// COMPASS WATCH

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A quarterly newsletter of Compass Capital Management, Inc. *Volume 20, Number 4: Winter 2008*

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MANAGING THE DOWNSIDE - - AN IMPORTANT CONSIDERATION IN GOOD PORTFOLIO MANAGEMENT

Investment professionals and investors themselves seem to devote most of their efforts to striving for "outperformance" when individual securities and the markets are moving up. Much time and ink is spent touting "hot" ideas, products and managers who can outperform during these bullish times. However, in reality, outperformance can be far more important when securities and markets are ***down*** in value. For example, if one started with $100 and lost 50% of this amount, a 100% return would be necessary just to get back to $100. This is simple arithmetic, but its significance seems to escape the notice of many investors. As the chart below shows, the greater the decline, the much greater the return needed to recover. Small declines are relatively easy to make up. Recovering from large losses is far more difficult.

% Decline In Value	-8%	-15%	-25%	-50%	-75%
Return Required to Restore Value	9%	18%	33%	100%	300%

Take bonds. When something goes seriously wrong in a bond (for example a significant credit downgrade or default), its price can drop by 50% or more in an instant. This is why we invest in high-quality, intermediate-term bonds only in our portfolios. As we see it, bonds generally don't pay enough interest to warrant taking a major credit risk. Following this discipline has served our clients well over the 1, 3, 5, 10 and 20-year periods ending 12/31/08, with our individual taxable bond portfolio returns exceeding not only inflation, but their benchmarks as well.[1]

We apply similar thinking in managing individual stocks. The stocks we buy are mid to large, well-established, high-quality, growth companies, purchased when they are underpriced. The reason for all these qualifications is that we want to hold companies which are more likely to prosper long-term, regardless of inevitable downturns in the market and economy. This approach served us well again in 2008, when our individual stock portfolios were down 8-9 percentage points less, on average, than the market itself (S & P 500). These portfolios have also outperformed the S & P 500 and other pertinent benchmarks over the 3, 5, 10 and 20-year periods ending 12/31/08.[1]

We also manage many "balanced" accounts at Compass, which contain stocks, bonds and cash in one portfolio. The idea of combining these asset classes is for diversification, but is also intended to lessen the downside risk inherent in a stock-only portfolio. With the strong returns of quality bonds last year, our balanced accounts were down only moderately versus the stock market's steep decline in 2008.[1]

It is important to emphasize that **it is still possible to lose money, even with high-quality bonds, stocks and balanced accounts!** We can't control the economy, the behavior of governments, the markets, or the companies in which we invest. Nevertheless, if successful long-term investing involves tilting the odds in the investor's favor, an important aspect of this is attempting to address downside risk as well as the upside potential of the investments we select. This is what we have been doing successfully for over twenty years at Compass. Be sure to call if you have questions or wish to receive more detailed information about our results and disciplines.

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[1] Detailed performance reports are available on request. These reports show our individual taxable bond and stock management results over the twenty-year period from 1989-2008 and our Minnesota tax-free municipal bond results over the sixteen-year period from 1993-2008.

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

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