

COMPASS WATCH

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PORTFOLIO CONSTRUCTION THE IMPORTANCE OF ASSET ALLOCATION

As the equity markets advance to new highs (+145% from their March 2009 low) and bonds appear stodgy by comparison, investors have begun to wonder if they should continue to hold bonds in their portfolios while major financial media outlets suggest stocks are the only place to invest. However, successful investors have found the path to long-term investment success is to avoid market predictions *and* market timing, but focus on the portfolio construction and asset allocation process.

At Compass, we do not attempt to predict every market shift. Instead, we focus on helping long-term investors build a portfolio that can navigate all conditions. Two critical points of asset allocation are 1) assembling a diversified portfolio and 2) to counteract human behavior (i.e., emotions) from shifting large chunks of their portfolios into commodities, hedge funds or other asset classes in the name of “diversification,” when in reality, investors are attempting to move to an asset class they hope will perform better in the short-term. At Compass, we assist and insist in developing sensible, long-term goals and investment guidelines and view this as one of the most important steps in the investment process.

Step 1: Asset Allocation

Determining your goals and objectives is the first task in constructing a portfolio with the following four key factors, namely 1) Investor Objectives, 2) Time Horizon, 3) Risk Tolerance and 4) Liquidity Needs. These become the building blocks for your customized Investment Policy Statement (IPS) which memorializes and guides the target asset allocation process. Because we know objectives and risk tolerances differ for each investor, portfolios will differ. There is no “one size fits all.”

A well-diversified portfolio is critical to an investor’s long-term success. Unfortunately, many have learned the harmful effects of *under* diversification and mistakenly believe that more is better. However, *over* diversification is also a serious and common mistake. A bloated portfolio increases “correlation” (statistical measure of the degree to which investment returns move together) which when combined with rising volatility, can negatively impact portfolio performance. A goal for your portfolio is to meet your future needs for capital (on your terms) and provide some peace of mind during the journey by utilizing a systematic investment approach.

Step 2: Security Selection

At Compass, although we are guided by a highly-disciplined investment philosophy, there is a great deal of flexibility to accommodate investor needs for growth, income and liquidity. Our 25-year process has been proven to be effective over multiple market cycles.

Our core individual stock discipline emphasizes high-quality, mid-to-large capitalization multinational growth companies purchased when they represent a good value for long-term wealth creation.

In managing fixed income portfolios, our bond discipline focuses on high-quality, intermediate-term bonds (that have a maturity date) including municipals, corporates and U.S. Treasuries for capital preservation, liquidity and income.

Step 3: Rebalancing

Over time, your portfolio will migrate away from its target asset allocation. The act of adjusting the portfolio to its target allocation is called “rebalancing.” Rebalancing is a sensible and effective way to buy low and sell high by removing the emotions that interfere with good investment decisions. This accomplishes two important aspects to successful investing: enhancing long-term performance and mitigating risk.

Asset allocation is key to portfolio success and is generally the most significant determinant of portfolio return. The asset allocation decision is usually far more important than a manager’s skill at picking individual stocks and bonds. It is also the most important determinant of portfolio volatility (risk). Successful investing is neither chaotic nor incoherent. It is long-term in orientation (the idea is not only to make money, but to keep it) and should also be understandable and transparent.

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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