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OBSERVATIONS ON THE MARKET

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How do I make money? Have you ever asked yourself that question? When you invest in a company, there are only two ways you make money. In the end, there is only one. You can buy a company for its dividend. The cash returned to shareholders is one way to make money. Over time, dividends can add up to a very large number. If that dividend grows, it adds up to an even larger number. The second way to make money is to sell a stock for more than you pay for it, regardless of the dividend or not.

In investing, there are few things as frustrating as receiving a nice dividend, then seeing the return disappear because the stock goes down. The dividend isn't enough to make up for the decline in the value of your stock. This sort of leaves us with only one way to make any kind of a competitive return - you must sell your investment for more than you paid for it. It's that simple.

There are all kinds of ways to value a company, as well as reasons as to why a company's stock price goes up. A question worth asking is; do you know why your stock should go up? We are in a very interesting investment climate right now. Many investors are buying stocks simply because they are going up. The problem with that approach is that it works great until it doesn't, and when it doesn't, you are stuck holding something which may or may not be a truly worthwhile investment. The only known is that everybody wanted it yesterday. What really makes this an interesting time is that most people find today's world a very confusing and anxiety producing place currently. If the market is lower one year from now, you can surely guess what investors will be telling themselves: "I knew the world was screwed up, but I invested anyway, how dumb was that?" Of course, the answer will be the same one it always is, greed.

The good news is that it is never easy, and there are no silver bullets. In fact, when market gains have outpaced earnings growth, it becomes harder. The reality is that you are simply moving future returns into the present. Returns three months from now may look great, but five years from now, returns will be minimal because it takes time for earnings to catch up. Once again, the great news is that they always catch up.

Where is this going? It appears that two factors are at play currently in the market. 1) Investors are paying up for income. 2) They don't really believe that they should be paying up for anything, but they are anyway. This leaves us in a precarious situation. Valuations are high, however, there is not the usual excitement associated with market bubbles. There was an article in yesterday's *Wall Street Journal* about a hedge fund manager who had built a great track record running Harvard's endowment fund several years ago. Now, success has become allusive as the last five years have all been losers. This normally brings on a dose of humility. Not for this guy, he is quoted as saying; I "used to think 80% of active managers didn't add value but now (I) think it is closer to 95%. Convexity is in that remaining 5%." Just because you think it is true, doesn't make it true. The markets have a way of testing your belief system.

Long-term success as an investor is not rocket science. It does require patience, discipline, and a belief that earnings and the economy will ultimately grow. The highs are inevitably higher, but knowing how much to pay for something is the key. If you are going to believe in higher highs, which incidentally has been true since the beginning of time (the world economy is a little bigger than it was a decade ago, a century ago, and a millennium ago), why not believe that the current high valuations of the market will become a little less highly valued in time. Another historical fact that always gets proven. It is just that we don't know when or how valuations will come down. Great investors don't always have to be doing something.