death and taxes is death doesn't get worse every time Congress meets."

"It is a good thing that we do not get as much government as we pay for."

INTRODUCING THE NEW, HELPFUL IRS GPS



New Ideas for Income Investors

Some of you may be old enough to remember when Treasury Bonds paid over 10% interest. Those were the days! More recently interest rates have been historically low and income investors have had to be both creative and selective.

Traditional bonds may still work for many investors and many of my clients still hold them. In the current environment if you have new money to invest for income, you may want to consider the following three income producing alternatives.

High Yield Bonds

High-yield bonds are an obvious asset class to consider for investors looking for income. The difference in yield between high-yield bonds and Treasury bonds is not as great as it once was but they still provide an attractive interest rate.

In addition to the income, high yield bonds can often weather rising interest rates better than more traditional, higher quality bonds. Last year the Barclays High-Yield Bond Index finished with a total return of 7.4% compared to a loss of 2% for the Barclays Aggregate Bond Index.

Before you dive right in, you need to understand high-yield bonds are the new, more polite name for what we used to call junk bonds. They are not investment grade securities and are subject to higher interest rate, credit and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors. We should talk before you take the plunge.

Floating Rate Bank Loans

Companies rated below investment grade often obtain bank loans for their short-term funding needs. Most of these loans are secured with collateral and carry a variable interest rate tied to the Prime Rate or LIBOR (London InterBank Offered Rate). Depending on the loan, the interest rate may be adjusted every three months.

Once originated by the banks, these loans can be turned into securities in which you can invest directly or through a mutual fund.

A floating rate security has a variable interest rate. That means its interest rate will go up and down or "float" to reflect changes in current market rates. Depending on the particular security, the rate may change daily, monthly, quarterly, annually or at another specified interval. In a declining interest rate environment, prepayment of loans may increase. If you expect interest rates to rise, you may be interested in a variable interest rate investment rather than one which pays a fixed rate. They are not for everyone but for some they can be the bees' knees.

Preferred Stocks

Despite the name, preferred stocks are actually fixed income securities. Not all companies that issue common stock issue preferred stock but financial companies often do. Over 80% of preferred stock is issued by financial companies.

Like traditional bonds, preferred stocks are sensitive to rising interest rates and can lose value. Preferred stock dividends to do not carry the same guarantees as interest payments from bonds and they are junior to all creditors. Preferred stock dividends are paid at the discretion of the company. Preferred stocks are attractive mainly for the income they pay which is typically higher than traditional, high-quality bonds.

The above-average income and hybrid nature make preferred stocks worth a look for income minded investors today.

Each of these income generating investments is complex enough we would recommend you use mutual funds or exchange traded index funds to participate. Each carries unique risks and benefits so we also recommend we talk to determine if any of these might be right for you.

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New Tools for New Times

Understanding Investor Behavior

Successful investing is not all about complicated financial calculations. It is also driven by human emotion. The human component is what makes predicting prices so difficult.

The numbers come first, they are important but we can boil them down to “good news” and “bad news.” The second phase is investor reaction and behavior. The study of this second phase is called behavioral finance.

Hope and Fear

The emotional component of behavioral finance is the tricky bit. Emotion adds a magic mirror distortion to the facts and data and it is different for every investor. It changes predictable clockwork to a more complex system.

The good news is we can determine our own behavior. If we understand the impact of emotions we may be able to make better decisions.

Exiting the Ride

Over time investments tend to go up then down then up again. With each switch we may naturally have an emotional response. Rising prices may prompt feelings of optimism and excitement, even euphoria – and we may want to buy. In a downturn we may feel anxiety, fear or panic – which may make us want to sell.

While these emotional responses are natural, if we recognize them we may be able to exit the emotional rollercoaster and make better decisions.

Tools for Today

In order to address the challenge of emotion-based decisions, I recommend the following three tips:

First, adopt a solid strategy. It should be one you can believe in; if you believe in the strategy you are more likely to stick to it. **Second, fight the urge to buy high and sell low.** This is not as easy as it sounds. **Finally, be patient.** Every blow-dried dream seller on the money shows will tell you otherwise, it is their job. I say ignore them, stick to your strategy and take the long-term view.

These three tips will not remove every challenge you face but you may find them profitable and they may help you find more joy in life.