COMPASS WATCH

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TODAY'S INVESTMENT LANDSCAPE

It is obvious that we are living in a time of dramatic change in the U.S. economy. While some of this change results from the collapse of the housing bubble in 2007-2009, on a deeper and more pervasive level, there is a fierce battle going on between advocates who believe free market forces are the best means of resolving the economic challenges we are facing, and supporters of central planning, who are confident government is the appropriate mechanism for addressing such economic problems. Although the individuals at Compass do and should have private opinions about this controversy, our responsibility is not to take sides publicly. Our duty is to dig beneath the surface of the battle and try to determine which key issues in this investment landscape may significantly affect the securities we consider for client portfolios.

Here are five of the more significant considerations:

THE ROLE OF GOVERNMENT IN THE ECONOMY IS EXPANDING: Some industries are now controlled to a great extent by the federal government – autos, housing, financial institutions and much of health care. This makes rational investment decision- making more difficult when key factors affecting a company's future may be determined on a political basis in Washington. Even if a company hasn't actually been taken over, litigation and regulation risks in these industries are increasing rapidly and must be considered as well. If we become interested in investing in these companies, we must first determine that the risks appear fully discounted in the price of their securities. Of course, the best way of avoiding such risks is simply by not investing in troubled industries. At present, our Core* stock portfolio contains no auto or home building stocks and the only financial company we hold is neither a bank nor insurance company and has come through the economic downturn in fine shape.

TAXES WILL BE INCREASING: Although the specifics are not yet known, taxes will be rising dramatically, especially on the "investment class", which includes those making over $200,000 annually in taxable income. For example, common stock dividends currently taxed at the 15% maximum federal rate may more than double to 40% under some proposals. Taxes on capital gains and other forms of "unearned income" will also be going up. Although we always consider taxes in our investment strategies, these changes will make such considerations even more important. Tax-free municipal bond interest could become more valuable, for example. It will also be essential to determine precisely what types of investments should be used in taxable vs. tax-exempt accounts, given the regulatory realities at that time.

CREDIT QUALITY RISK HAS INCREASED: Any bond investment is only as good as the issuer's ability to pay principal and interest on a timely basis. Many municipalities, even states such as California, are having trouble meeting their debt obligations. Some even wonder if the federal government may be unable to pay back all the money we owe U.S. and foreign investors. U.S. mortgage-related federal agencies such as Fannie Mae, Freddie Mac and the Federal Home Loan Bank have been particularly impacted by the housing debacle. With this in mind, we have been selling these bonds (at significant profits in most cases) and buying issues whose financial characteristics are more transparent and whose credit quality appears to be considerably better.

MANY U.S. CORPORATIONS APPEAR TO BE HEALTHY IN SPITE OF THE ECONOMIC DOWNTURN: These companies cut costs, reduced balance sheet leverage and maintained healthy cash flow and profitability in the recent downturn. We have been buying the stocks and bonds of some of these fine companies as a means of improving the financial health of our portfolios.

GLOBAL DIVERSIFICATION IS BECOMING MORE IMPORTANT: We certainly hope the U.S. economy will continue to recover and that policy makers will make wise decisions in the future. However, in this environment, it is important to hold investments which are diversified globally. Most of our stock companies have the financial flexibility to shift operations to geographical areas where the sale of their goods and services is valued and can grow. At the present time, 75% of the companies in our Core* stock portfolios have more than one fourth of their total sales outside the U.S. and 28% generate more than half their sales outside our country.

Periods of serious distress are never enjoyable, but they do create investment opportunities, and it is great fun finding them! This is how we view our job –looking for these mispriced and underappreciated gems, finding them and then helping clients benefit as their real value is discovered by others. We are also encouraged knowing that a strong recovery is clearly underway at the present time. We hope our federal and state governments will make wise and informed decisions, so the recovery will strengthen and expand. There really is no other choice, since it is the private economy which ultimately must pay for government.

**Our Compass core stock portfolio contains 25 stocks managed on a fully discretionary basis.*

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