

True North

Compass Financial Consulting, LLC

Providing Financial Direction

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The Road To Wealth—Does It Run Through Las Vegas?

Recently, we traveled to a conference in the city where capitalism has run amok—Las Vegas. This trip got us thinking that over the years, we have often heard cautious investors say that putting their money into the stock market is no different than slinging quarters down a slot machine. That is, you put the money in hoping to hit it big, but it usually ends up being a fruitless effort. So we landed in Vegas armed with rolls of quarters intent on testing this investment theory.

With regard to the slot machines, we easily proved the “fruitless” part of the equation, as we managed to lose 100% of our hard earned change. However, this result was in complete contrast to the experiences diversified investors have had in the market over the past decade, a decade that has seen diversified portfolios grow over 10% a year, on average. So, how do we reconcile losing 100% to the slots with the ability to earn a positive return in the stock market where, as we just mentioned, some people remark is a game akin to gambling?

Well, at the heart of gambling, there is one simple truth, the game is rigged. In the end, the house wins. The slots, for example, pay back on average 95-97% of the money gambled on them. This means the house keeps the other 3-5% as their take. So, in total, gamblers are statistically guaranteed to see a decline of 3-5% of their investment. The only way to consistently make money in gambling is to be on the other side of the table where you have the odds in your favor.

Contrast this 3 to 5% perpetual, gambling loss with the results of the stock market where, over the past 80 years, large company stocks have earned an annualized return of 10.5%. You can even look at

the bond market where government bonds would have put you ahead of the slots having earned 5.4% per year.

So what does the stock market have that gambling doesn't? We would make the point that it is the market's ability to create wealth and not just redistribute it. One just has to look at Coca-Cola with its market value of \$100 billion to see how the market can create wealth from



even the simplest beginnings; that is, \$100 billion of wealth created from a formula for a carbonated drink—that is a powerful premise. Or, how about the creation of Microsoft, where twenty-five years ago Bill Gates and Paul Allen were working in their garage only to end up creating a company worth \$295 billion? The magic of capitalism is that it is geared to create value where none existed before; whereas, in gambling, wealth is merely redistributed. If you sit down at the slot machine and proceed to *invest* \$100 then you are highly likely to realize no *value*; rather, someplace else in the casino, a lucky person wins \$95 and the house keeps your other \$5. The same cannot be said for the market, where a good idea and good management can create \$10,000 of *value* from an initial \$100 *investment*.

Upon arriving at our hotel and reading the welcome brochure, we noticed that Las Vegas bills itself as “the first and

largest city whose economy produces no products of any tangible value.” This also got us thinking about how some investors share a similar sentiment around their stocks; after all, what sort of tangible value comes with that one page trade confirmation? What exactly does the 500 shares of Lowe's stock you own tangibly represent? Simply, it represents true ownership of Lowe's earnings and assets. Lowe's buildings, you own them. Those forklifts cruising up and down the aisles—yep, you own those too. You are an owner of their business, no different than if you personally formed that business. If you own a REIT (Real Estate Investment Trust) or a fund that owns REITs, then you actually own office buildings, shopping centers and golf courses. Ownership in Tortoise Energy means you actually own a share of pipelines that transport oil. Now it doesn't get any more tangible than pipelines!

Is there an element of gambling involved in investing? Sure, as there is always the possibility that the businesses an investor owns will not perform, putting the investor at risk of losing some or all of their money. So, yes, there is risk in investing (if there wasn't we would not receive higher long-term returns) but capitalism has proven that it can create value from humble beginnings. Gambling, on the other hand, excels at making sure the odds are against you, and that no value is created, rather its only redistributed. You can rest assured that we are dedicated to creating portfolios that stress value creation over value redistribution.





Our 30 Second Super Bowl Commercial



As the Super Bowl and college bowl games are played out over the next few weeks, we are all inundated with advertisements from the big brokerages, insurance companies and other financially related entities all promising to deliver you to the financial promise land. We, personally, have grown tired of ads showing a broker and his clients sitting outside their beach house discussing how that broker's products and services will lead them to the good life. What disturbs us about these commercials is the untold part of the story. Figuring you do not care to see us raise your fees to the levels necessary for us to spend the \$2.4 million needed to buy 30 seconds of Super Bowl ad time, we decided to spend 37 cents and use this newsletter to "air" our own commercial and distinguish Compass Financial Consulting from the "other guys."

Imagine that you are watching the Super Bowl where the Chicago Bears are beating the Indianapolis Colts. There is a break in the action, and the announcers go to commercial. Here is how our ad would start—we would flash across the television screen, the headlines that investors seem to have largely ignored over the past few years...

"Morgan Stanley to pay \$50 million settlement."- USA Today. Morgan pays \$50 million to settle charges of abusive mutual fund sale practices. The SEC said that Morgan received millions of dollars in commissions to steer customers to a select group of mutual funds.

"Why a brokerage giant pushes some mediocre mutual funds"- Wall Street Journal. Edward Jones & Co. had strong incentive to sell poor performing Putnam funds instead of rivals that performed better because Jones received hefty payments- one estimate tops \$100 million a year- from Putnam and six other fund companies. While not illegal, the practice is not disclosed. The fund companies on the preferred list also paid for Caribbean cruises and African-wildlife tours for Jones brokers. More than half of the firm's brokers are invited on the semi-annual trips.

"Wall Street firms to pay \$1.4 billion to

end inquiry"- Wall Street Journal. In a pact that could change the face of Wall Street, ten of the nation's largest brokerages agreed to pay a record \$1.4 billion to settle government charges involving abuse of investors during the stock market bubble of the late 1990s.

"NASD fines Morgan Stanley \$2 million"- USA Today. The NASD, the self regulatory arm of the brokerage industry, fined Morgan Stanley \$2 million for using sales contests to reward brokers for selling the firm's mutual funds. Securities regulators have prohibited sales contests because of the conflicts of interest.

"As Wall Street Seeks pre-IPO Investments, Conflicts may arise."- Wall Street Journal. In December 1999, the investment banking arm of Chase published an analyst's report praising Infospace Inc. as a "must-own holding." A few weeks later, Chase reiterated the "buy" recommendation. But while the bank's analysts were telling customers to load up, Chase itself was bailing out. In late January 2000, with the buy rating still in place, Chase had sold all of the Infospace stock owned by its venture-capital arm, plus a stake owned by an employee fund.

"Financial Plans: Selling for In-House Gains?" Wall Street Journal. Former American Express (now Ameriprise) advisors say that when they presented a financial plan, they dubbed it "The Close," because of its usefulness in selling high-fee products, including proprietary funds and insurance that paid more to the advisor.

We shake our heads in disbelief when reading about these abuses wondering how these companies stay in business when they have so shamelessly ignored their duty to their clients? Unfortunately, the answer is easy, "MONEY" and lots of it. For example, in 2004, Merrill Lynch alone spent \$533 million in marketing development and advertisement. Spending that sum of money on glitzy spin control that paints a rosy picture seems enough to overcome the sordid

truth that the large brokerage firms are designed to work against investors. In our 30 second commercial, we would want to drive home the point that Wall Street is in the manufacturing and selling business, not the objective advice business. Warren Buffett, in his 2000 annual report summarized it well, "But a pin lies in the wait for every bubble. And when the two eventually meet, a new wave of investors learns some very old lessons: *First, many in Wall Street, a community in which quality control is not prized, will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest.*"

Our commercial (okay it is more than 30 seconds by this time but we are on a roll) would then elaborate on the games that Wall Street brokers play. Too many people think that Wall Street brokerage firms exist to provide investors with good, objective advice. From the outside this appears to have some validity, since the large firms come staffed with analysts, economists, etc. We would want to point out that even with all these well trained individuals, these firms are still a manufacturing business. Like other manufactures, their objective is to develop products that will sell and then hire salespeople to move those products. We would be the first to admit that there is nothing wrong with manufacturing and selling a product, it is capitalism at its core, but as an investor, are you willing to bet your financial future on receiving objective advice from the manufacturer of the actual product? Many times the only "objective" in these firms advice is to sell that stock they represent or product they created.



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This idea of objective advice becomes even messier when the firms start adding incentives. In fact, it becomes as messy as feeding a nine month old a cupcake. If you don't believe me then here is a picture to prove it.



The fact is that every manufacturer has some products that are the cream of the crop and are easy to sell. On the opposite end, there are always some lousy products that are tough to sell. So how does a manufacturer move these products off the shelf? Unfortunately for investors, the strategy can include contests for the sales team that rewards them with higher commissions or payouts. Many at the big brokerages have been enjoying cruises and safaris at the expense of the investors they are supposed to be serving by clearing the shelf of products that can't sell themselves.

Think about it this way. If you walk into a Harley Davidson dealership, you expect the salesperson to try to sell you a Harley. That is what they are paid to do. You aren't expecting objective advice regarding the pros and cons of a Harley versus a Honda. Everyone understands the game which is why selling products and receiving a fee is not a bad thing. The difference is that Harley is not spending million of dollars each year to convince you that their dealers are giving objective advice. Dan Wheeler, a columnist in *Investment Advisor* and former broker in two large brokerages, put it this way, "Almost from the moment I walked through the doors, I realized I had not been hired to give investment advice to my clients but to sell products. After three years, I had enough and quit. I must emphasize that these people aren't corrupt. They're simply being led by industry practices to act in their own self-interest. But they are not the right source of investment advice for investors. The question that investors should ask is: "Do I really

want to work with people who constantly are encouraged to put their needs ahead of mine?"

Our frustration is perfectly illustrated in the current storm surrounding the "Merrill Lynch Rule." The Merrill rule exempts large brokerage firms from having to register as a Registered Investment Advisor ("RIA") like Compass or disclose some interesting fine print.

Avoiding registration as a RIA allows these firms to operate under much less stringent standards. For example, those firms not electing to register can avoid responsibility for acting in the best interest of their client; that is, they have no fiduciary duty to the investors they serve. Believe us, the large brokerage firms have been fighting tooth and nail to keep the "Merrill Lynch" rule from passing. If it did pass, and they still elected not to register as a RIA, then their investors would be in for some interesting fine print. A sampling of how non-RIA disclosure might look (and how to interpret it) is:

"Our interests may not be the same as yours." In other words, the broker can place the interests of himself and his firm ahead of yours.

"We are paid both by you and, sometimes, by people who compensate us based on what you buy." A culture for the incentive shenanigans to continue unabated.

"Our profits and our financial advisor's compensation may vary by product and over time." Means if we can't sell these dogs on the shelf, we will just raise the level of incentive until we do.

Those three disclosures show the difference between a brokerage firm and a Registered Investment Advisor. So, we would want to stress in our commercial that, as a Registered Investment Advisor, our first and foremost duty is to always act in our client's best interest. For us, holding ourselves to this fiduciary standard means operating at a level that is fully transparent using principles that demonstrate that our business is built with the client's best interest in mind. We would want to stress the following examples:

- We "eat our own cooking," meaning we will personally invest in the same securities that are used for our client portfolios. After all, shouldn't you expect your advisor to have enough confidence in their recommendations to put their own money into it?
- When we buy or sell these investments, we place the client's interest before our own. This means we avoid buying a security until client accounts have been purchased for and we will look to be the last to sell a security if that position is ever exited. This process is done so the client is afforded the opportunity to receive the best price for a security.
- We will only be compensated by the client through the use of standard fees. There will be no commissions so as to avoid any incentive to just "buy and sell" nor push a product we would not buy ourselves. Our allegiance is always to our clients, and we will never allow our advice to be impaired by an outside party and any type of incentive that they would offer to us.
- We will avoid or disclose any situations that a client may consider a possible conflict of interest. We have gone so far as to make you aware of the token lunches, clothing, etc. we receive from any fund company or service provider we use and our operating procedures call for us to politely refuse or to actually pay for any potential significant gift offer that is made to us from vendors or other advisors (e.g., tickets to a sporting event).

As the commercial fades off the screen we would finish with the tag line, "Now that you know how the game is played on **Wall Street**, why don't you consider partnering with someone from **Main Street**, *Compass Financial Consulting, LLC*." And now back to Super Bowl XL...Go Bears!

Our Third Annual "Thermal Pollution" Contest

Once again, we are offering the opportunity to amaze and thrill us with your ability to accurately forecast the direction of the stock market in 2006. The brokerage houses, financial publications, and CNBC are in the midst of making their predictions for the upcoming year, so we wanted to give you a chance to add your voice to what we lovingly refer to as "the thermal pollution of the financial landscape." Or in layman's terms, "polluted with a bunch of hot air."



In an amazing feat, we are proud to announce that Ted Waters and Anne Kerner have won their second consecutive "Thermal Pollution" contest by having the closest forecast of where the Dow Jones average would finish the year. Ted and Anne predicted the Dow would finish at 10,890 which was closest to the actual Dow figure of

10,718. Most of the other guesses from last year proved again to be a little too bullish. Ted and Anne win a dinner from Compass along with the coveted "Thermal Pollution" trophy (in the shape of a charging bull.) When given the news Ted remarked that he has embarked on a project to build a new bookcase to house their collection of trophies.

We would invite all of you to break out your lucky 8 balls and get ready to make your predictions for Dow 2006. Email us your predictions of where the Dow Jones Industrial Average index will finish on December 31, 2006. All entries must be received by January 31, 2006. The winner will receive their very own "Thermal Pollution" trophy and will be treated to dinner for two so that we may converse on the strategy of how one can make such a great guess. Ladies and gentlemen, the challenge has been laid down, "Can somebody stop the guessing superpower known as Ted and Anne, or will they three-peat?"

TRIVIAL PURSUIT

The question for this quarter is: "In which Las Vegas hotel did Elvis marry Priscilla?" The winner of the contest will receive a new Canon Power Shot digital camera. Retail value is around \$175.00.

Please note the rules for our trivia contest. We will take all correct answers through 5pm Eastern Time on January 31st. You must respond to kraus@financialdirection.com or johnb@financialdirection.com with your answer. If you do not have email, you may call us to give us your answer. We will take all correct answers received by the deadline and include those names in a drawing to be certified by the staff of the accounting firm, Bridges & Dunn-Rankin, LLP.

Answer for Fall 2005. "What is the difference between a hog and a pig?" The most popular answer was "Pigs get fat and hogs get butchered" but the technical answer we were looking for was "Pigs weigh less than 140 pounds and hogs are over 140 pounds." Since there was no correct answer, we have decided to double the pot for the Winter 2006 trivia question.



200 Galleria Parkway
Suite 1950
Atlanta, Georgia 30339

Kevin Kraus, CFP®, CPA
John Bochniak, CFP®, CPA
Kent Bridges, PFS, CPA
Sander Abernathy, CPA

Phone: 770-563-8895
Fax: 770-563-8885

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WWW.FINANCIALDIRECTION.COM



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