

COMPASS WATCH

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WHAT HAVE WE BEEN DOING LATELY? GOING THE EXTRA MILE: FROM CLEVELAND TO HONG KONG

Over the past eighteen months, the performance of the S&P 500 Index has been modestly positive (primarily as a result of dividends) as ongoing news persists of slower growth in China, suspicious global central bank policies, the strong U.S. dollar and the sharp decline in oil prices. Additionally, the terror attacks in Nice, attempted coup in Turkey and the “Brexit” referendum caught investors by surprise, increasing the volatility in the global markets.

During this period, the Compass portfolio managers continue to actively monitor companies in the portfolio and look for new companies to purchase. In addition to drawing on a number of resources including many different types of articles, research reports, financial reports and conversations with individuals around the country, we have been traveling to meet face-to-face with both existing *and* potential companies for the Compass high-quality, high-conviction equity portfolio. Our size allows us to engage with senior leadership teams, observe body language and gain other valuable data points that can’t be obtained in an earnings release or company presentation. This “soft” information, combined with our fundamental analysis, helps us to make better decisions for the entire portfolio.

For example, over the past 12 months, we have met with a handful of our current and prospective companies in Cleveland, San Diego, Twin Cities, New York and even Hong Kong. Here are a few of our general observations:

1. Companies and their CFOs continue to maximize the low interest rate environment by adding debt to their balance sheet to repurchase company shares (many of whom are multinationals who have billions of cash trapped outside the United States and are unable to repatriate those dollars for dividend payments, R&D or capital expenditures without paying a hefty repatriation tax).
2. As a corollary to observation #1, we are witnessing many more “inversions” (moving company headquarters outside the U.S.) to gain access to this cash and avoid paying U.S. taxes on overseas earnings—think of the Medtronic/Covidien or Johnson Controls/Tyco merger.
3. After meeting with a major retailer and private equity firms on a recent trip to Hong Kong, we concluded that the environment in China is indeed changing, many publicly known and widely reported, but some due in large part to the Chinese government crackdown on bribery.
4. As companies consider building new manufacturing facilities, more are choosing Mexico (not China), affectionately known as “near-shoring.” As a response, China has taken steps to devalue its currency largely to help keep wages and goods cheaper for foreign buyers.
5. The drop in oil prices (down approximately 70% from just two years earlier) was largely the result of a supply glut, not demand weakness. Low oil prices have had an impact on Russia and sovereign wealth funds (massive outflows needed to balance their budgets, resulting in the likely sale of U.S. securities and subsequent temporary drop in the equity markets).
6. The rapid strengthening of the U.S. dollar (+32% over 1-year) has had a perceived impact on U.S. multinational’s revenue and earnings growth. For example, Johnson & Johnson in a recently reported quarter saw no change in revenues. However, excluding the impact of the strong U.S. dollar, revenue was positive 4%. In our opinion, it is far more important to evaluate investment opportunities on a “constant currency” basis, as currency translation is simply an accounting metric.

What does this mean for you? While the equity market indices may be more volatile, the Compass team continues to go the extra mile for you. High-quality investments focused on basic fundamentals, research and a time-tested investment discipline still matter. Bottom line: growing companies create wealth—increasing revenues, earnings and free-cash flow are important drivers of long-term stock value.

If your current portfolio hasn’t gone the extra mile, consider Compass Capital Management. How may we help?

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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