HOW TO THINK ABOUT YOUR INVESTMENTS

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Recently I was visiting with a couple of good friends of mine and the topic was an organization's endowment fund. As the discussion continued, one of my friends wanted to focus more on the cost basis of the investments, rather than the appreciated market value. This started me to think about how people generally look at their investments.

Cost doesn't matter much: Market value does matter:

My first observation is that the cost of an investment is not nearly as significant as the investment's market value. In fact, except as it relates to tax consequences, I think cost has almost no significance. Regardless of what the cost, what the investment is worth is what matters. As an example, if an investment cost $100,000 but the market value is $150,000 the important number is the value. Likewise, if the cost is $100,000 and the value is $50,000 the important number is still the current value, even though it is half the cost. One of the mistakes investors make is to focus on their cost when the value of the investment is down by never being willing to sell at a figure below the cost. However, many times the first loss is the least loss. By ignoring the cost, an investor can evaluate properly whether or not an investment should be held based on the fundamentals of the investment at that time, not its cost.

Reliable dividends matter:

However, it is equally important in investing to not become consumed with short term fluctuations in value when the actual intrinsic value of an investment has not changed. As an example, let's assume a person owns a high quality stock valued at $100 per share and the stock pays a $3 per share annual dividend that has historically increased every year and is expected to continue to increase every year at a reasonable growth rate. If an investor has the ability to spend the dividends each year without reducing the principal, then short term fluctuations in price based on stock market volatility shouldn't really concern the investor much. If the price drops to $75 per share and yet the dividend and the company fundamentals remain intact, then the investor can rationalize that the price will come back in time. In fact, in that situation, the investor may even want to buy more.

This is why a reliable, significant and increasing dividend stream is important because it can allow a person to more easily ignore short term price fluctuations. If the $100 stock drops and the investor is still receiving his $3 per share dividend, this pays him while he waits. In today's low interest rate environment, 3% in this example is a reasonable payment to get paid to wait. A security that doesn't pay a dividend or reasonable interest makes it much tougher to wait because the investor is not getting paid to wait.

Putting the two concepts together:

Putting these two concepts together means that market value of an investment matters, but the ultimate market value of an investment is most important of all. A steady dividend stream allows a person to wait for the ultimate value of an investment to be realized.

Remember that every investor's situation is unique and that it is important to review your specific situation with a financial professional.

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