JUNE 2017

# TWENTY YEARS

It has been twenty years since we started Compass. The timing couldn't have been much better. The stock market's last major correction was in 1990 and stood at an amazingly high 10,000. It would be two more years and over 6,000 more Dow points before the market began to fall in 2000. Interest rates had come down from over 9% on the 10 year Treasury in 1989 to a paltry 6.5% in 1997. With the dividend yield on the S&P of 1.6%, bonds still looked attractive, but the best was yet to come for stocks as 1997, 1998 and 1999 averaged better than 25% annual returns.

Declining interest rates and a soaring stock market meant that it was hard to go wrong, but we trailed the market averages for the first two years. Something that as a young company was hard to explain, but would later benefit our clients in the brutal bear markets of 2000, 2001 and 2002.

**What we learned early in the history of Compass was that there are times when a value investment style underperforms the market, and the bull market leading up to the 2000 crash was one of them.**

## RULER STOCK MANIA

Before we left Paine Webber in 1997 their chief strategist, Ed Kerschner, coined the term "ruler stocks" to describe big cap stocks whose earnings could be plotted on a straight upward line, making their lofty valuations seem cheap compared to less predictable companies. GE, J&J, Coke, Merck were all "ruler stocks", as were some names that now live in infamy like Enron and Tyco. Sure they were expensive at thirty times earnings or more, but they had to be bought because between big cap indexing and the constant hype they were getting in the press, these stocks had to keep going up.

We, of course, thought otherwise. Value investors don't pay 30 times earnings for stocks with single digit long term growth rates, no matter how predictable that growth might be. Then there was the nagging question of just how some of these companies were managing to produce straight line earnings growth when nobody else was? **We couldn't prove it, but it looked too good to be true.**

## THE TECH BUBBLE

Just as big cap mania began to fade in 1999, and a few of those companies began to disappoint, a new mania took over. The dotcom bubble sucked money from everything that wasn't tech or telecom. If we had trouble fully participating in "ruler stock" mania, we were even less enthusiastic about stocks with no earnings. In 2000 the tech bubble bust and a three year bear market commenced. However, we actually made money in 2000 and had only modest losses in 2001 as we avoided the worst of the damage that was being done to the tech sector.

## THE 2002 RECESSION

Proud of ourselves for saving our clients from the worst of the bear market, we entered 2002 confident in our superior investment style, only to be humbled as the year progressed. **The recession set in and the market gave us no place to hide. But it did give us great places to invest, because what a value manager needs is cheap stocks, and in 2002 there were a lot of them.**

## THE GREAT RECOVERY

What followed was the most significant period of market outperformance we have ever had. Fear had driven down the prices of great companies like Pepsi, CVS, United Technologies and Adobe to levels that made them compelling investments. We still own these stocks today with cost basis that are a small fraction of their current value, but it took a brutal bear market to allow us to make these investments.

## THE CRASH OF 2008

Now that was scary! The market crash of 2008 came on suddenly and for reasons not fully understood at the time. Were all the major banks suddenly insolvent? Could housing prices simultaneously crash everywhere? Should stocks be worth 40% less than they were a few months ago? How is this possible?

Again, a full scale panic ensued. It lasted just long enough to scare everyone senseless and then, somehow, it all changed almost overnight. In 2009 the next bull market took off with a vengeance. **Again, we outperformed with investments that we made when there was blood in the streets and our clients were glad we didn't panic. The few people we had to talk off the ledge learned again that jumping is a bad option when there is money to be made in the recovery.**

## THE SECOND GREAT RECOVERY

Recessions are common. Financial crises are once in a lifetime events. So, there were plenty of reasons to assume that the panic of 2008 and the resulting recession was not going to be over quickly. Banks were constrained in lending until they repaired their balance sheets. The consumers had taken a major hit in both their investments and their homes. With the baby boomers just reaching retirement age, this was no time to wipe out a good portion of their savings.

But somehow what followed the 2008 crash was 6 years in which the average annual return of the stock market was 17.5%. To be fair, the first three years were just making up for the losses suffered in 2008, but from 2011 to now, the market is up over 50% despite Washington gridlock, a sluggish domestic recovery and a dramatic slowing in China's economy. This has been offset by ridiculously low interest rates, rock bottom energy prices and a slowly improving economy. Add in a lack of any real alternatives to investing in equities and you get a bull market.

## MALAISE AND THE TRUMP RALLY

For much of 2015 and 2016 the market did nothing. It was waiting for the Fed to raise interest rates. It was waiting for the economy to improve and waiting for the election. Then boom, the market takes off and there is a change in leadership from defensive consumer and health care stocks to long suffering financials and natural resource stocks. Because we already owned them, the new market leaders did wonders for our portfolios and we ended up having a good year.

**WHAT WE LEARNED IN 20 YEARS…BUY PANICS AND SELL MANIAS**

In retrospect, it is obvious that the best time to buy stocks was during the panics of 2002 and 2008. After the fact, it is equally obvious that tech stocks were ridiculously overvalued in 2000 and financial stocks were unlikely to continue what had been a fantastic run much after 2007. What is never known at the time is where the bottom will be or how high the market can climb. If your objective is to pick bottoms and tops you are unlikely to succeed, but if you have a reasonable objective, the task is relatively simple. Buy low and sell high. **Which is why we have learned to be contrarian investors. When there is euphoria we are nervous, when there is fear, we get greedy. That is true of markets as a whole, industries and even individual companies.**

**VALUE INVESTING WORKS MOST OF THE TIME, BUT NOT ALL THE TIME**

We started Compass during two of the great manias in stock market history. The big cap growth stock mania of the nineties and tech stock mania of the century. We underperformed the market during both of them. Value investing was out of favor and some said dead, but we suffered less than the growth gurus in the market corrections that followed the manias, and we recovered faster in the subsequent bull markets than the trend follows.

**Our investment style should come with a warning label. "IF YOU ENJOY RIDING MANIAS DO NOT USE THIS PRODUCT. IT IS INTENDED FOR LONG TERM APPRECIATION, NOT SHORT TERM PROFITS."**

**DIVERSIFICATION WORKS ALL THE TIME**

We have always been big believers in diversification when building stock portfolios. Diversification by market capitalization when we first started, because we thought the big cap mania was way overdone and wanted mid and small cap companies to balance our large cap holdings. Diversification by industry group when technology stocks began to make up twice their normal weighting in the late nineties, and energy stocks made up a paltry part of the market when oil was $20 a barrel. In all these instances, the right thing to do was to keep with a long term diversification strategy.

**STRIKE OUTS ARE INEVITABLE**

Despite our best efforts, we have owned some real dogs. We got burned in the financial crises by owning stocks that we thought were immune from the crisis, but turned out to have leaky balance sheets. The crash in natural resource stocks hurt us particularly hard because they looked cheap when we bought them, but they got much cheaper as oil and mineral prices plummeted. Sometimes even great companies can change for the worse and buying them becomes a classic "Value Trap." Fortunately we have had lots of big winners to offset our mistakes.

**HOME RUNS ARE LESS IMPORTANT THAN HITTING SINGLES**

We were exposed enough to tech stocks during the mania to get some fabulous price appreciation. We've also had strong returns from stocks like Tyson and Constellation Brands, proving even boring industries can give you great returns. The airlines we bought when everybody hated them have taken off. Anything we added to technology and financials after their respective crashes has been golden.

But hitting home runs with 5 or 10% of the portfolio is much less important than what happens to the other 90 or 95% of a portfolio. It's about owning Pepsi instead of Coke because Pepsi is better diversified. Owning United Technologies instead of GE because we didn't trust GE's accounting. Owning JP Morgan instead of BankAmerica because they have better management. That's how you beat the market.

## WALL STREET'S SCAM MACHINE NEVER SLEEPS

For the past twenty years while we have been turning out better than average returns for our clients with simple stock and bond portfolios, the charlatans of Wall Street have been producing one investment scheme after another. Ed Kerschner left Paine Webber when the "ruler stocks" needed parachutes. Henry Blodget and Mary Meeker escaped jail for pumping tech stocks they knew were worthless, but investors at their big firms lost their shirts. When it became clear that beating the market by flipping mutual funds was a fool's errand, they invented ETFs, but now they are trying to do the same thing by trading them franticly.

The worst piece of misrepresentation we have ever seen is what "investment managers" are pushing today in their proposals to clients, using past returns on hypothetically constructed portfolios of mutual funds, ETFs and outside managers (SMAs). We've looked at dozens of these is recent years with lovely charts illustrating jaw dropping returns and low risk. If only you had done years ago what the advisor is recommending today. This is kind of like picking the winning team after the game is over. Plus, they failed to tell you that the illustrations are pure fantasy, because they didn't include the fees. To add insult to injury, there are always two fees on these accounts, one for the advisor and one for the actual money manager.

**Nowhere in these slick presentations will you see the actual past performance of the advisors' clients after all the rebalancing, switching of managers and massive fees. Have they no shame?**

## WE HAVE THE GREATEST CLIENTS IN THE WORLD

Many of you have been with us for twenty years at Compass, and many of you go back ten or fifteen years prior to that. Anniversaries are meant for retrospection, but they are also a great time to thank people who you love for the wonderful things they do**. We can't thank you enough for the patience, understanding and loyalty you have shown us. For over twenty years we have been blessed.**

On our 20th anniversary we are also getting younger with a refreshed branding effort. We have a new logo, a new brochure, and a great looking newsletter. Our investment style won't change, but we are growing with the times and always looking at what services will best help our clients. **Please share with your friends and family, and look for more to come as we take on the next twenty years together!**

**The Compass Team**

**William Matthes, CIO**



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