IFB202: Derivatives, Tobacco, and Inheritance

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Dave: [00:00:00] Welcome to investing for beginners podcast. Today, we have episode 202 tonight. We are going to return to answer some great listener questions we got recently.

So without any further ado, I'm going to go ahead and jump in and read the first question. So I have a good morning; if you don't usually answer questions like these, sorry for taking up your time. I'll get to the point. A mutual friend of mine recommended it. Take a look at JUSHY J U H J U S H F. The stock meets zero of your prerequisites dividends, cash flow positive market cap, et cetera.

But I have a question about their financial statements located on SEDAR operating income for 2020 was negative 92 30. But a fair value change in derivatives of negative, 173,707 drops net income to a negative 1 92, 2 33 further derivative liabilities account for over half of their total liabilities.

I cannot find any information about these derivatives and why there is such a large part of the business. Professor Google and their annual report have not yielded much. Is there somewhere else you recommend working, or could you explain why companies generally use derivatives? The whole thing confuses me.

Thank you so much. Liam. Andrew, what are your thoughts on Liam's really good question. I'm curious to know, too, because I'm not super up on derivatives myself.

Andrew: [00:01:20] Yeah. It's one of those where. Derivatives are basically like options, so if you want to go back and listen to the episode, we just did with Cameron.

And that could be a good primer for talking about different sorts of options. In his case, he was talking about puts, we have called, and you have putts. So options are derivatives, but a derivative doesn't always have to be an option, but, we saw with the great financial crisis, what can happen with Really messy. And we saw it more recently with the art arch to if I knew how to pronounce or take us, I think that's it. Yeah. I PR well, we still bet drain it, but the Archegos goes thing. You had a lot of derivatives exposure. And so it's just one of these weird things and, I don't know why that's the case.

And it's one of those mysteries right now with the finance world. But. Three of those basically will give you the option, and it's a contract. So you're able to be positive on security or negative on security. You can go; you can like leverage up and basically be acting like you have a lot of positions in stock but not have to pay too much.

So it's a form of leverage. So you'll have companies use it what Cameron was talking about a couple of weeks. As a hedge. So they won't use that as a hedge. And so, they use the derivatives to hedge against interest rates. They'll use derivatives to hedge against currency risk, so if you're a.

A company that's selling stuff to Southeast Asia and also to Europe, you do not necessarily want, if your core competence is, we make really great components or something, or we make a really great electronics product. You don't necessarily want to play this currency trading game because that's not in your core competence, but it does have an effect on what your profits are going to be.

And so to try to. Mitigate that exposure and make your financial results follow your true operations and not have to do so much for currencies. They'll use derivatives. Derivatives are tough because if you really search into a company's financial report, they should have some disclosure on it, but there's not as far as I'm concerned, and what I'm familiar with, there's not like.

It's not as detailed as I am; a financial statement would be like a balance sheet or an income statement, and then it's just not. And we also talked to Jeff from Visual Capitalist, and he had a really cool infographic where he talked about the world's different wealth. And I wrote a blog post on it too, or.

I linked to his infographic, but it was amazing because you have wealth and stocks, bonds, real estate, and then there was this huge bubble that's derivatives. And so you have the actual financial value of the derivatives, and then how much, basically the bigger bubble of what the derivatives could control.

So again, I like to use an example; let's say I have a derivative to go along a stock, so maybe I would pay. I don't know, a hundred dollars. And if the stock goes up 10%, I go up a hundred percent or 200% instead of just that 10% because I'm using derivatives to maximize the leverage. Does that make sense?

So you have the value that I paid for the derivative, which was like a hundred bucks. Really what the outcome could be, which is multiples more of that. And that's like a notional value is one of the ways that they use to describe this difference between how much do you pay for the derivative and how much exposure you have to it.

And so, a lot of these financial instruments have a lot of not notional value. And so there's a big part of. The market and we don't really know to what extent it is because it's so under the table, but a big part of it is possibly controlled by derivatives. And again, we saw with the Archegos thing where.

Some derivatives went upside down, and the stock crash was at 25, 30, 40%, something crazy. Who knows how much of the current market is subject to that kind of a thing. And so when to circle all the way back to this question about this company which I'm assuming is in Canada because this Sedar thing is like Edgar in the U S just the fact that they already lost that much.

And it's wow if operating income is like 9 million or 9 billion, whatever the scale is on this, and they're losing 173 million, a 173 billion from derivatives. That's a huge proportion compared to what their operating income was. So it just raises a lot of red flags to me.

And if you're having trouble finding. Disclosures about it, is it because they don't want you to know? I don't know if that's the answer or not, but when it comes to finding good investments and being able to stick with them for the longterm if you're really struggling to find reasons to be comfortable for a stock, then you know, there are thousands of stocks out there that choose from it.

You don't necessarily have to go to places where you're uncomfortable. I think it's good to try to dig around and uncover those rocks. But to me, it just throws up all sorts of red flags because. Like you say, you're having trouble figuring out what their derivative exposure is. And they've already shown that they're not good at managing it by losing so much.

So I don't care what the other financial say. I would not feel comfortable putting your money in something like that.

Dave: [00:06:35] Would it be fair to say that the derivatives are something that you would find in companies that deal more internationally? Would that be fair?

Andrew: [00:06:47] Yeah, I think international is part of it.

The biggest exposures that I've seen so far out tend to be with the financials, and you'll see it with the banks too. And so they'll call like this off-balance sheet. Not, it's not like off-balance sheet exposure, but there's there; it might be off-balance sheet exposure. There's a certain you have obligations and potential commitments.

Are you familiar with that term? I think it's obligations and potential commissions.

Dave: [00:07:12] Evidential commitments. Yeah. Yeah.

Andrew: [00:07:16] Yeah. Maybe you can explain the obligations and commitments first. Cause I think the derivatives fall into commitment, but not an obligation.

Dave: [00:07:25] I think obligations that commitments basically refer to. Outside commitments that the company may have in different contracts, whether it's derivatives or whether it's operating leases, or anything of that nature. I think it's just, I think it's my understanding is its money that the company owes to somebody outside of the business for other commitments that pertain to either making money or operating.

In a certain way that they could make money, whether it's something like a lease or whether it's a derivative. That's my understanding. Yeah. Yeah.

Andrew: [00:08:03] And from what I saw, cause I remember reading this, one of the companies I was looking at the difference between obligation and commitment is a commitment is something you could possibly have to pay.

But a lot of times, you probably don't have to, whereas obligations like this are going to be due, and so you're going to have to pay it regardless. And so that's where I've seen the whole derivative thing show up, but it is not something that's super common. And nobody can fault you for not wanting to invest in the.

Super exotic derivatives, especially when this kind of stuff blew up AIG and some of the other big companies.

Dave: [00:08:41] Yeah, exactly. I know that this is not something that I honestly am super familiar with, mostly because the companies that I have worked with and worked at it generally tend to be minor.

Part of their business, whether it's, they're using it to offset any sort of currency fluctuations, if they deal with other countries selling their products or buying products or supplies or raw materials from other countries, they may use derivatives as a way to even out the cash flows from.

Yeah, paying this a dollar and buying this in, Yuan or something along those lines or Reais for Brazil, whatever it may be. So generally, it's a very, the ones I've dealt with personally have always been such a minor thing that it's honestly just one of those things. They go, oh, okay. Yeah.

And move on. And it's, it's like one of those companies that they may have. A billion or a million dollars in investments, and it makes them almost nothing. It's okay, great. I see that they have it, but it's just not something you're going to focus a lot of attention on, but it looks like with this company in particular, that it is very much a big impact on the business and has obviously helped contribute to some serious negative numbers.

As I did a real quick talking about. 32nd quick look at this company before we jumped on here, and it looks like it's a cannabis company out of Canada. And I know that the cannabis stocks are a far different breed than they are here in the United States because it's legal in the country, from what I understand.

And so, I think there's probably more opportunity to investigate other cannabis or marijuana companies in Canada that might have better opportunities than this one. Not trying to tell you, no, like Andrew was saying, there are so many red flags about this. You even mentioned that in an email that means zero of our prerequisites, no dividends, no cash flow, positive market cap, et cetera, et cetera.

Yeah. Oh, I was like, do. Okay. But, it's interesting to look at these things, and it could be a great learning tool. Liam is trying to use it to learn more about derivatives because that could impact something else that you learned. In the future. And so the more you learn about different things, even if you pass on the company, it's still going to help you in the future.

So I applaud them for doing that.

Andrew: [00:10:59] Yeah. 100%. Technically, I guess anybody can do anything within the business like Berkshire was a textile company. The CEO had this crazy idea that you wanted to buy stocks and businesses. Obviously, it turned out really well for him. I don't know this company that we were talking about personally, and I could be great at what they do, but it's good to be aware and, kudos to Liam.

Doing the research and digging in and finding this because how many people just look at the surface level numbers? I could imagine people looking at revenues and completely glossing over the fact that, yeah, this is a huge part of their business, and you need to be aware of it because, if you go along the stock, and then it turns out two years later, The publicity around their derivatives exposure becomes more apparent, or people start to care about that.

All of a sudden, if you didn't know about it, then you'll probably freak out and sell. But if you were already aware of it and you knew that this was part of the long-term plan, then you're able to stick it through, and probably, yeah. Add more to the position of Wall Street freaks. So all positives are still doing that research and no negatives from what I see.

Dave: [00:12:10] Yeah, I would agree with that. And one of the things, I guess I would like to throw out there a, as a possible consideration is when we think about different businesses that we want to invest in, we're not just buying the company, and we're not just buying the product or the service that they produce ourselves.

We're also buying the management that runs the company as well. And so one of the things that we have to. Attempt to do is to determine whether those people are going to be good stewards of our capital and the other people that invest in the company as well. And so when you see situations like that, it would naturally cause you to ask questions and wonder if this person or the people running the company, the right people to be running that company.

And maybe they're just not the best managers of the capital. They may be great salespeople. They may be great. Technicians and come up with a fantastic product, but they may not be great at managing the money part of the business. And those are all things to consider. It's all part of the process of thinking about buying a company is assessing the management as well.

It's a soft skill. It's not something that gets discussed a whole lot, but it's, it certainly is important because the better capital allocators, the Warren Buffett of the world, people like that's part of what makes him so special. Is that he's able to take the money that people give him as an investment and turn that into more returns for not only the business but also for the people that are investing in him.

And so that's why it's like finding a great coach in a sport or finding a great producer of record albums back in my day. Back in the old days, there were two or three producers that were famous for producing all these albums and all these top albums, and all the artists wanted them to produce their music because they knew it was going to give them a good outcome.

And it's the same idea. When you're thinking about buying stocks, is looking for good CEOs or CFOs. The management team overall and assessing whether that's going to be a good fit for you as well as for the company. And so those are all questions you can add to your list of questions. You want to ask when you're thinking about investing in different companies,

Andrew: [00:14:18] that's super key.

And if that idea didn't cement in your brain, I'd recommend going back and relistening to that. Cause that's. That's a lot of wisdom packed in what it takes to find good investments. Another reason why I like companies that pay a lot of dividends and buybacks a lot of shares is because they're showing that they're willing to give the money back to where it belongs.

So moving on to the next question. Hey Andrew, I was wondering about your opinion on the tobacco industry, and I don't give specific advice wondering more about the industry as a whole. A lot of tobacco stocks have high dividend yields. I've been growing for a while and have some pretty stable capital appreciation over time.

However, they're obviously not very sustainable companies. And with the high potential for a big move towards ESG investing, they may become even more unpopular. Additionally, I haven't looked into this as much as I should have probably, but I know there was at least in the attempt to ban menthol C regrets, maybe only in New York, other than that in a very high dividend payout ratio, which you've mentioned, you would prefer less.

To a lower payout ratio, leaving more room for growth, many have a relatively strong financial summary, even dividend kings. What do you think about companies? What do you think about companies like that? Decent financials, high dividends, historical dividend growth, uncertain futures. They have; let's throw that off to you first. I'm curious.

Dave: [00:15:36] I guess for me personally, tobacco companies or companies that I stay away from, and for me, it's more of a personal choice. I don't like smoking. I don't believe in smoking. I personally have never smoked. I've literally never smoked a cigarette in my entire life. I worked in the restaurant business for a very long time, over 20 years, and I saw a lot of people smoking and.

I just, I don't know anything good that comes from it. I know that they all swore by it, that it helped to calm their nerves. The restaurant business is a very stressful business, and there's a lot of stress and a lot of just a lot of anxiety and a lot of stress that go into it. Just because of the nature of the business and it doesn't excuse people.

Smoking, but I guess underneath it all, it always frustrated me that smokers would get a break, but we non-smokers never would. So I guess maybe I always ran slanted that, but the health benefits, there are none for smoking, and I don't know anybody that could. Reasonably that there is, the flip side of that is the tobacco industry has been smart about a few things.

Number one, I think they saw the tea leaves or the tobacco leaves changing many years ago. And they jumped on the bandwagon for creating the patches. Gums and Nicorette gums and all of those things to help people stop smoking. So they would get people to smoke, and then they created the products to help them stop smoking.

And then they jumped on the vaping bandwagon as well. So they're trying to play both sides of it, which is smart, but I agree with what the. The questioner was, it was commenting about ESG even whether it's ESG or not. I really think that the health effects of smoking are going to lessen, and over time, hopefully, I know that my generation we're a big smoker.

And I think as they got older, they moved away from it. That Andrew's generation, at least from what I saw in the restaurant business, were big-time smokers too. So I'm hoping that maybe they would move away from that. But as far as the idea of what they do and how they do it, and all the things that they mentioned at the end, decent financials, high dividends, historical dividend growth, those are things where those are all awesome.

But I think one of the things that would turn me off is if I was just taking. The ethical part of it for me personally, again, is just my opinion. So if somebody else disagrees with me, obviously more power to you, but the uncertain futures of what's going to happen with Tobacco and the tobacco industry going down the road will go away.

No, but what lesson in prominence probably. And I think that would be something that would give me pause about thinking about having this as something as a long-term investment. And I think there are so many other opportunities out there that offer a lot of the same. Ideas that you're talking about are decent financials, high dividends, historical dividend growth, and maybe not the most outstanding financial futures, but certainly, if you look at utilities, just as a brief example, that utilities offer all those same kinds of ideas.

Financials strong moats, strong businesses. They may not have huge growth rates, but they all pay dividends. They all pay strong dividends. They all pay growing dividends. And in some cases, they are. In essence, a monopoly in their region. And it's unlikely because of the high costs to unseat them. And I'm thinking of a company like ConEd, for example, which is, which does service here in Illinois, but also in the Northeast, I believe.

And to unseat to somebody like that is going to cost billions, if not trillions of dollars, to develop an infrastructure and all the things that go into unseating. A utility like that. So there's some stability in that, but, and they pay great dividends, but you may not see five, 10% growth in the stock price over a long period of time, just because of the nature of the beast.

But I guess my point is that you can find some of these other characteristics outside of the tobacco industry. If you look a little bit and there are other industrials that will offer a similar idea. And I guess along with the same idea, the oil industry is probably maybe on the same kind of a tenuous future, possibly that Tobacco is who knows what's going to happen over the next 5, 10, 20 years.

Nobody does, but the signs are on the wall that maybe the oil industry could. It could be in for a struggle bus here over the next five, ten years as green becomes more of a thing. But again, I think to go back to the question for me; the tobacco industry is something that I would stay away from personally.

I'm curious to hear what Andrew has to say about this.

Andrew: [00:20:17] Since I used to be a smoker and I smoked for a while, I guess I could be the natural person to take the other side of the argument. There is. It's like a; it's like paying your bills. Like you just, you gotta buy your cigarettes, and there's nothing like it. And, it's great for building relationships and just hanging out and all of that. I think that all said, I have noticed. Between people who I used to smoke with or just looking around and seeing people out in public, there is a big move towards vaping.

And then you also have to wonder how much is cannabis going to eat into what used to be Tobacco. And so a hundred percent agree, like when the financials look good, the dividend yield is very high. I think there's a lot of opportunities, like Dave said, and industries that are maybe unfairly beaten up where the sentiment says this industry is not going to last.

And so there's going to be a lot of opportunity and industries like that. But I think when it comes to Tobacco, it's, there's a lot, even if we want to compare like Tobacco, the oil how many. And I guess, it all depends on what circles you run into, there, a lot of this can be anecdotal or personal opinion, and maybe that does play a lot into the valuation, how many,

I don't want to; I don't want to bring oil into it. Forget it. Forget. I even said anything about oil, but the fact of the matter remains. There's a lot of pressure against Tobacco. And I think it's obvious over the last 20, 30 years that health has become a greater priority for society and within the culture.

And I think you're seeing a lot more, especially in the past 10, 15 years than you have seen in the past. Even something as simple as calories used to never be on in drive-through. Windows now you see them all the time. So information informed people are trying to be more healthy trying to live longer.

These are all things that don't really fit in with what Tobacco is. So you're always going to have people who love it, but you wonder to Dave's point with the newer generations coming in. They take on to a similar demand that somebody like Dave's generation saw, and if not, what's that gonna do to the demand for this kind of a product.

So that makes it really tough. You combine that with the fact of a high dividend payout ratio. So what that means is just one-on-one super quick. A company makes this much in profit, and then they'll pay this much in a different. And so, the more of their profits that go towards the dividend, the higher the payout ratio is.

And so if their payout ratio has been increasing over time, what that means is they're eventually gonna run out of profits. That's not a trend that can sustain itself. And so, if you want to continue growing a high growing dividend, you have to have growth in the business. And so the question becomes.

Where's the growth going to come from, and how confident can you be that growth is going to be there? I think when you have things that are societal changes, it's hard to; it's hard to project that demand of them even. Warren Buffet, when he bought Coca-Cola, he bought Coca-Cola in 1987.

There was not much going against people drinking sodas. Would he buy Coca-Cola again today? I don't know what the answer to that question is, but you do wonder with all of them, again, Focus on health and the idea that products like Coca Cola are really bad for people and just different consumer behaviors of people switching I know an of offices have like the LaCroix stuff, it's like soda, but there are no calories and no bad ingredients in it.

So these are the types of things where. No, no business lives forever. And every business kind of goes through its life cycle, and they have these periods where they have high demand, but that they're not able to move with the evolving tastes of consumers. Then they're going to get left behind. And so when I look at the tobacco industry, I just, I don't even if the prices are low if I feel like I'm pulling onto a ticking time bomb, that doesn't fit in with what I'm trying to do.

I'm trying to do buy investments for the long-term that can compound over decades and where the time is on your side and not against. Because trying to play that game of hot potato and trying to be the one who's not holding that hot potato it's a tough game, especially on Wall Street when everybody else is trying to play it too.

Dave: [00:24:50] Yeah. I would agree with that. And the thing that I go back to when I think about the tobacco industry, and you were talking about the other side of my negativity about it. I cannot remember. And maybe you could correct me. I can not remember a single person that I've ever talked to that didn't regret smoking and didn't want to quit; every single one of them that I talked to wanted to quit.

They all knew it was bad for them, but they still did it. Now. I can't get on my high horse too much because here I am drinking soda. Every day and it's my addiction. And so I understand that there's an addiction. Part of it was cigarettes, for sure. And, but. I just wonder about the long-term viability of investing in companies like that.

And, you brought up a great point with Coca-Cola, like when Buffett did buy it in 87, there was not the stigma that there is now of soda. And so you just wonder. What's gonna, not what's gonna come next, but what's gonna come next, and where is the next thing?

That's that could be potentially not good for us, that we all know is not good for us. I know that soda is not good for me, but I still am. The combination of the bubbles and the sugar and being a diabetic. I, this is my only access to some sort of sweetness, and it doesn't seem to freak my body out so much so I can, it can handle it.

But those are all things you have to consider when you are thinking about investing in anything. As you just have to, you have to look at what the long-term effects could be of the particular product or service that they're offering and decide if that is something that you want to be involved with and whether you think it could be or could not be something that is beneficial down the road.

Andrew: [00:26:37] Yeah. That's a great point. I think it speaks to the personalized nature of investing, a whole group of people looking at the same set of facts and coming up to wildly different conclusions, just to go back to the financials, having payout ratios that are increasing, particularly if revenues are decreasing that's a very different situation than an industry that is cheap and things are growing revenues.

Growing profits are growing dividends grow. Those are two very different scenarios. And so investors need to be careful when they're looking for value like that.

Dave: [00:27:12] Yep. I would agree with that. That's a very good assessment. So I have, hi. I have a question. I was hoping you could address in one of your upcoming podcast. I, unfortunately, lost a parent last year and inherited a substantial amount of money.

I already have a good deal. Save for retirement 20 years off and don't need the money for my day-to-day. So the question is how to invest it while minimizing the risk of investing in a market after a historic rebound coming out of the 2020 pandemic crash. For example, if dollar-cost averaging is one possible strategy, what sort of timeframe should one consider?

Thanks, Andrew; what are your thoughts on this really interesting question?

Andrew: [00:27:50] Yeah. First, I'm sorry for your loss. That's awfully here. I am having 20 years until retirement and receiving a substantial amount of money. I like the idea of dollar-cost averaging that I know there are studies that say a time in the market versus timing the market.

If you're just going to throw it in an index fund, and that's maybe the better option, but there's a lot of psychological benefits too, I think, cushioning any potential Crash that could come cause a crash one year in the market crash could happen at any time. And so we have to be cognizant of that.

And so if this is like a crazy amount of money to you and imagine putting it in, and if the market were the crowd. 20% tomorrow. And you would see that negative dollar amount in your portfolio with it freak you out. And the answer is yes. Then don't put it all in at once. For me, like I've mentioned this several times, but when I did a rollover from 401k, I think I had 20 or $25,000 at the time.

It was a lot of money. And so what I did is I just split it up into ten months and. Every month, I put in $2,000, and then by the end of those ten months, I had fully diversified that's that lump sum. And so what that does for you is several things. Number one, you can find ten different, great companies instead of just having to find one.

And when you put it into ten different companies, you can afford to be wrong. And, or you can afford for a company to stumble or for it to have some big change happen that's out of its control. So those are the benefits of dollar-cost averaging that if the timeline to retirement was closer, maybe if it was me personally, I'd look more into putting some of that into bonds, but something that's still 20 years off, I feel like.

It fills me. I'm very comfortable with the stock market. I know the history of the stock market, and that's something I've studied for a very long time, and I'm very familiar with. So that's why I'd be comfortable putting it on the market. But at the same time, I like spacing out over time because he had diversification of timeframe.

And then you also get the diversification of companies and opportunities. If you're doing individual stocks,

Dave: [00:30:01] That's great. . All right. Folks who will, with that, we are going to wrap up our conversation for today.

I wanted to thank everybody for taking the time to write us those great questions. Keep them coming. You guys are asking some really good stuff, and we hope you guys are getting some good value out of our answers. So without any further ado, I'm going to go ahead and sign us off—you guys. Go out there and invest with a margin of safety emphasis on safety.

Have a great week. We'll talk to you all next week.