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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

What Makes a Stock Worth Buying? If you have any interest in investing, that title grabs your attention. It was the title of an article in last week's Barron's. Unfortunately, it is the last article David Englander is writing for the paper. The column summarizes a few of his successful picks over the last five years, but also highlights a few of his duds. More importantly, the author attempts to illustrate why his stock picks performed as they did. It is refreshing to see accountability in the media. It rarely happens. It makes it a little easier when you are writing your last article, however, at least he evaluated his track record. He also provided a list of his favorite investing books. If you enjoy reading about investing, it is a quality list. This sort of leads to the question; is it even worth buying an individual stock? Why not just buy an index fund and keep it simple?

This is the very conversation that I had with a friend that works at Merrill Lynch in Phoenix. He started in the business the same year I did, but was a better sales person than I am. He currently has over $500 million in assets that he manages. We occasionally talk about the markets, and what ideas we are working on. Lately, the debate has turned to: Why even buy a stock when the S&P 500 index beats 90% of mutual fund managers over most time frames. The news about investor behavior gets worse. The statistics prove that most investors don't even match the performance of the fund they own due to poor investor behavior. In the interest of full discloser, I personally own about 20 individual stocks. A handful are significantly larger positions than the others. However, the single largest position is an ETF that is a version of the S&P 500 index. What follows is my rational as to why I own over 20 individual stocks.

If you have been reading my monthly letter for a while, you probably know that cash flow is a big deal to me. I really like it when companies pay part of their profits to me as a shareholder, and I really get excited when they raise that dividend every year. As always, it is not a free lunch. Low volatility funds became popular a few years ago. They were basically sold as the solution to earning the market return with lower risk. They invest in steady dividend growth stocks that are supposed to be more stable. If you pay too much for something, the return disappears. Low volatility funds have underperformed the market in the past year, and they have done it with more volatility. Not exactly a desirable outcome. You may be thinking: This sounds like a reason to just buy a S&P 500 index fund. It is also proof that you just can't pay any price for something, you need to use discipline.

In the book, *Made to Stick* by *The Heath Brothers,* they explore the concept of why we remember some ideas or advertising, while most are soon forgotten. There are a few key factors that help us remember something we see or hear. One is that it must be concrete. You probably remember the name of the company who used the "where's the beef" slogan. It was years ago, but the little old lady was selling hamburgers for Wendy's. Regarding your investments, if you are convinced that the S&P 500 beats most mutual funds, then you become focused on market performance. However, if the S&P 500 starts to decline for several months, your reference becomes "I am going down with everything else, and I don't know when this will stop." What becomes concrete is that the market is going down and you may no longer care that the S&P 500 is a superior investment.

My approach is to focus instead on the income a portfolio creates. If that income grows every year, I will be less concerned about what the market may or may not do. The dividend income is what becomes concrete, not what the price of the stock is from day to day. My rebuttal to just owning the S&P 500 then becomes - I am more likely to remain invested if I continue to see something positive happening in my portfolio. The dividends are being paid every quarter. Dividend investing has its own challenges currently, however, opportunities always seem to present themselves when we least expect them.