
COMPASS WATCH

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WHAT WE MEAN BY "QUALITY" INVESTMENTS (AND WHY WE INVEST IN THEM)

Those familiar with how we manage money for clients know we invest in "quality" stocks and bonds. We are investors, not speculators. But what, precisely, do we mean by "quality"? It means we buy bonds whose issuers are very likely to be able to pay principal and interest when due. It also means we buy common stocks of companies which are financially strong and likely to be able to grow earnings (profits) and dividends (if any) well into the future. So, why do we do this? For one thing, to protect principal. Our clients don't want to have to earn again the money they entrust with us. As we see it, the first rule of investing, as in medicine, is "first, do no harm." In our business, the equivalent is, "first, don't lose the money". Successful investing requires an effort to tilt the odds in the investor's favor. Investing in issuers which have a demonstrated ability to deliver in good times and bad helps to do just that.

But what determines quality? As we said earlier, with bonds, quality issuers have a high likelihood of being able to pay interest and principal when due. Several services attempt to determine this ability by analyzing and rating bond issuers. Several of the best-known services are Moody's, Standard & Poor's and Fitch. There are many financial tools and analytical services that help us determine quality in common stock issuers as well. We analyze balance sheet strength, cash flow, earnings predictability and many other financial aspects to determine corporate quality. We also subscribe to services such as Value Line, Zacks and Bloomberg to assist us as well. Finally, we receive Wall Street research from some of the finest analysts in the U.S. to help us assess quality.

Can investors lose money in quality investments? **Yes! They can!** (if they sell when these investments are down in value). Even the best bonds go down in price when interest rates rise (though good bonds still pay off at par/face value if held to maturity.) Even the best quality stocks can and do decline in price if there is negative news or if the market generally is in decline. However, quality companies are resilient and their stocks tend to recover and prosper over time.

9/11 should have taught us (again) there are no "guarantees" in investing. The life insurance industry talks about "guaranteed" income from certain types of annuities and guaranteed investment contracts (G.I.C.s). But this is misleading. Some of us are old enough to remember when a number of large life insurance annuity/GIC issuers filed bankruptcy (Baldwin-United in 1983 and Executive Life in 1991, for example). Most of us learned long ago that only death and taxes are guaranteed, so we don't apply the term to investing of any sort. Our view is that quality investments are prudent investments and again, help tilt the odds in the investor's favor, making success more likely, but not guaranteed.

Although Wall Street doesn't always practice this, we believe the first and most important consideration in prudent investing is assessing **risk**. Our job, as we see it, is matching an appropriate risk level to a client's needs, circumstances and goals. Return, then, derives from the level of risk taken, the investment style employed, and the time frame used to let the style work. It seems to us too many investors chase return, ignoring risk and investment style, and suffer the unfortunate consequences (see Compass Watch, Volume 17, Number 1: Spring 2005. "Investment Mistake #1: Chasing Returns".)

Does this mean we are "conservative" in our approach? No. It means that it simply hasn't been necessary to buy poor quality investments to try to get favorable returns. We have found that since it is possible to achieve desirable results while limiting risk, this is a "win-win" formula. That's what we are doing - - helping our clients win - - with quality investments.

**** For more information, visit and bookmark our website: www.compasscap.com ****

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