

True North

Compass Financial Consulting, LLC

Providing Financial Direction

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A Look Back—What Did We Learn?

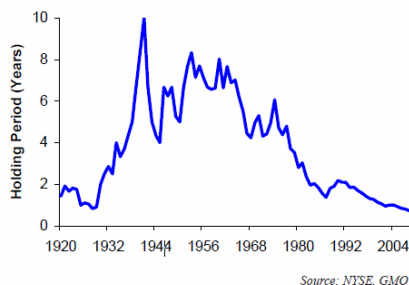
With the Stock Market's strong recovery since its lows in March of 2009, it doesn't take more than a few minutes of watching CNBC, or some other financial glee club, to wonder if they are treating the "Great Recession" as nothing more than a bad dream—as something that really didn't happen. We have always drawn attention to the idea that it is the purpose of bear markets to make investors forget about bull markets. Of course, the opposite is true as well. That is, bull markets certainly help investors forget about bear markets. To that end, the market's bull run over the last year has been amazing, if only to watch investors' memories get shorter and shorter with each passing market uptick.

One of our favorite observations about the fickleness of investors' memories comes from Jeremy Grantham, the renowned Chief Investment Strategist of the institutional money manager, GMO, LLC. As Jeremy put it, when asked what he thought investors will learn from recent market turmoil, "*We will learn an enormous amount in a very short time, quite a bit in the medium term and absolutely nothing in the long term.*" We have taken this observation as a challenge to list a few of the more important lessons learned from the worst period in markets since the Great Depression, so that we and our clients can commit them to memory, forever!

Lesson One: Be Skeptical

At its simplest, good investing tells us to avoid purchasing expensive assets. This simple statement seems so self-evident that it is hardly worth saying, yet we repeatedly come across investors who

are willing to take an investment at face value based on the promoter's excitement for the idea. These investors are unwilling to do the research commensurate with making sure that an investment is made at a fair, and even better, a "cheap," price. Investors have become an increasingly short-term lot. Case-in-point, according to data from the New York Stock Exchange, the average holding period for a stock listed on its exchange is currently just 6 months.



Instead of focusing on the long-term value of an asset, today, investors seem to focus on the equivalent of just two quarterly earnings releases. In our opinion, that is an incredibly deficient attention span.

Instead, we want to remind everyone of Warren Buffett's plea to look for the "fat pitch," or the perfect moment when patience is rewarded by a perfect investment opportunity at a perfect price. In order to find the fat pitch though, an investor has to have one important trait—skepticism.

In a perfect world, we would see individuals treat every investment opportunity as one of those late night

"get-rich-quick" infomercials. Here, folks would have the discipline to get past all the glitzy marketing and head straight to the infomercial's fine print where they would quickly discover sentences like the following, "*The majority of participants will make little or no money in this program.*" We bet all those who invested with Bernie Madoff wished their skeptical gene had been stronger—if it sounds too good to be true, it is, so take a pass!

In many ways, one should consider the investment process as really being a rejection game. Much more time needs to be spent trying to kill an investment idea, rather than trying to support it.

Finally, as another reason why one should always be skeptical, let's never forget this quote:

"There is no housing bubble to go bust."
(Ben Bernanke, October 27, 2005)

Lesson Two: There Is A Better Way To Define Risk

Too many think that risk is simply defined as the potential price decline in an investment. However, many fail to realize that a price decline may only prove to be temporary. An interesting exercise is to review a stock's high and low price over the last 52 weeks. We promise that this exercise will show you that, over the course of a year, a stock's price moves up and down a lot! But, to us, an investment's price movement is not risk. Rather, risk is best defined as the chance that an investment will suffer

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a permanent and non-recoverable loss.

To us, there are three main paths to exposing oneself to such risk. These paths are: *valuation risk* (buying an asset at too high of a price), *business risk* (exposing oneself to a company that cannot or does not execute its business vision) and *financing risk* (taking on too much debt - more on this factor in the “leverage” lesson below).

By ignoring the anxiety of price movements, and, instead, looking for hazards within an investment’s valuation, business, and financing attributes, we think investors will learn a valuable lesson about how to define risk, going forward.

Lesson Three: Sentiment Matters

Valuation is not the only thing that affects returns. Market sentiment, or the degree of investors’ collective greed or fear, can play just as important a role. At the height of the financial crisis, many were suffering from what might be termed as “indefinite anxiety” (i.e., things will always be this bad and will never get better). At times like these, many prices bear very little relationship to a security’s long-term value.

We know the opposite feeling can exist as well, given the “indefinite optimism” we found at the end of the 1990’s. Here, prices also exhibited little resemblance to many a security’s long-term value; hence, investors just suffered through a “lost decade,” as equity prices adjusted down and back towards reality from 2000 to 2009.

Over the years, we have put together the following advice on buying and selling various investments based on sentiment:

One should sell:

**Stocks* when your barber or taxi driver starts handing out stock tips;

**Gold* when your neighbors are inviting you to a “gold party” every other week;

**Real estate* when there are more real estate agents than homes for sale.

Conversely, one should consider buying:

**Stocks* when the media hails “The Death of Equities,” as Business Week did so famously on its 1979 cover (about 3 years before the start of the greatest bull market in history);

**Gold* when you don’t even know what a “gold party” is;

**Real estate* when there are more houses for sale than agents to list them.

Lesson Four: Leverage Can’t Make A Bad Investment Good, But It Sure Can Make A Good Investment Bad!

Here may be the king of all lessons to be learned from the last few years. Another Buffet truism we like is, “Leverage is the only thing that can make a smart man go broke.” We are sure there were plenty of smart people working at Bear Stearns, Lehman Brothers, AIG, and Washington Mutual, but we all know what happened in the end, they went broke!

Like we said in this lesson’s title, leverage (a.k.a. debt) cannot make a bad investment good. A bad investment is a bad investment, and it will lose no matter the circumstances. However, what may not have been so obvious to many was how leverage can make a good investment bad. Why? Well, let’s look at the math of the situation in an all too real example.

Say in 2005, your cousin decided to make an “investment” in a home valued at \$300,000. He was able to make a 10% down payment with the purchase so that he had \$30,000 of equity in the house. He then borrows the remaining \$270,000.

Over the course of the next two years, your cousin watches house prices in his area drop by 10%. Not too bad, you think, given the 40% to 50% price crashes happening in other areas of the country. But your cousin is not happy about it at all for, you see, his investment in his house has been “wiped out.” That 10% price correction has brought the value of his home down to \$270,000 which is essentially the amount he owes

the bank. If he were to sell now, he would realize absolutely nothing. That is right nothing—nil, nought, zip, zilch. And here is the danger of leverage—it can amplify a mere 10% price decline into a 100% total loss!

Leverage is also dangerous in that it can shorten one’s staying power when faced with a temporary price decline. The best example of this risk is to think of all the hedge funds who were levered 10, 20 or even 30 times prior to the market crash in the fall of 2008. Once prices started to drop, their ability to ride out the storm proved non-existent given their highly levered positions. With their banks calling in their loans and their counter-parties knocking on their doors, they had nothing else to do but sell assets at fire sale prices.

Speaking of fire, perhaps we should think of leverage like gasoline. That is, it is a catalyst that can make your “investment” fire start more quickly and burn better, but, when used carelessly, that catalyst can explode and cause permanent damage, as highly levered investments (unlike eyebrows) don’t grow back.

Therefore, we ask you to join us and prove Mr. Grantham wrong by acknowledging that there are things we can learn from the stock market’s recent crisis and never forget. Namely, these permanent lessons should include always *remaining skeptical, properly defining risk, always being aware of market sentiment, and recognizing that leverage is a one-of-a-kind tool for turning your good investment bad*. If you can memorize these lessons, we think you will pass many investment tests!



Ah, The Joys of The Estate Tax



Most financial advisors, including us, think that our tax code is (how can we put this delicately?) not the most streamlined or user-friendly system we've ever worked with. The U.S. Government Printing Office says that our current IRS Tax Code runs to 13,458 pages and roughly 5.8 million words. (A little longer than ten copies of the unabridged version of Tolstoy's War and Peace.)

Most of the language is less fun to read than you might imagine, with phrases like:

"If during any taxable year any building to which section 47(d) applied ceases (by reason of sale or other disposition, cancellation or abandonment of contract, or otherwise) to be, with respect to the taxpayer, property which, when placed in service, will be a qualified rehabilitated building, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero the credit determined under this subpart with respect to such building." (IRS Section 50, (a)(2)(A)).

But if you talk to tax professionals, they'll tell you that, right now, the messiest corner of the tax code involves the money you leave to your heirs, or the so-called "estate tax."

Why? Well, if somebody had died last December 31, \$3.5 million worth of his or her assets would pass to heirs free of federal estate taxes, and for amounts above that, the federal estate tax rate maxed out at 45%. If that same person had managed to survive until today, the U.S. Tax Code assesses ZERO federal estate taxes--none whatsoever--even if the deceased happens to be a multi-billionaire like Bill Gates or Warren Buffett.

It gets better. As things stand now, if that same famous multi-billionaire were to die in January of 2011 or any time thereafter, only \$1 million of the ten-figure estate could be passed on estate-tax-free, and the tax rate is scheduled to go back up higher than it was last year, to a 55% maximum rate. Suddenly, a lot of people have to start thinking about estate taxes again. There is also a one-year change in how to calculate the capital gains tax on the sale of inherited assets, which will almost certainly affect many more people than the inheritance tax did (don't ask).

The majority of the estate attorneys we know believed that there was almost no possibility that the estate tax would be allowed to disappear, given record federal spending and budget deficits. Yet, against all reasonable predictions, when the calendar turned over to 2010, Congress had failed to act and the estate tax that had been in place since 1916 was repealed, even if it was only for one year. Congress is looking at ways to fix this issue. For now, though, we are faced with a situation where some of the tax terms used in wills and revocable trusts may be ambiguous in the event of a death in 2010. To address this potential ambiguity, let us describe some of the options an individual has in dealing with this situation.

First, one could adopt a "wait and see" approach to their estate planning. Unless a person dies in 2010, the repeal of the estate tax has no effect on their estate plan. If Congress acts this year to make the estate tax permanent, then one can react to the new law by making changes to their estate documents if necessary.

Second, if one chooses to avoid any ambiguity in their will's or revocable trust's tax terminology, a brief amendment can be executed to clarify that all tax terms used in the will refer to definitions in place before the estate tax repeal in 2010. This is a reasonably low-cost approach that gives an individual additional time to see what, if anything, Congress will do with pending estate tax legislation this year, while avoiding any question over the interpretation of the tax terms in their will.

Finally, for those individuals with a more complicated estate plan, a full estate review may be warranted. A review of this nature might result in several hours of legal time being billed by the estate attorney making the necessary document changes to address the issues.

There's also been a lot of discussion these days about when and how it's beneficial to convert a traditional IRA to a Roth. One estate tax factor in the decision: the rules governing inherited Roth IRAs are very different from inherited traditional IRAs. Meanwhile, whoever is administering the money left to heirs often has the joy of calculating something called the "income in respect of a decedent." And, in the convoluted logic of U.S. taxes, there are different tax breaks on assets that have gone up in value depending on whether they were owned as community property or joint tenancy.

Of course, when you decide who should inherit your IRA (Roth or otherwise), you simply specify this important information in your last will & testament, right? Wrong! (MUCH too logical!) Under our tax code, it doesn't matter what you say about your IRA in your will. Instead, you have to specify who will receive your IRA assets with a "beneficiary designation form."

Not surprisingly, a lot of people forget to update these forms as their life circumstances change. Every advisor knows it is not uncommon to review beneficiary designations and find people who are no longer living listed as the inheritors. This is not ideal from an estate tax perspective!

Clients of Compass Financial Consulting know that we stand ready to help them navigate the above examples of "the joys of the estate tax." If you are not yet a client, please feel free to contact us so we might help you assess today's changing estate tax landscape.

“Attention All Home Shoppers, The ‘Credit’ Store Will Be Closing in 15 Minutes.”

Time is running out on one of Congress’ economic stimulus tactics—the new homebuyer’s credit. To qualify for the credit, you must have a contract on a home by May 1st. Given the date of this newsletter, that gives you about two weeks to find the house of your dreams, so stop reading and call your real estate agent!

Also, as discussed in our previous article, there seems to be a rule in Congress that no tax initiative can ever be simple. To qualify for the credit, you can't buy a house from a relative, and you can't claim the credit if you can be claimed as a dependent on another person's tax return. The buyer or buyer's spouse must be at least 18 years of age, and the price of the

home being purchased cannot exceed \$800,000.

Of course, this is all subject to income restrictions. The full credit is available to single taxpayers with income of less than \$125,000; joint filers earning up to \$225,000; it phases out altogether at incomes above \$145,000 and \$245,000 respectively.

For those of you who can use the credit, here is an interesting twist, even if you bought the home in 2010, you can jump in a time machine by filing an amended return and claim it on your 2009 taxes.



IN PURSUIT OF THE TRIVIAL

The question for this quarter is: “According to the 1979 Business Week article titled, ‘The Death of Equities,’ what was the main cause of equities ‘dying’ back then?”

We will take answers through 5pm Eastern Time on April 30th. You must respond to either kraus@financialdirection.com or johnb@financialdirection.com with your answer. If you do not have email, you may call us. We will include all those providing the correct answer in a drawing to determine the winner. Staff from the accounting firm of Bridges & Dunn-Rankin will conduct the drawing and certify the results. The winner will receive a \$100 Lowe’s gift card.

Answer for Winter 2010. Last quarter’s question was, “What was the cost for a 30 second commercial for the first Super Bowl?” We took answers that had a range from \$40,000 to \$42,000 for the drawing. William and Angie Fain won the drawing of the Lowe’s gift certificate.



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