

COMPASS WATCH

DAVID M. CARLSON

LEIGH E. NIEBUHR

A quarterly newsletter of Compass Capital Management, Inc.

RONALD J. POOLE

MARK S. HALVERSON

CHARLES M. KELLEY

JAY M. JACKLEY

Volume 22, Number 3: Fall 2010

INVESTMENT MISTAKE #5: CHASING YIELDS

Every so often, when large numbers of institutions and individuals seem to be making a major investment mistake, we write about it (largely to explain why we aren't joining the stampede).¹ This is one of those times. Many yield-hungry investors from the largest endowment and pension funds to the smallest retail investors appear to be rushing to higher-yielding securities as interest rates continue falling, in an attempt to lock in favorable yields before rates decline even further. While some investors may be fleeing the volatility and unpredictability of the stock market, others just don't want to be stuck in money-market funds or other short-term securities yielding almost nothing. Still others simply won't accept U.S. Treasury and quality municipal bond yields which are in the low single digits at the present time. Reaching for yield, some of these investors are buying very long-term maturities, low-quality securities, high-risk real-estate-based investments and other products which claim to offer higher income streams.

Stretching for yield is a dangerous game. If interest rates and inflation rise significantly, long-term bonds will decline dramatically in price and low-quality securities may not survive the economic storm we have been experiencing. So, here are just a few of the ways in which we at Compass address the challenge of producing income in our client portfolios while striving to protect principal:

1. We prefer to **diversify** the sources of income - - from stocks as well as bonds. While the bonds we buy pay a fixed rate of interest, our stocks generally produce a growing dividend stream. More about this below.
2. We continue to hold **high-quality, intermediate-term** bonds only, rather than lowering quality and lengthening maturities. We do, however, shop among the various sectors of the bond market - - U.S. Treasuries, Agencies, corporate, taxable municipals and tax-free municipals - - for attractive yields which meet our parameters. We won't extend maturities or lower our credit quality to chase higher-yielding bonds. As we remind our clients, it is far better to give up a little yield than a lot of principal.
3. Most of the stocks in our portfolio pay attractive and **rising dividends**. In fact, the dividend-paying stocks in our portfolios have increased their dividends by over 15% per year, on average, over the last ten years. This has provided a significant measure of inflation protection over this time period and has served as a helpful offset to declining bond yields.
4. Although it isn't always possible or necessary, some clients are able to **reduce** their **spending rates** when yields are low, thereby preserving principal for the future. Helping clients determine the rate at which they can prudently withdraw income from their portfolios is one of the many investment advisory services we provide at Compass.

Yogi Berra has been credited with observing that "predictions are hard to get right, especially when they're about the future." Even John Kenneth Galbraith, the famous economist, used to remind his audiences that "economists predict not because they know, but because they are asked." We don't claim to be able to predict the future with precision either. Fortunately, successful investing doesn't depend on that ability. Interest rates and inflation may rise (or fall): Stock and bond prices may do the same. Our job is not to predict. Our responsibility is to manage client portfolios day by day, applying sensible, time-tested disciplines which address client needs. Managing the income needs of our clients **prudently**, especially now, during this period of low interest rates, is one of the most important tasks we perform at Compass.

¹ Previous Compass Watch "Investment Mistake" articles are: #1: Chasing Returns; #2: Ignoring Risk; #3: Lack of Discipline; and #4 Investing In Things You Don't Understand.

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

*Compass Capital Management, Inc. * Baker Building, Suite 400 * 706 Second Avenue South * Minneapolis, MN 55402 * (612) 338-4051*