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Investment Directions

Fall 2008

Ouch!

There is no denying it, the past year has been painful. The big question before us is this:

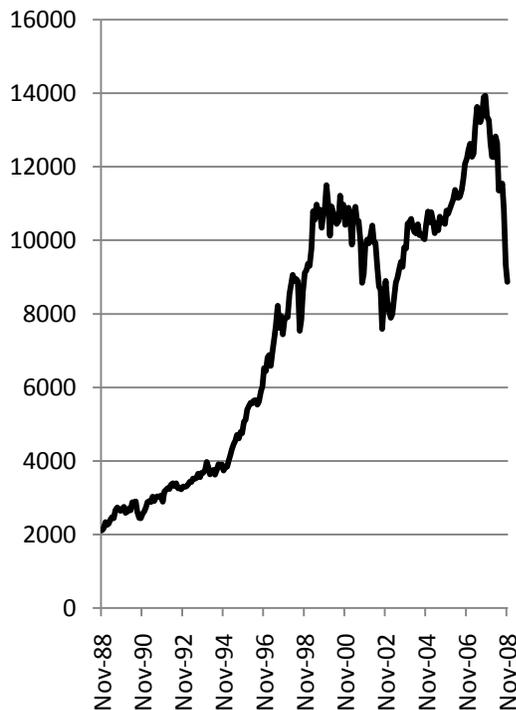
What will happen now?

Some say the foundations of our economic system are crumbling beneath us. We have started a downward spiral that will end in chaos: bartering for lack of currency and the end of our economy as we know it.

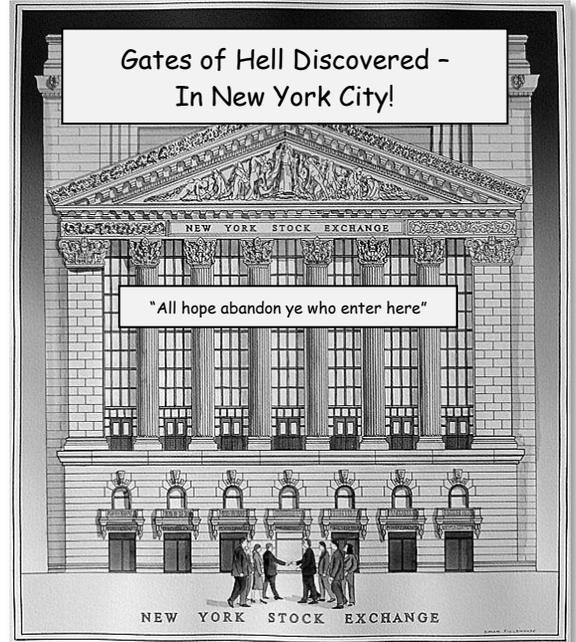
Others consider the quick drop in investment prices a fluke that will rebound just as quickly. Talk of a recession is overblown; real estate values, stock prices and economic vitality will return in a matter of months.

The truth likely lies between these two extremes.

20-Year History of the Dow Jones Industrial Average



Source: Historical stock prices provided by CSI, Inc. Monthly prices (Nov 1988 to Nov 2008). The Dow Jones Industrial Average is an unmanaged index of 30 stocks which does not accommodate direct investment. Past performance does not guarantee future results.



Reality Check

Although the speed and severity of this downturn is unprecedented in our lifetimes, history does record similar setbacks. These can be classified into two types: a terminal event marking the end of a bull market or a correction in the midst of an upward trend.

The crash of 1929 is the best known example of a terminal event. After the prosperity of the 1920s the crash was the end of the bull market and the beginning of the Great Depression.

“Black Monday” in 1988 and the more recent downturn in 2000-2002 are examples of corrections which simply slowed an upward moving market.

Time will tell whether our current drop marks the end of an era or just a very large bump in the road.

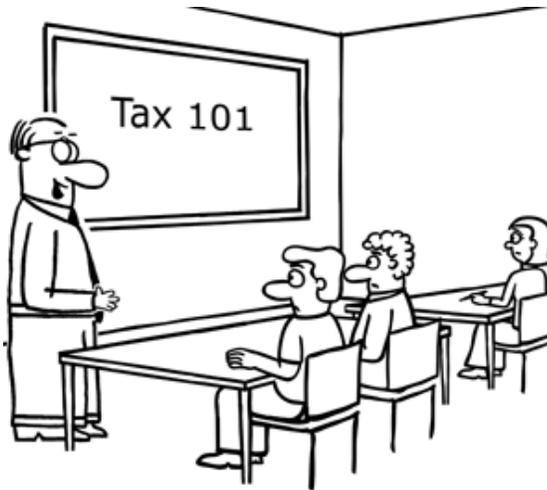
One fact to keep in mind is that historically, both terminal events and corrections have eventually given way to a rebound. While that is no guarantee this time, we do have reason to hope.

Warren Buffet, the famous Wall Street investor, is on record siding with those who hope; me too. If we are right, this may be a buying opportunity. Let’s hope.



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The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.

Welcome!

Marie Harvey has recently joined the Compass Team to strengthen our client care department.

Marie worked as an administrative assistant at Bank of America for more than a decade and escaped the banking industry just in time.

We are grateful to have Marie on the team and have already benefited from her many talents.

Welcome Marie!

Humorous Headlines

performance and \$30
and \$15 for stu-
the matinee per-
For reservations,
0403.

MING — The Palos
peninsula Unified
District and Friends of
Music host the 15th
Ardes Elementary
Festival on March 23,
5 at the Norri
for the Perform
70 Crossfield
shows begin a
tickets, call the
office at 544-0403.

Times — "Wild Years"
"an exhibit of 3-D
by artist Steve
through March 30.
hours, call

ING — "Natural
"exhibition contin-

Two years ago, U.S. Navy personnel and their families assigned to the Orange County Symphony and Mike Astugi N Kittyha

"Man is fatally slain"

his local Irish/American band, 25 years. They have played at pubs, Innisfree, traveled to the base to entertain them on St. Pat

"Enraged cow injures farmer with ax"

Fleming and the other five of Innisfree were delighted

"Iraqi head seeks arms"

ored to be able to go to Japan and lift the spirits, if only for a few hours, of the band got the opportunity to travel to Japan. Another band was unable

"War dims hope for peace"

Hills by day and an entertainer by night — and the band travel to entertain the Navy men, women and families at various base throughout

the only member of the band from Ireland. Other members include lead singer Julie Delaney, a civil engineer in Newport Beach; Terry Doyle, a star, a news director with CBS in Denis Doyle, Celtic harpist, a professor at Glendale College; Kevin Wecc, keyboards and bagpipes, music

south of Tokyo — felt like home away from home, with its lush green rolling landscape and its multitude of cherry blossom trees. "Yet," Fleming says, "one was struck by the commitment and dedication of our men and women in uniform as they played

"Grandmother of eight makes hole in one"

A couple of the families even took time out from their busy schedule to host Terry and the band members. They treated them to a guided tour of the base and accompanied them on a

"Milk drinkers are turning to powder"

Even though far from home, the band members took over the stage

the band members took over the stage

and entertained fun-filled hours. was just one of in the city.

A special bond the band members and already ex

id when leave in

FOR more info band, log www.innisfree.com

26

DGE ON THE AGE AT HOWE HE HOWARD THE-NEE AND

PULL STADIUM STAKE SEAT Purchase Tickets by or online @ www. Director's Hall INDIAN SPECIAL STUDENT P

BARGAIN MAT TAKING LIVES (R) SH

DOW (P

'S HALL 10:15 / SAND 12:25 "CENTER STAGE" STARSKY AND HUT

The Butterfly Effect: Computers and Volatility

The “butterfly effect” refers to the idea that the flap of a single butterfly’s wings might create tiny changes in the atmosphere that could cause a chain reaction and ultimately alter the path of a tornado.

This may seem a bizarre theory but in the financial world we sometimes see things equally as bizarre. Take for example the recent drop in United Airlines’ market value by \$1 billion.

The Wing Flap

Google, the popular internet search site, has a news service that searches the “most viewed” pages from newspaper websites around the world. Headlines are posted on Google’s site with links back to the original articles.

Early one Sunday morning in September, when internet traffic was slow, one person searched the South Florida Sun Sentinel’s website and viewed a 2002 article on United Airlines’ bankruptcy.

At 1:37am Google swept the website and found the article posted on a “popular stories” list in the business section. Google scanned the article and, finding no date line, included a link to the article on its news site.

The Chain Reaction

At 1:40am Google News readers started clicking the link and reading the story on the Sun Sentinel’s website. On Monday morning an investment firm in Florida saw the story and posted a summary on the Bloomberg financial information service.

Bloomberg’s website is seen by thousands of investment managers

and traders. Once the story hit Bloomberg the run on United shares started in earnest.



Although the story was missing a date line, the body of the article contained clues that this was old news.

Apparently traders didn’t actually read the article and began selling the shares in haste.

By 11:00 am Monday morning United was contacted and a spokesman denied the bankruptcy rumors but the downward spiral was underway.

The Tornado

According to a recent study by Aite Group, in 2006 automated computer trading handled 30% of all stock trades¹. Once the selling started, the computers kicked in unimpeded by common sense and the price of United’s shares plummeted.

Clearly investors were nervous about the airline industry and United Airlines’ shareholders in particular were worried about going down the bankruptcy road again.

The stock price dropped from \$12 to \$3 before trading was halted. That created a loss of over \$1 billion in market value. Once trading resumed and the mistake was cleared up, the price rebounded but only to \$11 per share.

Lessons Learned

From this we can learn volatility is here to stay. In our

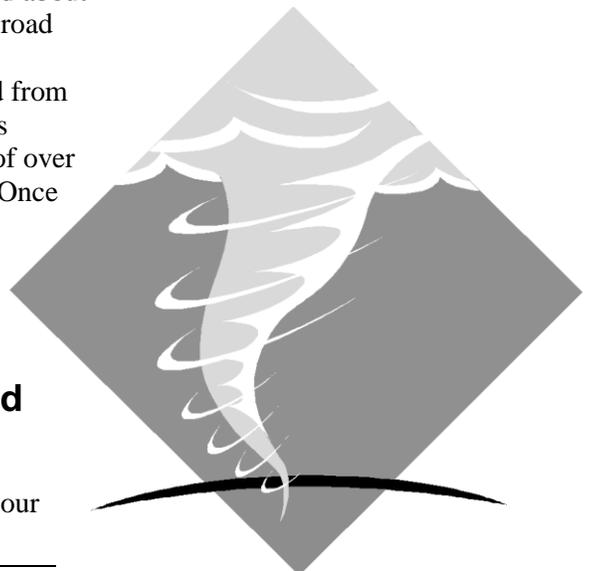
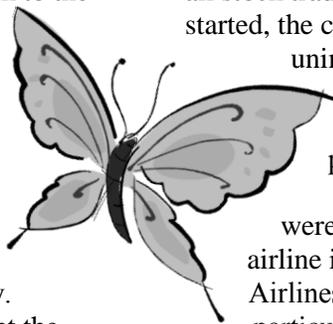
information-saturated society even false information has an impact.

On Wall Street, traders are ever anxious to get ahead of competitors and in their rush they have created automated trading programs that can turn a small price swing into a tsunami of selling or a bonanza of buying.

In this environment I recommend prudent patience.

Rather than reacting to hourly or daily price swings you may find taking a longer-term view will serve you better. This opinion of course will surprise few readers of this newsletter. Allow me to reiterate a line quoted here before:

*It is not timing the market
but time in the market
that is most likely
to bring you
long-term
investment success.*



¹<http://www.aitegroup.com/reports/200610311.php>. See also a source article by Mike Harvey: timesonline.co.uk



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The Road to Recession

Now that the election is past perhaps we can set politics aside and see more clearly what caused this economic mess. It is not about blaming republicans or democrats, rich or poor, Wall Street or Main Street. This is a story of market interference, greed and foolishness.

Step 1: Regulation

Back in the late 1970's legislation was passed to put an end to discriminatory lending and enable more people to purchase homes. It was a good goal to be sure but it had unexpected consequences.

Government agencies pressed banks to make loans which they were previously unwilling to do. Fannie Mae and Freddie Mac were part of that effort; they buy or guarantee about 40% of all mortgages in the nation.

Fannie and Freddie helped create a market for buying and selling risky mortgages. The creation of this complex and temperamental mortgage market is step one on our road to recession.

Step 2: Market Reaction

The lending industry rather quickly adapted to the new regulations. Banks, who used to make loans and keep them, began making lower quality loans then selling them.

As the market for those loans developed, Wall Street created complicated securities using risky loans as collateral. Investors loved the interest but few understood the assumptions behind the investment vehicles.

With Fannie and Freddie feeding the fire, sub-prime loans took off. Borrowers borrowed, lenders lent and investors invested. At first everybody seemed to win.

Greed fed the flames and demand for homes soared. Real estate prices rose to the

sky. This surge in property values is the second step on our road to recession.

Step 3: The Unraveling

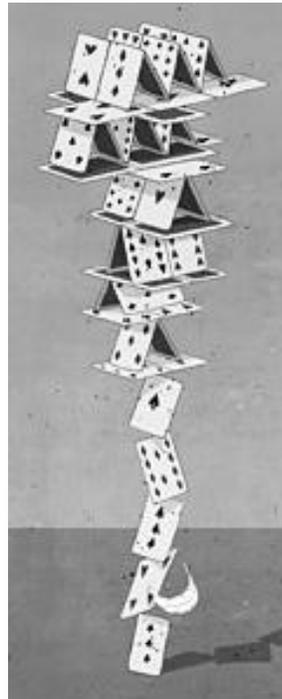
The rain began to fall when the economy slowed. Borrowers could not make their payments; thousands of homes went up for sale and prices dropped.

Home buyers, especially those with little equity and little to lose, walked away. Folks the regulations intended to help were once again unable to own a home.

Lenders took losses on loans they never should have made. They were left with lots of expenses but no money to lend.

Investors saw income producing assets become worthless paper. The collateral and strength behind their investments had been an illusion.

Many financial institutions struggled to stay solvent. Banks stopped lending what little money they had left and without that grease America's economic engine squealed and seized up. This is the final step on our road to recession.



Now What?

Fortunately the economy is resilient. Lending money is still a profitable enterprise and will likely expand once again. With that grease applied, America's great economic engine can power up once more.

This is not the great depression. Our homes are still valuable, America's great companies are still selling their wares and most of us who want a job have one.

I hope we can learn from our mistakes and be more wise in the years ahead. Let's agree not to invest in what we don't understand, achieve home ownership by working and saving, and let's teach our children the American dream is still available to anyone willing to sacrifice for it.