COMPASS WATCH

DAVID M. CARLSON | CHARLES M. KELLEY, CFA
LEIGH E. NIEBUHR | MARK S. HALVERSON | JAY M. JACKLEY, CIMA | MARK A. VITELLI, CFA

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BLACK SWANS AND BLACK HELICOPTERS

It comes as no surprise to us, especially during periods of significant market stresses (think 2000 or 2008) or today's startlingly low interest rates; pundits begin to emerge promising and promoting "solutions" with their clairvoyance. How do institutions and individuals, with limited time and resources, separate fact from fiction in what sound like plausible scenarios? What are the 100-year Black Swan events and alleged Black Helicopter conspiracies today? Let's examine a few.

1. **Party Affiliation and Market Performance.** Election season has been in high-gear and there have been many claims that the political party affiliation of an elected President has a profound effect on future stock market returns. However, if you examine a President's first 200 trading days going back to late 19th century, there appears to be little, if any, correlation between equity market performance and party affiliation. Since 1896, the stock market has gained an average of 5.6% under Republican Presidents vs. 4.9% for Democrats[1]. This is hardly a material difference spanning a majority of our industrialized history.

2. **QE1, QE2 & QE3 *must* be inflationary.** With the recent announcement of a third round of quantitative easing, investors are again (prudently so), nervous about the negative impact this might have on future interest rates. There are two primary forces behind inflation—the *supply* of money and the *velocity* of money. The Federal Reserve's latest QE program will effectively expand the supply of money, which has the *potential* for future inflation, but does not increase the velocity of money. Velocity is closely tied to bank lending and this remains anemic as banks face a combination of higher capital requirements and regulations (Dodd-Frank). Another component of inflation is wages. As of September, 14.7% of Americans are either unemployed or underemployed, keeping a lid on wages. Moreover, a cohort of baby boomers is exiting the labor force, which is hugely deflationary.

3. **Emerging markets lead to superior returns.** As you know, GDP (Gross Domestic Product) growth in the U.S. has decelerated while the prospects for higher GDP growth in emerging markets has led to a resurgence of the "future growth means higher returns" scenario. The fact that emerging markets are *projected* to grow does not indicate they will necessarily provide superior investment returns. Why not? First, we are referring to growth in each country's real economy, which is not the same as growth in the stock market. Second, even stock market expansion may not provide profits for investors. Third, the companies that benefit from emerging growth may be in the developed markets (i.e. U.S. multinationals, like we hold at Compass). Fourth, it may be (new) private companies contributing to GDP growth, but not to stock market returns (this may help explain why the relationship between GDP growth and stock returns is so noisy). Moreover, the link between GDP growth and stock returns is empirically weak. In fact, data suggests that 99% of the variability in equity returns is associated with factors other than changes in GDP[2].

We don't claim to be able to predict the future with precision either. Fortunately, successful investing doesn't depend on that ability. Interest rates and inflation may rise (or fall); stock and bond prices may do the same. Our job is not to predict. Our responsibility is to manage client portfolios day by day; applying sensible, time-tested disciplines which address client needs and responding appropriately to changing realities. Conspiracy theories and fanciful scenarios make interesting stories, but they are a very poor basis for implementing a sound investment strategy.

[1] The Leuthold Group.
[2] Credit Suisse.

For more information regarding our company, disciplines and results, please call, write, e-mail or visit our website: www.compasscap.com

Compass Capital Management, Inc. * Baker Building, Suite 400 * 706 Second Avenue South * Minneapolis, MN 55402 * (612) 338-4051