COMPASS WATCH

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COMPASS INVESTING vs. PASSIVE INVESTING

Passive investing or stock market indexing—investing in a fund which closely tracks a well-known index—has been one of the most popular trends in history. Little surprise then, that during 2014, investors pulled $98 billion out of active U.S. mutual funds while adding approximately $71 billion into "passive" funds.

As 2014 finished with the S&P 500 Index positive for the sixth straight year, the ongoing "debate" between active and passive investing appears to have grabbed the attention of investors again (why does this only occur during bull markets and not when the market is negative 37% as in 2008?). The question raised recently by numerous academic and financial publications has been, "is there value in active management or are you better off buying the index?" The S&P 500 Index has characteristics which make it a highly specific investment style.

Let's examine a few differences between Compass Capital's investment style and that of passive investing:

	COMPASS CAPITAL	PASSIVE
Portfolio Construction	Equal-weighted: trim/add discipline with ability to screen for quality & attractive franchises with cheap valuations.	Capitalization-weighted: by definition, disproportionally purchasing greater percentage of biggest companies.
Fundamentals	Growing companies with strong free cash-flow, diversified customer base & high barriers to entry.	None—no judgment required. Inclusion based on size.
Risk Management	Strong focus on fundamentals & price paid with the ability to deploy cash as appropriate.	Minimal to none—only factor driving portfolio composition is the relative size of the company within the index.
Compass vs. Passive	Active (experienced Compass investment team).	Active (index committee).
Outcome	Winning by not losing—demonstrated ability to make it in the good years and not give it away in down years.	Vulnerable to momentum investing.

The risk of passive investing is particularly pronounced with the S&P 500 Index, which is a market-weighted index—the larger a company's market capitalization, the more impact it has on the calculation of index performance. For example, in 1993, the technology sector represented just 6% of the S&P 500 index. By 1999, the sector commanded 30% of the index[1]. Price appreciation became a self-fulfilling prophecy as momentum—not fundamentals—drove prices higher; until it didn't. This momentum based investing was one factor of the "tech bubble." Passive investing is easy, cheap and requires no judgment. Claims of low fees do not make questionable ideas good investments. This style of investing pays no regards to underlying fundamental value, which is rooted in a classic "bubble mentality."

At Compass, we have found that by owning a diversified portfolio exclusively of 25 mid-to-large sized and growing companies—that these companies do outperform over long periods of time, due to their superior earnings and dividend growth. Moreover, our emphasis on quality and valuation means that our companies can withstand downturns in the economy better than many others in the S&P 500 Index. In years when market leadership is concentrated in relatively few names or non-growth sectors (technology or financials, for example), we may lag temporarily. But over longer, more meaningful periods, our companies have performed very well and with less risk than the overall market.

[1] Bloomberg

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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