Brian Feroldi Discusses the Importance of Quality and Valuation

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[00:00:00] **Dave:** All right, folks. Welcome to Investing for Beginners podcast. As you can see, the folks that are watching a video now can see that we have one of our good friends back, the semi-homeless guy on the internet.

Brian Feroldi is here to join us again today to talk to us about all things stocks. So for the two or three people of you out there that are not familiar with Brian, Brian is a financial educator that shares a lot of his knowledge. He's very active on Twitter, YouTube,and Fool.com, and he has his great new book out, which I highly, highly recommend, especially for beginners.

Why Does the stock market Go Up? Everything You Should Know, or You Should Have Been Taught about Investing in School, But Weren't.

So, Brian, thank you again for coming back to join us today. We really appreciate it. And we're looking forward to our chat today. So I guess tell us what's been going on with you; what have you seen in the markets lately?

[00:00:51] **Brian:** The markets have been a little wild recently. I don't know if you guys have noticed that but the last, but the last three years have been some of the most extreme volatility that I've, I've seen in my investing career. And I've been investing for just about 20, 20 years now.

It seemed like 2020 was the year where you could do no wrong. Buy anything. In fact, the lower the quality, the thing that you bought, the better you were likely to do. And 2021. So 2022 has been the exact opposite, where you could buy anything, even, even the highest quality businesses out there. And you're probably down on your investment.

That is a really hard thing for people to wrap their heads around. And this is why investing in stocks has the reputation that it does. So many people don't understand it. All they see is a number squiggling around. They think that it's rigged. And when you see stocks go straight up in 2020 and straight down in 2020, two, and so many people entered.

Started investing in late 2020, and they're down 20, 30, 40, and 50% in like 18 months. It's very understandable. Why do many people just throw up their hands and say, investing doesn't work, it's rigged, the market's terrible, et cetera? So we have a big challenge as financial educators to convince people to zoom out because your whole life has lived zoomed.

[00:02:10] **Andrew:** Hm. That's very well said. Maybe help us zoom out. Obviously, you've been doing this for a long time, so give us some light at the end of the tunnel. What, you know, you remember a time when stocks didn't always go down, it seems. So can you bring us back to a stock or two that would fit in that criteria of being one where, Hey, this is actually a pretty good example of when things can go well?

And what people could maybe think for the next ten years. So maybe take us back like five, ten years and, and break down the stock that you looked at before. That did really well.

[00:02:52] **Brian:** Sure. So when you're measuring your investing results, one tricky thing is that you're constantly getting false feedback, right?

If you buy a stock or an index today, you're gonna know within a few seconds whether you're up on that investment or you're down on that investment. And it's really easy to look at that and say, oh, I made a good decision or, oh, I made a bad decision. The tricky thing about investing is there's a long lead time between you making a decision and you actually know whether or not that decision was a good one or, or not.

And if you invest in individual stocks, like, like I do that, that, that lag can be measured in three-year periods or five-year periods, but all along the way while you're waiting to see was at a good, smart thing to do, or a dumb thing to do, you're gonna be up on your investment, or you're gonna be down in your investment based on what is happening in the overall macro environment.

This is why it's so critical. If you're gonna invest the way I do, which is an individual company, is that you do your best to focus your energy on following the business performance, looking at the company, how the company is doing, which direction revenue is heading, which direction margins are heading is the company profitable.

What's this balance sheet look like? Those are, those are the signal. Paying attention to everything else about investing is noise. The stock, the day, the daily day, the day-to-day gyration of the stock movement is noise. And that is the thing that 99% of people are hyper-focused on. So it's really hard to, to, to remind yourself, to zoom out and look through, look beyond the stock price, but that's what you have to do.

When do I think back to some of the best investments that I've made over the last five or ten years? Pretty much in every case, when I bought those companies, that looks like a dumb decision at some point, right? Many of my biggest winners of all time, from peak to trough, fell 50%, 60%, and even 70% along the way to delivering multi-bagger returns for me.

And the really tricky thing about investing is that. If the best companies did that, the worst companies did that. And then they just never recovered. So it's really hard to figure out in real-time if this is a temporary blip or if this is a permanent blip, but this is why when I'm making investments, which I'm, I'm trying to constantly do.

I'm buying 'em all the time. What I'm doing is I'm asking myself, do I think that this company, if, if it successfully executes can be, can be multiple bigger than it is today, three years from now, five years from now, and, and ten years from now. And I just know, and I have faith that if I consistently do that, well, I'm gonna be wrong a whole lot.

I'm gonna occasionally be really, really right. And when I'm really, really right on an investment, the gains on that investment will pay for all of my mistakes combined.

[00:05:41] **Andrew:** And I'm thinking of one in particular, and it's just, cuz we, we had a quick chat before coming on and recording. I feel like there's this misconception that with investing, you know, you talk about having to wait three or five years or ten years, and it's like, man, do I ever get to enjoy the fruits of a good investment?

I know you've, you've done that. And I think it's an inspiring thing because when I was first starting, I heard a similar story from one of my colleagues.

So can you talk? The stock that you had that happened with?

[00:06:15] **Brian:** Sure. I've been, I've been fortunate enough to have several companies do very, very well for me and deliver, you know, 10, 10 plus bagger returns for me. However, my biggest winner of all time has been, has been Tesla. This is a company that.

I personally would've never invested in 10, 10 plus years ago because it was losing money. It was in an industry that I don't follow, don't care about, and generally has very poor economics, which is the auto industry had a very short, high, short interest. So a lot of people were betting against it, and the odds historically were massive, massively stacked against Tesla.

However, one of my investing mentors, one of the co-founders of Motley Fool, is David Gardner. He recommended Tesla, and I literally made fun of him. The next time I saw him about that investment. I said you've gotta be kidding me. Like this is what you're recommending, but after I studied the company, look learned more about it.

I actually changed my mindset and bought a very teeny slice of Tesla for myself for more than 11 years. And that is an investment that has just paid off spectacularly. Well, I would not have guessed in a million years that Tesla was going to do what it has done. But it is, it is approaching if, if it's not a 50 X return for me, it's, it's, it's tiring than that.

It's somewhere along those lines. And then, in 2020, because the stock was up so tremendously for me, I'd actually been eye. Buying a Tesla for myself. And there's no way I could convince my wife to do that. However, I was able to do. So cuz one, I got my kids interested, and that's a good way to, to do it.

But the two I, I, I said that we would sell some of our Tesla position and we would pay for the car that way. So that was me actually being able to realize the fruits of the gains of my extreme patience with that stock and actually buying a Tesla. But I had to wait over ten years of owning that stock and, and dealing with the volatility for, for that to pay off as, as big as it did.

[00:08:12] **Andrew:** That's really cool. Obviously, we've, we've chatted before on this show. And if people haven't listened, I recommend they check it out, but I don't wanna like paint, paint you into a bucket and say that like, all of your investment strategies are kind of like a stock like that. Cause I know you have a wide range of different kinds of stocks in your portfolio, but I kind of wanna double click on it.

That idea of looking for a stock, like a Tesla, just because I think that's not something we cover much on the show in general. So can you take us maybe like behind the scenes of, and maybe we could do it with Tesla or maybe we could do it with a different company, but like, This company might sound interesting?

Maybe it's out of my circle of competence. It's something I'm not necessarily comfortable with, like you said, in the auto industry, but where did, how did you get from the mindset of I'm really skeptical about this to okay? I feel like maybe this thing has a shot and then kind of walks us through that.

[00:09:13] **Brian:** Sure. So Tesla was a very weird purchase for me in so many ways in general, nowadays when I'm, when I'm investing. What I, what I am personally looking for is companies that are very high-quality high quality to me means that they are their profit. They're growing quickly. They have a very debt-free balance sheet.

They have tons of cash. Employees like working there. The management team is, is vested owns. A lot of stock has diversified customer base growth opportunities galore, like all these factors into me. Dictate whether a company is worth investing in or not. When I looked back ten years ago, when you're investing in Tesla, it did not check many of those boxes, so it was a, it was a weird investment in so many ways.

At the time, I viewed it as an asymmetric risk reward. Bet. I knew at the time that it was a very risky, risky company. However, I also felt that on the small chance that this would work out, the payoff could be enormous. And, and it just so happens that Tesla has defied so many odds and has just become a massive, massive winner.

But I knew the odds were stacked heavily against me at the beginning. And when I encounter a company like that, I'm willing to take a very small part of my portfolio, like 1% of my portfolio, and buy a handful of companies like that, going in knowing that I'm gonna be wrong a lot, like a whole bunch of those are going to, to, to flame out.

But occasionally, I'm gonna catch lightning in a bottle. And if I can just do that occasionally, maybe one out of every 20 times. Like literally went outta 20 times that the gains are, could be so big that that endeavor is work is worthwhile. But nowadays, when I'm I'm investing, I'm primarily looking for the combination of the following three things.

First I'm looking for very high-quality companies. And I have a checklist that I take companies through to determine quality. The second thing I'm looking for is massive upside potential. So I want a high-quality company that I also believe has the potential to 10, 10 times in value. So for that to happen, the market cap and the size of the company today have to be to a point where I could envision a 10 X.

And then three, I'm looking at the valuation of the company. And what I'm trying to do when I'm deploying capital is buy whatever company, at any given moment, has the highest combination of those three things. So business quality, upside potential, and best valuation. And that, that kind of is always changing.

But I'm, I'm that, that's me. The general strategy is to continually buy whatever company is the number one across those three criteria and just do that continually. And if I stick to that process for a long enough time period, I'm pretty sure I'm gonna have a smile on my face.

[00:12:01] **Dave:** Yeah, for sure you will. So I guess, can we kind of dive into each of those three sections a little bit and maybe walk through a company or two and kind of, so people can kind of get, you know, an insight into the crazy brain there and see kind of how that works for, for you.

[00:12:17] **Brian:** Sure. So let's take a company that I like a lot. That is also huge. I think it's extremely high quality but isn't talked a lot about despite being, I think, almost a 200 billion company. So one of one company that I think is a very, very high-quality company is Adobe systems. I mean, everybody knows Adobe for Photoshop, Acrobat for Premier, for their suite of tools that they have.

I don't think people realize how big and important and just what a monster winner Adobe has been for investors over time and for full disclosure. This is a company that I own, in case that wasn't obvious. I have owned for many, many years and plan to own for many, many more. And Adobe today is worth $204 billion, $204 billion, which I think is way more massive than you would assume.

But just, just ticking through some of the things I like about this. Its balance sheet is very strong. Has a lot of cash but not that much debt. It has a very high gross margin. So the amount that it makes off of every, every dollar in sales that it makes, it keeps a very high percentage of that.

It has very high returns on capital. It's free cash flow, positive. It's profit. Hopefully, this is the stage; it should be profitable, right? It's been around for like 30 or 40 years. I think Adobe has built itself a moat. Once you start using Adobe's tools and get, spend all that time, it's very hard to switch away.

I think it still has lots of growth and potential ahead of it. The company has been moving aggressively into the business market. So not just providing tools to end consumers, but also providing tools that help with marketing and business kind of encroaching on Microsoft's turf, and they're doing so successfully.

It's got a wonderful CEO that has been at the company for a few decades. Now he gets glowing reviews on, on Glassdoor. The place is a wonderful place to work. And the stock itself has not only smashed the market, which is something that I consider to be a huge positive, but they also buy back stock regularly and have a diversified customer base.

And I generally think the business itself is very low risk. So this is a company that I have owned for a couple of years. It's been a big winner, and I could easily see holding onto this thing for another decade.

[00:14:34] **Dave:** Yeah. That's amazing.

[00:14:36] **Andrew:** It seems to be in that sweet spot of still having high growth and. Being one that it's harvesting a little bit in that they buy back a lot of shares, mm-hmm, so investors almost get the best of both worlds. If they, if it can continue,

[00:14:52] **Brian:** I would never have guessed that this company has been around for so long.

I mean, it's on; I think it was created in the eighties, so it's like literally 40-plus years old, still growing its top line, double digits. So more than 10% per year. And thanks to stock buybacks growing its bottom line even faster. Then that is not something you see in companies that have been around this long and are this big and this mature.

So for those reasons, I think the company still has a very bright future ahead.

[00:15:22] **Andrew:** think if you're, I don't know if you wanna call it, like maybe not digital marketing, but like if you're in the illustrator space or you're familiar with one of the tools they do, because you interact with it as a hobby or as a job.

Adobe maybe sounds super intuitive. What about somebody who has never come across a product like Adobe? How would they get best to get educated on those products? So they can kind of get a grasp on just what makes it so sticky.

[00:15:56] **Brian:** So the way that I judge companies such as this, which I may or may not be of the consumer is, is it's really two, two twofold.

Every company has a story, right? If you dig into the annual report, or if you go to the about us section of a company's website, especially if you go to the investor relations tab, what that company is trying to do is to present to you the case for investing in, in, in their company and anyone that's worth their salt will have a very convincing presentation that says here's all the great things that we do.

Here are all the reasons why you should in invest in us. So I always read through that, and I'm asking myself the entire way, does this seem logical? Does this company seem like it's reaching for things that are unobtainable, or what are they trying to do? In Adobe's case, while I'm not a user of many of their products?

I mean, everybody knows pDFs. Everyone knows Acrobat. Everyone knows many people have used their e-signature tools, et cetera, but beyond just seeing, okay, this is what we wanna do. I also wanna see a track record of the company actually doing and actually executing on the things that they are are, are talking about.

So I, I, I use the story part of the business, if you will create a thesis for myself about what this company has said it's going to do and what it's going to do moving forward. And then, I look at the actual track record of the business. I look at revenue; I look at margins; I look at profits. I look at the balance sheet too, which is like the wake that a company produces to say, is it actually doing what it says that it's gonna do?

If I see a company that tells a good story, that seems reasonable. And has a track record for executing that story. That is a company that I believe, in general, is worth betting on. Right? My favorite investing thesis that's out there is when you see something that's working, and you say, I bet that thing that's working is gonna keep working.

Like that, to me, is a fairly low-risk bet. It's a much higher risk bet to say this is a management team. That's an unproven business model, that's unproven, and here's what they say they wanna do. And actually have that company execute on it. That's why Tesla was a bit of a weird investment for me ten years ago because they had these grand ambitions, but they didn't have a track record established of them actually executing.

Now they do. Now, they clearly have a track record of executing on that. But I do think when you're investing; you do have to be, have, have a, have the mindset of this company has a story. This company has a vision for what they wanna do, and you have to back that up with, well, prove that you've actually done it.

[00:18:36] **Dave:** Yeah, that's, that's very insightful. So I guess the sticking point for me is it, it's the valuation, and that's always, you know, that's always the trouble spot for me is that I can get excited about a company like Adobe or Intuit, or, you know, pick a name, insert here. And it's, it's hard to get over the valuation part.

So, could you kind of talk to us about what your thoughts on valuation are and how you kind of work through those different ideas?

[00:19:05] **Brian:** Yes, valuation first off, let's acknowledge one of the trickiest things about it, in investing and you, if you, there, there is a broad spectrum of, of people when it comes to, to valuation.

On the one hand, the conservative side is that people consider themselves to be self-value investors. And the lens through that they see the world through investing is valuation first. Right? They'll. Garbage is a garbage business if it's cheap enough, right? If you give me a terrible business at two times earnings, I'll buy it.

Right. Right. Because it's like, well, the business isn't that bad; on the other side of the spectrum are people who don't look at valuation at all. It's not a part of their process. The only thing they care about is upside potential and the quality of the business. And this is how a lot of venture capitalists invest.

Right. They just want they're; they're interested in a story and. And they're willing to swing and strike out a whole lot because eventually, they'll buy the next Airbnb. They'll buy the next Facebook; they'll buy the next whatever, whatever the huge winner is, is out there. And that's how I, I view it.

I view it as like, a spectrum. When I first started investing, I was, oh, I was very much a value. The lens that I saw the world through was valuation first. Over time, I've learned through trial and error and studying other investors that it actually makes far more sense to look at business quality first and actually look at valuation as a component of investing, but not everything to do with investing.

But when, when, when you're judging whether or not valuation is, is important, I think it matters greatly where this company is in its growth cycle. So imagine for a second that we found a business today.

And we have huge plans for our business over time. And our business goes on to be hugely successful. In the beginning, when we were hyper-focused on the opportunity and growth, it was not uncommon for us to have very little revenue and no profits. In fact, we could be losing money for the business because of all of our energy.

It is focused on top-line growth, executing on the opportunity. As we're successful and our business matures, suddenly, our losses decrease over time, and we eventually reach a break-even period. And then eventually, once we're big and established and mature, the focus becomes profitability, and we focus all of our energy on profits at the time.

But it's, it's a bit of a slope that investors go, that companies go through whereas a hypergrowth phase, in the beginning, then they kind of reach a maturity phase and then they go through the decline and the death phase. The problem that investors get into with valuation. And this is a mistake that I made is they judge a company by its profit.

Before the company is focused on generating profits, this is, for example, why? Companies like Amazon have perplexed investors for two decades now. Jeff Bezos focused all of Amazon's energy and resources on top-line growth, acquiring customers, rolling out products, rolling out services, and doing everything he could to capture market share and grow revenue profits were not a focus.

In fact, he tried to run the company and essentially break even for a couple of years in an effort to drive that top line higher, so, because profits were not the focus, the price-to-earnings ratio, which is a very popular metric for judging a company's value. Didn't work. Because of the earnings power of the business, the E in that equation was understated way understated to what the business could do.

So the PE ratio was way overstated. So if you were looking at Amazon anytime in the last 20 years, and you just look at the PE ratio, you'd say overvalued pass, and you would've missed out on a multi-bagger. Conversely, if I'm finding, if I'm considering a company for investment, such as Adobe, such as Apple, or Microsoft, these are mature companies, the hyper-growth is gone, and these companies are focused on profits.

They are focused on delivering bottom-line profitability for companies like these. I think the PE ratio can be a great tool for figuring out valuation because the earnings power of the company is meaningful. It's what management is focused on. So if I was going to make an investment in a company like Adobe, I would very much pay attention to the PE ratio of the company, but investors get into trouble.

When they look at growth companies with a value investor's lens because that company isn't focused on profits, it's focused on growth. So you have to be, you have to be able to shift your mindset, to focus on valuation. In some cases, when a company matures and you have to be able to de-emphasize valuation.

In other cases, when a company is in a different stage of its cycle.

[00:24:11] **Dave:** That makes total sense. So, you know, I'll throw an example at you of a company that I really like and I think it has great potential, but I've really struggled. I struggle with the valuation part of it because, unfortunately, I sometimes sit too much in the value investor camp.

And so the company is CrowdStrike. When I look at the company and the potential and what they're moving quickly towards profitability, but I, you know, I understand what you're saying because they, they are moving they're, they're investing everything in growing, and they're trying to take market share. And there's, there's lots of competition, and it's a newer field, but it seems like a, a fantastic company.

But I just struggle with the valuation because it's not profitable at this time.

[00:24:54] **Brian:** So Crowdstrike is one that I own. It is one that I have. I agree with you. I think it's an extremely high-quality company growing, very growing very rapidly. And it is one that's one of the harder ones to think about from a valuation perspective.

When I think about CrowdStrike, rather than focusing on the company's valuation metrics, what I'm actually looking at now is the company's market capitalization. So CrowdStrike is a 45 billion business today; it's growing extremely rapidly. I think it's gonna grow 50% revenue this year and 36% revenue next year.

So it's still growing very, very, very quickly. But a company like a CrowdStrike, you are betting that they are going to. Essentially grow for the next decade-plus at a very, very high rate. And if the company can do that, the returns to investors should be, should be pretty decent. The tricky thing with them, as you know, is they're valued so highly that instead of growing at 50% per year, they grow at 40% per year.

Look out below this company is going to. Smash right. This stock is going to go down very, very hard. So if I was gonna make a new investment in CrowdStrike today, what I would be focused on would actually be the market cap first as a 45 billion company. Do you think that this could be a 250 billion company someday?

Do you think that it could be bigger than Adobe in, in, in, in a couple of years, right? Doing so would give investors a five X return from today. Okay. So that. That's the upside. If you believe that, what are the chances of that happening, right? And how much growth you have to is embedded in this company today and how much, how much assumptions you have to make about what this company's gonna grow into.

So Crowdstrike is a tricky one for me too. I would much prefer to invest in this company today at a 10 billion valuation. Cause I could, I could easily see this company being worth a hundred billion dollars someday. I have a harder time seeing this company is worth 300 billion or 500 billion or just that math.

So, I do own some Crowdstrike. It's one of the riskier stocks that I own from a valuation perspective, but like you, it is one that I would struggle with the valuation on.

[00:27:12] **Dave:** Good. I don't feel so bad now.

So I, I, I guess if we could, you know, I guess one more question for valuation for me, cuz that's, I'm kind of a nerd that way. When you think about a company like Visa or Costco, who are definitely more on the profitable, more mature side of their businesses, but they always trade it elevated. Valuations.

How do you, how do you, how do you work with those kinds of companies? How do you think about them and how, you know, you know, at Costco, I think it is probably one of those companies that I think everybody wants to buy, and Visa's probably kind of similar because of the quality of the businesses, but the prices that you could pay are so elevated.

It's, it's tough.

[00:27:55] **Brian:** Very, very much. So this is another thing that I, that I've, I've had to learn the hard way. Some businesses. Traded a premium because they deserve to trade at a premium. The businesses themselves are so high quality that they are traded at a premium to the market. And you can still outperform by buying them because what you're betting is that in five years' time, the company will still be very high quality and will still deserve a premium price tag.

Now, Costco and Visa, in particular, have two, have, have many characteristics that make them fantastic. Two of the ones that I think really stand out with investors are just how recession-proof their business models are when times are tough. People are not gonna stop shopping at Costco. In fact, you could argue that people, more people would shop at Costco because it's such a good, good deal.

So the business cycle is what's happening in the economy. It almost doesn't matter to Costco's business. So investors are willing to pay a very high amount for the company's profits because it has so much faith that those profits will come in in any market condition save, could be said of, of Visa, by the way, another extremely high-quality business its growth might slow.

In a recession, you can be pretty confident it's still gonna grow during a, a recession. So that is a reason that those companies trade at such high valuations because there aren't, the quality of their earnings is so high. Conversely, take a company like an automaker like Ford. I'm looking at Ford right now.

And its PE ratio is five. Okay. I don't know if that's real. That's from Yahoo finance, but automakers, in general, tend to trade at very low PE ratios. Why is that? Because what happens to their profits? When the economy turns south? They disappear. It's not uncommon for automakers and industrial companies, and steel makers.

Those kinds of companies are very sensitive to what's happening in the economy; for that reason, investors know. That when bad times come, their profit's gonna disappear for that reason. They're unwilling to assign a high PE ratio or high multiple to those earnings because they have no faith in those earnings sticking around.

So that's just one thing that you have to think about, not so sometimes paying a premium for a company. It's, it's hard to do mentally, but if that company is the very, very high quality, do you understand why the premium exists?

[00:30:39] **Dave:** Yeah. That's very well said. And I, I, I looked at a chart of Costco not too long ago.

And I think over the last ten years, the lowest their PE ratio has been around 28 or 29. Yeah. Somewhere in that range. And so if you had, even if you had bought it at that low rate, you still would've gotten a 10 or 15% return over the same period. So it's one of those things where it's, it's, you know, number wise, you see it, and it's really, it's really tough to struggle with, but then when you look, there really wasn't ever a real air quote, cheat time to ever buy it.

[00:31:12] **Brian:** Yep. Now conversely, of course, if, if, if Costco is reaching, I mean, it's a mature company, right? So with growth rate is not going to be that high moving forward. So you are, to me, if you're making an investment in Costco today, the number one risk you're taking on is valuation, right? The I, the, the business is gonna do what the business does.

The business itself is extremely low risk. The question you have to wrestle with is, is the valuation that I'm paying, going to be persistent going, going to, so when you're that, that's why I would think about Costco, but does, does Costco, the company deserve to trade a high PE ratio? In my opinion, the answer is yes.

[00:31:51] **Dave:** Yeah, I would; I would probably agree.

[00:31:53] **Andrew:** They certainly have shown in their business results over the last 5, 10, 15, and 20 years that they have earned that high valuation.

[00:32:03] **Brian:** very much. Yep. It it's an extremely reliable company.

[00:32:09] **Dave:** I think it kind of goes back to what Charlie Munger was saying about Costco and other companies like that. If, if you, you know, if the returns on capital are higher, even if you pay a little bit more for it, you're still gonna get a good, good return over a longer period of time.

[00:32:23] **Brian:** Yep. And that exactly, that's such a good quote.

And, and this is what, what I'm saying, by the way, is something that investors like Warren Buffett and Charlie Munger had also learned the hard way Warren Buffett when he first started. A hundred percent focus on valuation, right? He came from the school of Benjamin Graham, buys it cheap, buys it, cheap, buys it cheap.

And Charlie Munger has slowly shifted Buffet's mindset to being focused on awesome quality businesses first. And if you can get them cheap, great, but be willing to pay a fair price for them because the business quality is what matters in the long term.

[00:33:02] **Dave:** Yeah, totally.

[00:33:02] **Andrew:** These have been some really great teaching lessons. I hope people are taking notes unless you're driving. Maybe you're taking notes in your brain. We've touched on business quality valuation. The other one you mentioned was potential talk about potential and why that's important.

[00:33:22] **Brian:** Yeah. If I'm gonna be buying a stock, if I'm going through the effort of not if I'm going for the extra effort of searching for my own stocks, right? I want something that's different from what the market can provide. Cuz if I'm going through this effort and I'm just gonna earn market returns, I'm wasting. Why don't I just buy the index itself, call it a day, and never have to study or do any of that stuff?

Now, the thing that there are a number of things that you can get that is different than the market. Some people just wanna a higher dividend yield than the market wants. And for them picking dividend stocks can make sense. Some people want a lower risk. The market in general and some people want higher returns. I'm after the higher returns part.

So that's why I go through the effort; if I'm going through this effort and my returns are lower than the market, I've wasted time period. Right. I would've been better off not doing any of this. So if I'm gonna make an investment in a company, I wanna know that the risk that I'm assuming is justified by the potential upside of the business.

So when I'm looking at a stock I'm, I'm one of the metrics that I look at is the company's market capitalization. That's the that's that's roughly speaking what it would cost you to buy the entire business. Today it's not technically true, but roughly that, that that's And in general, if I find a company that's very high quality, that's growing quickly, that I think can continue growing for a long time.

The best case scenario for me is that company is small, really small. In fact, the smaller, the smaller it is, the better, because let's say I find a very high-quality company that's trading for a billion, roughly a billion dollars. It doesn't take a huge leap of imagination to imagine that a company that's growing quickly, that's high quality, can go from 1 billion to 10 billion.

Ten billion is big in absolute terms, but that's not a massive business. And if I buy that company at a 1 billion valuation and it goes to 10 billion, I've earned roughly a 10 X return on my capital, which is fantastic. Suppose that same company enters my radar when it's at a 10 billion valuation. Well, for me to earn a 10 X return, it has to become a 100 billion company.

There are not many companies out there that are gonna grow to a hundred billion. Conversely, if you look at Apple's stock today, Apple is a $3 trillion company trillion with a T. So, for Apple's stock to deliver 10 X returns to investors, it would have to become a $3 trillion company. I know that's not technically true when you factor in buybacks and dividends and stuff, but essentially, Apple is already so big.

If this becomes a 6 billion company, if it doubles, that would be. The massive, massive increase in this company's size. I mean, what's, what's the GDP of America? Is it like 30 billion, 30 trillion? Something like that, something like that. I think. Yeah. So Apple is, is a gargantuan company. And this is the thing that bothered me about a company like Rivian; for example, Rivian, a lot of people thought was going to be the next Tesla.

And I was shaking my head because when they came public, their market capitalization was. A hundred billion or something like that. And you had to believe that this company was gonna be worth like 500 billion just to earn a five X return on the on, on the investment. So if I was gonna invest in a super-risky, super speculative company, direct Rivian, I would wanna be sure that the upside potential was 50 X minimum.

Right. And I have a hard time seeing 50 X returns from where Riv. Market cap was when, when it came public. So that's just broadly speaking, something I'm trying to do when I'm saying how risky this company is and whether it is worth betting on. I wanna know what is the potential upside, the realistic potential upside if I'm right.

And conversely, what is the potential downside if I'm, if I'm wrong? So, that absolutely factors in, and all things are created equal. If you gave me two companies that were growing the same, the same high quality, I would pick the one that's smaller, that, that I just, because I believe that would have more hop side potential.

[00:37:30] **Andrew:** That that's a very interesting point. Are there exceptions to that rule? Is there a case where a company that's bigger actually? Greater growth potential than a smaller market cap company. And how would you identify that?

[00:37:44] **Brian:** That's a really tricky, tricky thing. Yeah. If you invest, you know that there are exceptions to every rule period.

I mean, I personally sold all of my Apple stock when it was a 600 billion company, cuz I thought so huge. It's 600 billion. How can it get bigger? And it's five X ed from, from when I thought it was too big to, to, to multiply. I mean, it wasn't all that long ago that trillion-dollar companies did not exist.

And now there's several of them that, that, that are out there. So it really depends on just the the the size of the business and the size of the opportunity that you really have to, to, to, to keep in, keep in mind, Apple is still growing, which is just mind-boggling. Amazon is still growing, which is just mind-boggling, even at the scale that these companies are operating at.

But again, that gets back to the research of the company and understanding how big the market potential is for this company's products and services and potential Mar products and services in the future. That's, that's, that's one thing that's I think surprises, a lot of people is a lot of value gets created when a company launches a brand new product or brand new service that nobody saw coming, and that opens up new opportunities for them, the textbook example of that is, is.

Amazon has opened up so many new businesses for itself, the most profitable which is Amazon web services. When I bought Amazon for the first time, Amazon web services were like a blip on their radar. It was like a tiny little, little thing. And now, now it's the lion's share of profits. Mm-hmm

[00:39:22] **Dave:** Yeah. Look at the iPhone for Apple, though. The same, same kind of idea.

[00:39:26] **Brian:** Very much. Yeah. And not only the iPhone, but how about the iPad? A brand new business that spawned after I bought it and many, many years ago, and just was a huge money maker for, for the business. Apple's very good about taking things that work and then creating brand new products and then creating billions of dollars in revenue from those products.

[00:39:45] **Andrew:** Well, that's, what's fun about investing too, is that. You know, you're you talked about surprises may be on the downside of, of selling Apple too soon, but also on the upside of like buying Tesla and just, let's just see what the company can do. And a company can surprise you by overcoming crazy odds.

Or they could do it by creating a brand new product, a brand new business model. And guess what, as an investor, all you had to do is just sit there and wait. That's pretty; that's a pretty cool part of investing.

[00:40:13] **Brian:** Very, very much investing. You are judging other people's actions and determining, do I wanna sit with this company or not.

The other thing that's worth noting is it's not a binary decision. Either. Like when I first bought Tesla, it was an extremely speculative company, and I just devoted a teeny tiny bit of my capital to it. Over time I saw the company execute, and its stock price was, was going up, and I added to my position on the way up because of the business.

It was creating a track record for itself, but more importantly to me, it was getting less risky over time as revenue was growing as its brand value was growing as its business was becoming more diversified, and Tesla, the business today, the business is way less risky than it was ten years ago. When when I bought it, the stocks were a different story, but the business itself, I, I, I think at this point, is fairly low risk.

[00:41:11] **Andrew:** They're debt free for one, they have operating margins that are like, what, 2, 3, 4 X, the traditional automakers. It truly is generational. I mean, I'm a little bit of a fanboy of Elon at this point. So take that, take this with a grain of salt, but I mean, I kind of look at him like you would look at a Nicola Tesla or a Thomas Edison, you know, it's, it's just been.

Crazy to see what they've done. And I can envision myself being the grouchy value investor who never pulls the trigger, and it becomes my Costco. Do you know what I mean?

[00:41:49] **Brian:** And to be fair, Tesla is probably the hardest company in the world to value.

[00:41:57] **Andrew:** It's a good point.

[00:41:58] **Dave:** Yeah. Very good point.

[00:42:00] **Andrew:** Well, Brian, this has been a ton of fun again, as always.

We really appreciate you coming on and joining us and being so generous with your ideas and lessons. So, where can people learn more about you and get more of The ideas and lessons that you have on your YouTube channel, right?

[00:42:16] **Brian:** Yeah, there's a couple of places you can, you can find me. I'm generally the most active on Twitter.

I tweet a couple of times a day. I also have a YouTube channel. If, if you're interested in valuation or digging into the details, or learning how, what, and what I think is a quality business. We have lots of videos on my YouTube channel that talk about the nitty gritty details of investing.

[00:42:36] **Andrew:** What's your, what's your Twitter handle for people listening

[00:42:38] **Brian:** On both my YouTube channel and my Twitter handle are Brian Feroldi

So it's B R I A N F E R O L D I.

[00:42:46] **Dave:** Awesome. Awesome. Well, again, Brian, thank you very much for your time. We appreciate you taking the time outta your day to come to talk to us. This was awesome. And I know I was taking notes even though I was participating. So it was some very interesting stuff and we, we appreciate you.

You are sharing all this with us. So everyone out there, go out, invest with the margin of safety emphasis on the safety. Have a great week, and we'll talk to y'all next week.

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