REPRINTED FROM FEBRUARY 20, 2012

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Concentrated Investing for Long-Term Growth

DAVID M. CARLSON has been in the investment field for over 30 years and is one of the Founders of Compass Capital Management, Inc., in Minneapolis. He is also one of the six Portfolio Managers responsible for investing over $560 million in assets — as of Feb. 7, 2012 — for individual and institutional clients. He finds the best aspects of his role are helping clients identify and achieve their long-term financial goals, and working with the other five portfolio managers and five administrative support staff at Compass. Mr. Carlson graduated from Luther College, Decorah, Iowa, and holds master's and Ph.D. degrees from the University of Michigan, Ann Arbor.

SECTOR — GENERAL INVESTING

TWST: Please tell us about the history of Compass Capital, and what made you decide to found the company.

Mr. Carlson: Charlie Kelley and I founded Compass in August of 1988. We had worked for a number of large financial companies which provided many related and unrelated services, and it occurred to us we could do our best work for clients if we could focus primarily on the investment style we preferred and had used successfully for years, so we created Compass. At that time, back in 1988, there weren't many independent registered investment advisers in the Minneapolis/St. Paul area, so it was a somewhat daring beginning, but we registered and got started. It has been great fun and has worked out very well for our clients and for us.

TWST: Why did you decide to focus on individual securities rather than on mutual funds?

Mr. Carlson: The most popular buzzword in our industry right now is "uncertainty." Everyone seems to be talking about it. Because of this uncertainty, we are now seeing an epidemic of what we call "grandma's attic" portfolios. Bankers, brokers, planners, managers and many other advisers are routinely putting together very complex portfolios for clients. Ted Benna, for example, the creator of the 401(k), recently said he had created a monster because of this complexity. We talked just a few weeks ago to a corporate retirement plan that offered 163 fund choices in their plan, which they affectionately referred to as their "dartboard program," since the participants had no idea how to choose among all these options. Peter Lynch has been quoted as saying that, although diversification is fine, if it goes too far, this becomes "di-worse-ification." We think he is correct. There seems to be an element of desperation in the air, as financial advisers appear to throw nearly everything and anything into portfolios hoping something will work. In our view, this isn't how portfolios should be managed. At Compass, we move in the opposite direction. We want clarity, we want transparency, we want greater control over our holdings. We and our clients want to know what we are invested in and why we are holding these securities. So we feel we have a better likelihood of achieving these goals with a limited number of carefully selected individual stocks and individual bonds for our core stock and bond portfolios.

TWST: When you meet with someone to set up individual accounts, what are the types of issues you ask them about and take into account to develop their portfolio?

Mr. Carlson: Although we have a very disciplined investment style, we have many different types of accounts. So with each client, we start at the very beginning, getting to know precisely who they are and what they are looking for. We have accounts for clients who are primarily seeking income. Others may want an all-stock portfolio for growth. Many want a combination of growth and income. The most important thing for us is to know specifically what the client is looking for. If they are appropriate clients for Compass, then the question is asset allocation; how much of the portfolio should be in bonds; how much should be committed to stocks. All of this information is formalized in a written investment policy statement for each account we manage. The client drives everything, but the stock and bond investment disciplines we use are followed across all of our Compass portfolios. The six portfolio managers at Compass all manage our core stocks and bonds in the same way. They also make up the Compass investment team which meets weekly to review holdings, discuss pertinent economic issues and to present new investment ideas.

TWST: You mentioned you have a disciplined style. What do you mean by that?

Mr. Carlson: Our core stock style has just 25 different stocks, and they are equally weighted. They are large, well-established, growing, high-quality, primarily global companies. We buy bonds for principal preservation and income, so we limit purchases to high-quality bonds only and maturities of one to 10 years. We add value by shopping and swapping between sectors — tax-free and taxable municipals, corporates, U.S. Treasuries, among others.

TWST: How would you characterize your investment philosophy?

Mr. Carlson: As in medicine, our governing principle at Compass is "first, do no harm." What this means is that managing risk is at least as important to us as striving for high returns. This is why we focus on high-quality stock companies and high-quality bond issuers we can understand and follow closely over time. Risk and return are really two sides of the same coin. Simple math reminds us that if we lose 50% of the money, we then must generate a return of 100% just to get back to even. It's best not to lose money in the first place, if possible. We clearly don't control the markets and obviously cannot promise we will never lose money. Nevertheless, over the past 24 years this Compass philosophy has served our clients very well — especially during periods of economic stress.

Highlights

David M. Carlson discusses the investment strategy at Compass Capital Management, including some of the stocks in its portfolio. The portfolio holds 25 stocks, all equally weighted, and seeks to mitigate risk while investing in growth stocks — growth being defined as faster earnings and revenue increases than the S&P500. The portfolio is currently overweight basic materials and industrials, and does not include energy or utilities. Mr. Carlson says some of the reasons to sell include a stock becoming larger than its intended 4%, a loss of faith in a company or the finding of a more attractive stock. Companies include: Franklin Resources (BEN); CVS Caremark Corporation (CVS); Accenture plc. (ACN) and Illinois Tool Works (ITW).

TWST: How do you define a growth stock and how do you identify something that fits into that category? What are the factors that you look at specifically when you are picking stocks?

Mr. Carlson: The simple definition for us is a company whose earnings and revenues are growing faster than the broad market — S&P 500. And if there is a dividend, we want the dividend to be growing as well.

improving, but valuations of many of these big high-quality growth companies are still very appealing. So for us, growth is wherever you find it; earnings, revenues, dividends, and it looks to us like many of these companies are once again in the bargain bin.

TWST: What about specific sectors?

Mr. Carlson: As we define growth, it's usually difficult for us to buy commodity-based companies such as energy stocks. Nor do we buy utilities. We also have only one financial stock, and that dramatic underweighting helped us come through the 2008 downturn in fine shape. Within our 25-stock portfolio, as you can imagine, we have some dramatic overweightings and underweightings versus the S&P 500 index. For example, we have a triple weighting in basic materials; 12% there versus 4% for the S&P. In industrials, we have nearly a double weighting, 20% versus 11%. Our consumer discretionary weighting is about the same as the market. Consumer staples are slightly overweighted, 16% versus 12% for the S&P. In technology we are very similar, 16% versus the S&P's 19%. As I mentioned, we hold just one financial stock, so that's a 4% weighting while the market weighting is 14%. Reflecting our contrarian bent, we have a considerable overweighting in health care, 20% versus 12%. Health care is obviously very much in the center of one of the many economic/political storms going on in this election year. We are finding some great companies at bargain prices there.

TWST: So health care is a good example of your basic philosophy. Are there good values attracting you to the space?

Mr. Carlson: Yes. The health care companies we own have been through tough times before, and most of them are globally positioned. So even if times are rough in the U.S., they can direct more of their business elsewhere and benefit from it.

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TWST: What are some of the major themes that are impacting your investments right now? What are some of the sectors that you feel are best positioned given the current state of the economy?

Mr. Carlson: When I last spoke to *The Wall Street Transcript* back in June of 2009, it was great timing because we had just gone through the dramatic downturn of 2008. That may sound strange, but what I mean is, it was bargain-bin time, which was great for us. We found all kinds of wonderful companies available at very cheap prices. So we were buying many names in the fourth quarter of 2008 and the first quarter of 2009. I'm feeling a bit like that now. The economy seems to be

TWST: What about specifics? Would you tell us about some of your top picks right now and why you like them?

Mr. Carlson: Certainly. Keep in mind, these aren't specific recommendations to buy or sell now. I'm just describing companies that are in our universe. As you know, the 10-year U.S. Treasury note now yields about 1.9%/year. Here are several quality growth stocks which in some cases yield more than the 10-year Treasury, but whose dividends are growing rapidly, unlike the Treasury. **Franklin Resources** (BEN) increased their dividend 14% last year and paid an additional $2 per share special cash dividend as well. **CVS Caremark** (CVS) increased their dividend 43% last year; **Accenture** (ACN), 36%. **Illinois Tool**

Works (ITW) increased their dividend by only 6% last year, but the stock currently yields about 2.75%/year, and the dividend has increased by over 18%/year on average over the last five years. Taking a longer-term view of our 25-stock portfolio, you would see that among the stocks which pay dividends, the average dividend increase for the five years ended 2011 is over 16%/year. Many investors are hunting for income. It may seem ironic, but big growth stocks could be a wonderful place to find it. Two or three years ago, this opportunity was not broadly recognized. We're now starting to see more interest in this —although such investors must be prepared for stock market risks.

1-Year Daily Chart of Franklin Resources

Chart provided by www.BigCharts.com

example, that might cause us to sell. If they have a major management change and we no longer have confidence in the track record of the new management, we may sell the name too. We also have very stringent leverage requirements, so if a company gets much over 40% debt to total capital, we would sell the stock. Third, the most common reason for selling a name is that we simply found another company that appears to have better growth prospects at a better price.

TWST: How often do you sell?

Mr. Carlson: If you look at our 24-year history, our average turnover is about 20% per year — five names. But of course, that varies greatly depending on market conditions. As I mentioned, we had a field day in the fourth quarter of 2008 and the first quarter of 2009, when so many bargains appeared. That downturn gave us an opportunity to upgrade a number of our holdings, which led to higher portfolio turnover at that time.

TWST: How else do you manage risk in your portfolios?

Mr. Carlson: The main consideration is asset allocation, especially the percentage committed to equities. One could argue that now, however, with U.S. Treasuries yielding 1.9% on the 10-year maturity, bonds may be vulnerable as well. But as mentioned, we try to manage risk with bonds by limiting our purchases to one-to-10-year maturities only. With our bonds maturing and paying interest on a regular basis, this reduces some of the reinvestment-rate risk. We also only buy bonds that are rated A or better at purchase. On the equity side, by equally weighting our stock portfolio, there's some risk protection there. And the quality of our companies is such that even if they have a bad quarter or must go

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TWST: Why did you choose to have 25 stocks in the portfolio? What is right with that number?

Mr. Carlson: Studies indicate that, with the kinds of large global companies we emphasize, our stock portfolio is probably adequately diversified with just 15 names, so we might even be overly diversified. But 25 stocks has been a good number for what we do. We also want to be sure to make meaningful commitments to the portfolio so that the choices we make will have a significant impact. One of the problems with the "grandma's attic portfolios" described earlier is that they may have hundreds, even thousands, of holdings. Whether these individual holdings quintuple in value, or go to zero will have little impact on such a portfolio. We want to make sure that when we buy 25 stocks — a 4% commitment each to the equity segment of the portfolio — each one will have a meaningful impact. If a stock runs up to a 5% weighting we'll trim it back to 4%. If it drifts down to 3% we'll add to it, bringing it back to 4%. This forces us to be objective, buy low/sell high and lessens risk to some extent.

TWST: So if a stock goes to more than 5%, you'll trim it. What else makes you decide to sell a stock?

Mr. Carlson: There are three reasons. First, if it's considerably overvalued. Second, if something significant has gone wrong or changed in the company. We want highly predictable, transparent companies. If they make a large acquisition outside their core business, for

1-Year Daily Chart of CVS Caremark Corporation

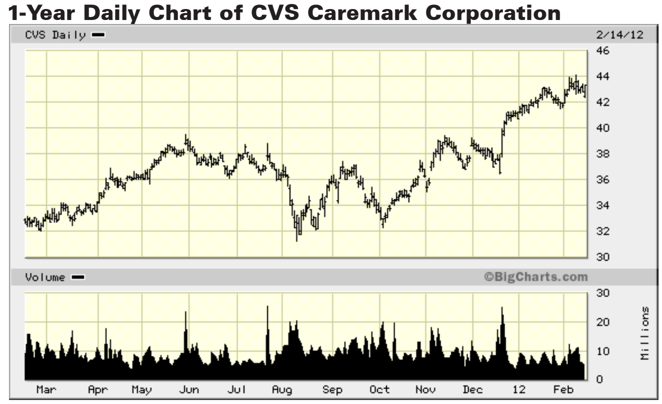

Chart provided by www.BigCharts.com

through economic times like the present, they have had a long track record of navigating successfully through such times before.

TWST: What's your outlook for 2012?

Mr. Carlson: As everyone is saying, it's an age of uncertainty, isn't it — and this is an election year besides. I remember John Kenneth Galbraith saying that economists predict not because they know but because they're asked. So it is a particularly hazardous time to make predictions. What we do know is that some economies, including the U.S., are recovering. Corporate profits in the U.S. are generally impressive as well. We are particularly encouraged by the valuation of quality growth stocks in the U.S. and the performance of the U.S. equity market as a whole so far this year. So overall, we are optimistic for equities; less so for bonds which have been in a bull market for decades. However, even bond investors should fare acceptably if they keep their maturities fairly short — 10 years and less — and their credit quality high. So overall, I am optimistic about 2012.

TWST: You have a background in music. How did you get into investing?

Mr. Carlson: I've encountered many people who've been in other careers first before entering the investment field. We are a nation of career changers. I was a Professor for some years who happened to also be interested in investing. The trouble with being a Professor in the humanities is that I didn't have much to invest. So I decided to change that, did a great deal of additional study, and have spent over 30 years in the investment field. It's been a fascinating career for me, as was university teaching.

TWST: What is the best advice you would give investors looking to get into the market or those that are already there?

Mr. Carlson: I think the best advice I can provide is simply to become truly long-term investors. We should try to invest in great businesses that are likely to be able to deliver results you can see, understand and feel good about over a long period of time. I think our attention spans have become far too short, with the endless barrage of TV chatter, e-mails, faxes, tweets, cell calls, etc. So I would say become longer-term, focus on quality, look at great growth stocks in the market now, the better-quality ones I've been describing. I'm not predicting whether they will go up, down or sideways tomorrow. I'm just saying that over a long period of time, some of these companies have really delivered. I remember buying Illinois Tool Works back in 1989 at $4.75/share — adjusted for splits. The stock is now $56.10 — Feb. 8, 2012 — and it pays a dividend of $1.44/share, for a yield on original cost of over 30%/year. This is not to argue for a buy-and-hold approach, which too often means buy and forget. No, watch your investments like a hawk, but if the companies are delivering good business results, stay with them. Give them a chance to reward you.

TWST: Thank you. (LMR)

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