COMPASS WATCH

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2012: REASONS FOR OPTIMISM

If you touch a red hot stove and burn your finger and tomorrow you see the red hot stove again, chances are you would not touch it. Researchers call this the recency effect—satisfactory for human evolution, but not for investing. For many investors, this trait focuses a disproportionate amount of attention on recent market events and makes inferences about the future based on this short-term skewed perspective. 2011 will be remembered as a year of high volatility (68 S&P 500 sessions with movements of at least 2%—in contrast, there were just two such days in 2005)[1]. Given this volatility, it might seem tempting to stay in cash until this year's U.S. Presidential election has passed or Europe has stabilized, but that is probably a mistake. Even if you could predict the events, you don't know how the market will react. The equity market's gyrations have been driven by high anxiety. As a result, many stocks have become cheap. Stocks in general are being painted with the same brush, regardless of their differing financial strengths and results. Instead, the market has moved in broad waves: "risk on and risk off." According to the Leuthold Group (January 2012), high-quality companies (like we own at Compass) are still inexpensive relative to lower-quality companies. While the market ignores key differences between stocks, active managers can now identify attractively priced high-quality franchises at bargain prices.

Of course, it won't necessarily be smooth sailing for the U.S. and global economy in 2012. Unresolved problems still exist. However, recent signals are encouraging. We believe there are positive signs for long-term equity investors.

Valuations still remain attractive as the bull market enters its fourth consecutive year. The trailing P/E on the S&P 500 is near a 20-year low. Current dividend yields, when compared to bond yields, also suggest equity market valuations are attractive. U.S. corporations continue to grow sales and expand earnings while simultaneously improving their balance sheets (e.g. build cash and pay down debt).

Corporate profitability is strong and continues to improve. Record earnings fueled by the highest profit margins since 1993 are giving CEOs more leeway to boost dividends. Companies in 2011 that paid higher dividends outperformed those that did not[2]. The earnings growth we are witnessing should translate to stock price appreciation and additional dividend increases in the future.

Strength in the U.S. economy continues to gain traction. Industrial production has risen steadily from recessionary lows, real GDP is poised to surpass pre-recession highs and consumer and manufacturing spending has rebounded sharply over the past three years. Moreover, as of January, the U.S. unemployment rate dropped to 8.3% and jobless claims were the lowest since September 2008.

It's important to remember that fundamentals of the underlying businesses we own do not fluctuate as dramatically as the daily swings in stock prices. While many investors continue to focus on daily volatility, seizing on every piece of macroeconomic and political news to gain a sense of the overall shape of the economic future (and attempt to position their portfolio accordingly), Compass remains focused and disciplined on high-quality individual companies and the opportunity each presents.

[1] Barron's, January 30, 2012.
[2] Bank of America Merrill Lynch Performance Monitor, January 3, 2012.

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

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