IFB241: How to Get Started Valuing Companies

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Dave

0:00

All right, folks, welcome to Investing for Beginners podcast today we have episode 241. Today, Andrew and I are going to answer to great listener questions. And we're going to have a little segue from that and talk about some valuation stuff. So don't worry, we're not going to go too deep into the weeds.

But we just wanted to give you kind of an overview of how you can think about valuing companies now and going forward. So let's go ahead and take a look at the first question. So this is from Twitter. It's from Kevin handlers at Dan flashes FF, is it better to pick one index, s&p 500 versus total US market and put 100% of my investable dollars into it to maximize compounding or hold both funds equally, ie $250 a month into one or 125? month into each both? So Andrew, what are your thoughts on Kevin's Great question?

Andrew

0:49

Let's maybe define it first. For people who are more on the beginner level. An index fund is simply a group of stocks. So if you're talking about the market, or the s&p 500, those are the 500 businesses, some of the biggest businesses in the world. So that's the s&p 500. There's two probably the two most popular index funds, which hold these huge baskets of big businesses is the s&p 500. And the other one is the total market funds, which I think Vanguard has that. And actually it's one that's actually more popular than the s&p 501. Believe it or not, but interesting. The other one that Kevin talked about here is the total US market. So it's like what's the difference between the total US market and the s&p 500, the total US market covers any publicly traded business in the United States is headquartered in the United States. So I don't have the exact number, I think it's probably somewhere 2000 3000 stocks. Now it's probably more than that it's probably four or 5000. So you're talking about a lot more stocks than s&p is just 500.

And the s&p 500. By the way, it has some stocks that are not headquartered in the United States, I think big ones would be like a censure comes to mind, there are some big businesses in the s&p 500 that are not headquartered in the United States. But as of now, most of those are in the United States. So his question is, do I want to put all of it all of my money into the s&p? Do I want to put all of it into the total US market? There's not going to be a right or wrong answer to this. Because it all depends, it all depends when you buy it, or when you sell it. So sometimes, the s&p 500 is the best investment there is.

Sometimes it's too expensive. And if you buy it when it's too expensive, you fast forward five or 10 years, and you're not going to do as well. So understand that one of the things about investing in the stock market that can be frustrating, is the timing can make a big difference. You could buy the best business in the world. But if you buy at the wrong time when it's too expensive, you won't do as well. So that's kind of my first thought about s&p 500 versus US market. What is your kind of initial take on it?

Dave

3:17

Well, I think it's an interesting idea. And I guess, to throw a little bit extra information at everybody. The s&p 500 Obviously covers 500 companies, the total US market covers more, it also focuses more on smaller cap and mid cap companies, whereas the s&p 500 is like the largest of the large and kind of works down from there.

So there's one idea I was just looking this up a little bit ago and John Bogle stated that the s&p 500 has earned 10.4% Since 1928, whereas the US total market has earned 10.2% over that same time period. So they're roughly the same. And so if you look at historically, the returns, I think they're probably going to they're either going to even out a little bit. And some reason for that is that a lot of the companies in the s&p 500 are also going to be in the total US market.

So you're going to get some overlap, you're definitely going to have an apple and both, you're definitely going to have Microsoft and both your Google's definitely going to be in both, but there is that I think a lot of it comes down to what kind of market exposure you want to have. And I guess it also would come down to for me it would come down to how much do I want to pay attention? What is my ultimate goal with this?

And I guess if I was trying to be more diversified, I guess I would probably look maybe outside of the US as a possibility or into something else that may be more fixed income related ie bonds. So not necessarily looking at just stocks but maybe looking at some other things. Outside of that, ie bonds now talking about crypto, but just look at more fixed income assets as an alternative investment. You also maybe could look at different sectors too, because the s&p 500 is not going to contain every sector. To a large degree, I think we're just talking to Brad Thomas was one REIT, I believe in the s&p 500. Is that correct? Or am I wrong on that? Okay,

Andrew

5:24

all right. All right.

Dave

5:25

So scratch that. But for me, if I was looking at this, I guess I would probably pick one or the other, and then maybe look at something else to diversify. If that's really what I'm looking to do, you could argue that you are getting diversified if you have smaller and more mid cap stocks in there, too. So there is that idea as well, I don't think you're gonna go wrong. By doing it. Either way that Kevin is asking about, I think, really, it comes down to what your risk tolerance is, how long you're going to invest, like Andrew said, when you get invested.

And having a long time horizon, I think that's something that is not discussed enough, is that that's one advantage that we have is having a long term horizon to kind of play out the smooths, and the ups and downs of the market. And that can give us a bit of an advantage. So something to think about.

So I don't think that Kevin can definitely go wrong. Either way. I guess if it was me, I would probably do the s&p and maybe something else outside of the US stock market, whether it was bonds, or whether it was something outside the United States. That would be my thought, but it would probably be largely if I did something like that, depending on my age level, it will largely be the s&p 500 and then much smaller percentages elsewhere. Otherwise, so what are your thoughts on my thoughts?

Andrew

6:42

I'll just say if just even broaching that subject starts to make your head spin, just to make it super simple, okay. Either you believe that you'd rather be in like the biggest businesses, or you want to be in all of the businesses. So if you believe you want to be in just the biggest businesses, which is a very great way to go. And it's a very vanilla. Very, even Warren Buffett says just buy the s&p 500, then you can buy the s&p 500 index, the ticker symbol that I like to tell is sp y, just put a spy into your broker, you can buy it, continue to buy it time and time again.

And over the long term, you'll be wealthy. Okay? The other option if you want to be more diversified, and you feel like I want all of the businesses instead of just the biggest businesses. That's cool, too. You can do a fund called Vanguard Total Stock market index fund. And from my understanding, I've never purchased it, but from my understanding, it's VTS a x. And so that will give you exposure, like Dave was saying, not only in the United States, but internationally and a very small businesses too.

Dave

7:49

Yeah, those are great resources. And I think it's a great question. And I don't think he can go wrong either way, whichever one he decides to do. All right. So let's move on to the next question. Hi, Andrew, and Dave, I love using the VTi. And the little package evaluation.

As a segue, one of the past II winner picks was a REIT using the other two resources that helped me make smart decisions with stocks. So my question is, can a little package of valuation be used to value REITs? And can the VTi be used to avoid value traps and REITs? If not, what are some resources I could use to do this? Thanks, Nate. Alright, so Andrew, what is your thoughts on Nate's? Great question?

Andrew

8:27

Do you want to give like a basic overview of what the little package evaluation is, we probably don't discuss what it is enough, because it's not necessarily for beginners. But people have found that useful.

Dave

8:37

Yeah, for sure. So the little package of valuation is kind of what it sounds like. It's a combination of different tools that you can use to help you value companies. And we'll discuss this a little bit more in depth here in a few minutes. But the basic overview is it gives you some resources that you can use to value pretty much any company that's out there, whether it's a REIT, or whether it's apple, or whether it's a bank, there's all kinds of different tools that you can use to cover all those different companies and find a good price to buy. That's really what it comes down to.

Andrew

9:10

And that's awesome. And then when he mentions the VTi, that's the value trap indicator. It's a package I made a while ago. And among other things, you also can use it to evaluate a business. If the numbers are telling you that the business is financials are deteriorating, then the VTi will tell you stay away from this stock.

So it's another kind of tool to have under the belt to help you navigate a lot of different companies. So if the low package evaluations like a sniper rifle, the VTi is like a scatter shot shotgun, where you can filter through lots of companies really quickly, can it be used for companies like REITs? Yes, again, that answers that question.

There's a version seven and the version six of the VTi which you get if you purchase it. version seven, you can use for a revision six you can Okay, perfect. Awesome. Yeah, and And for the little package, the little package you can definitely use to value REITs. Absolutely, there's

Dave

10:04

lots of great tools that you can use to value, like I said earlier, just about any company that you're interested in valuing. So I think that's probably a good segue for us to maybe talk a little bit about, not necessarily just what's in the little package evaluation, but maybe how we approach looking at companies that we want to buy, what are some of the tools that we can help not only sort through those companies, but also try to determine what is a good price to pay for our company?

That's important. It's not the most important thing, but it's definitely probably in the top two or three. So I think, you know, like Buffett likes to say, you know, don't lose money. Don't forget rule number one, you know, so I guess what are your thoughts on something like valuation?

How do you approach valuing a company? What are some of the steps? Let's say, let's just throw out a company. Let's say that you are going to value Mehta, how would you value Mehta? You don't need to give us like the hoary beaten the gory details of our numbers. But just like, how would you look at valuing a company like that?

Andrew

11:02

I think when investors hear evaluation, they think of some of the shortcut tools, things like price to earnings, or the P E ratio, that's a really good thing to learn, because it gives you a shortcut to valuation, but it does not give you actual valuation. So Warren Buffett to go back to him probably the greatest investor of all time, I think we should pay attention to him a little bit. He talks about how you want to take future cash flows of a business, how much do you expect this business to make a cash flow? And then you discount that to the present?

What that means is, how uncertain are those cash flows? And then how much in the future are they because $1 today is worth more than $1, in 10 years, if you wanted evidence of that, you could just look at inflation numbers over the past several months, the dollar today will not buy as much as it did like 10 years ago. So basically, future cash flow that's more closer in the future is more valuable. The longer it goes, the less valuable $1 is. So that's why it's discounted.

That's what that means. So you combine the future cash flows and the discounted part, and you get what's called a discounted cash flow. And that's how Buffett has said he uses it, he's referenced a guy named John burr Williams, who wrote about it in 1928. And if you go back way, in our archives, when Dave, very eloquently described the dividend discount model, that is a discounted cash flow model as well.

So you can use a dividend discount model you can use, you know, we have multiple models within the level package, Dave, and I even use different models. But at the end of the day, they're both cash flow models that are discounted. And that's how you determine the value.

Dave

12:51

Yeah,that's exactly right. And I think the understanding the difference between the metrics that you hear a lot of people talk about, and the more than not advanced, but I just, I guess a little bit more in depth analysis of companies, whether you are looking at using DCF, or discounted cash flow models, or whether you're looking at using dividend discount models, or any kind of model, you're really looking at, like Andrew said, you're valuing the future, cash flows to the present.

And you're trying to determine what is that worth to me now, because if I buy it, now, it's going to be worth something in the future, I want to kind of try to figure that out. And I want to do better than that. And so these models will help you do that, when you're looking at a price to earnings ratio, or price to sales, which was really popular about a year ago or so before everything kind of turned when you look at those give you they're called relative valuation models, or their relative metrics. And the reason for that is because you use them to compare the price to earnings of Company A to Company B, or company A, B, C, and D

. And that's how you judge whether the company is expensive or not. And I guess the backup just a second, when we when we're talking about expensive versus cheap, we're not talking about $1 is cheaper than $2. We're talking about the value of what you think you're buying versus the value of something else. And the value of the newest iPhone, you could argue is more valuable now than it was three years ago. And so you wouldn't pay the same price for a three year old iPhone that you would today, but you might pay less for the iPhone three years ago, and the hopes of upgrading and selling it for a profit and using some of those profits to buy the new iPhone, whatever the latest version of that is.

So if you kind of put it in that perspective, it helps you understand the difference between cheap and expensive. It's not the actual dollar amount. It's the value of what it is that you're buying and the way you think about valuing companies. When you think about using a ratio like a price to earnings or price to sales, those are metrics, I will use them, but I don't use them to value companies, I use them to help me screen for companies, because like Andrew said, they're shortcuts. And so it's if you look at the price to earnings of a company, let's say that the price to earnings of a company is 50. And the other one that you're looking at is 20. It doesn't matter how you slice and dice, a model, an Excel spreadsheet or anything, it doesn't matter how you slice and dice it, the one with the higher price to earnings is going to come out more expensive. And you may think to yourself,

Okay, what's the big deal? I mean, so what is if you buy Microsoft in 2000, at the height of the.com, bubble, and then you held on to that for the next 13 years, you would have not made a single penny on that investment, that's a big deal. If you're 19, and you wait till you're 32, to make money on an investment, you got a lot of staying power, you got incredible patients and you know, more power to you. Because your way, you're better than me, I just I will admit it, you're better than me. And I couldn't do that. And so that's where the price you pay Matters has an impact.

If you think about 13 years of your life, that you're going to wait for something to improve that you're going to make a profit on the investment you bought, that puts it in terms that you maybe people can relate to and understand that it has an impact. And so when you pay a price for things now, you hear people all the time talk about the market, yeah, I'm gonna pay up for quality.

That's where the all this gets really complicated and can get really tricky is, there are times where you can do that, and you can do really well. And there's a lot of times where you can make get lucky and buy things I know that's happened to me, and it's happened to millions of investors. But when you're thinking about valuing companies, you have to think about the price you pay matters. And so using price to earnings price to book price to sales price to free cash flow, Evie to EBIT, da all these different acronyms and metrics you can throw out there, they, they're helpful, and they can help you find companies that are good to further investigate.

But if you really want to value a company, you have to kind of dig into the numbers. And you have to really kind of understand what the business is doing and where you think and where they think they're gonna go in the future. And nobody has a crystal ball, none of us can predict where a company is going to go. But that's really kind of where the rubber meets the road when you're trying to make investments. And I will say this, this is one of the things that Andrew has, has done really religiously.

And this is one of the things that kind of really separates him from other investors is that he's very diligent about you know, doing a lot of work to try to determine what the values of these companies are. And I'm not saying this to blow up his ego or make him feel better. It's, it's a truth. And you when you are valuing companies like this, you have to do work, you have to understand the business model and where you think that company is gonna go. Because that's the only way that you can truly find the value of a company.

You think about Warren Buffett and you think about Charlie Munger and some of these great investors, they are buying and trading things on a daily basis. In a lot of cases, they're sitting and thinking about these companies that they buy, for years, if not decades, before they actually pull the trigger on an investment. And to say that they have the knowledge of American Express is kind of an understatement.

And so I think that's the thing you have to think about when you're trying to work through valuing companies and whatnot. But to kind of go back to the little package evaluation, in the little package evaluation, there's a lot of different tools that you can use. So Andrew was mentioning that he and I kind of use different models. And we kind of do. But there's also when you value companies you can't do it's not one size fits all, you have to think about a bank. And the business model that the bank operates in has requires you to use a different model, because those cash flows that Andrew was discussing earlier, are completely different from a bank than they are from Apple.

And so you can't use the same kinds of models. And that's where having a bunch of different tools at your disposal can be very, very helpful. Because we're not all just buying Apple and Microsoft and Google although you could argue that's probably not a bad way to go.

But you know, kind of segwaying off of that talking about REITs REITs are a different kind of animal, they speak a different language, you have to understand the businesses. Same thing with banks. Same thing with FinTech, same thing with, you know, other types of businesses out there. You know, the oil industry, for example, is a completely different beast. And so having those different tools can be very, very helpful to value those companies. Okay. I've talked a lot. Andrew needs to talk now.

Andrew

19:36

It's good, like you said, lots of different tools for lots of different applications. But at the end of the day, there's basically the excess returns model and the DCF model. So the DCF model that we're talking about the discounted cash flow that's going to work for probably 80% of businesses, you have to make adjustments, like you'd mentioned the oil, the energy, it's very cyclical, so you have to account for that, because their cash flows are so volatile.

So there's other ways to make adjustments to that. But by and large, I think if unless you're looking at a financial like a bank, or a real estate investment trust that is buying and selling and renting real estate, those two would be like excess returns. Take Matt, as an example. You mentioned them earlier. If we were to do a baseline DCF on them,

I guess how would you start, like trying to explain it to somebody who's never even seen a DCF? Before? Right, like, what's the two, three steps that you would go through? And then what's the ending result?

Dave

20:38

All right? Well, I think the first thing that I would want to do is, I think the easiest way to start to look at these kinds of ideas is to understand overall, which model might fit better for which company. So the first thing that I would do is I would look at the income statement, and based on how the company generates revenue, will tell me how I need to value the company. So for example, Mehta is more of a air quote, traditional business, where they generate revenues, they have cost of goods sold, they have, they have operating costs, and all that gobbly gook in the income statement leads to the bottom line, which is the net income, which flows to the free cash flow or the cash flow statement of the business. So I can determine fairly quickly that using a DCF, for accompanying like meta would make perfect sense.

So that's, I guess the first thing I would do from there, it really kind of depends on you would want to look at, generally, my buddy professor, the Modren always talks about, there's basically three inputs you want to look at, there's three things that are going to drive the value of a business, the first is a revenue. So you want to determine how quickly Mehta is going to grow. And we could talk about that, you also want to look at the costs that the business generates.

And where are those going to go, those you would find in the margins. So something like a gross margin and operating margin and net income margin, those will tell you how the business how profitable the businesses, because profits lead to free cash flow. And then the last thing you would want to look at is reinvestment. Every company has to reinvest to grow. Even companies as awesome as Apple, they still reinvest, they spend a lot of money in r&d. And that's a reinvestment for them.

And so you have to determine what kind of level a company has to reinvest to continue to grow. So those are kind of the three inputs that you look at, for kind of every business. But how that impacts the model that you're looking at, I guess would be where you would kind of go from there. So I guess, what are your thoughts on this?

Andrew

22:48

Yeah, if I had to break it down into like a big three concepts, First, figure out the model, that's perfect. Like, if it looks like a lot of the other businesses, once you do this enough, you see them and they look similar. They don't, that's a great first step. And then, for me, it's really like you said, its growth. And then it's the actual free cash flow number itself, which is where the margins come in.

And then the third thing I would look at would be like the discount rate. So as an example, I've purchased VSA and I've purchased Microsoft, at much higher P E price to earnings ratios than a lot of the other companies in my portfolio. And the reason behind that is because their discount rates a lot lower, because their cash flows are a lot more slow and steady, not slow. They're a lot more steady and a lot more predictable. Microsoft has so much recurring revenue, that they're able to say, You know what, we think we're going to make $60 billion next year, and then they do like, they're always hitting guidance. So that's where that third piece of discount rate comes in. How uncertain are those cash flows?

How much do they fluctuate, so the growth is probably the number one because you have to differentiate between a company that grows like Microsoft or visa and a company that grows like somebody like targets and much slower grower, so that affects the final price of what the company is worth. And then you have to go through all the steps, all the fun steps of figuring out what the free cash flow is, and that's beyond the extent of this podcast. And but then the third part is the discount rate.

And the interest rates play into that and how steady or how wildly swinging the free cash flow is. And then it spits out a number and then you say, okay, Microsoft is worth $286 A share as an example. So, using that model by Microsoft, I like to add is a pretty good bike because I got a margin of safety because I think it's worth 286 a share. But if Microsoft's a 315. That's a bad time to buy Microsoft because I estimated its value at 286. Prices. 316 That's overpaying for the SOC. So that's kind of what it boils down to what makes it true Key is, those numbers will change every quarter, even every day, because you have interest rates moving every day. So that changes the discount rate.

So that's why we say it's, it's like the price you pay is can be so important, because it's always moving. And that's why sometimes buying the s&p is good. Sometimes buying an individual company is good. Sometimes buying targets good. And sometimes buying targets bad. It all depends on like, what else is out there. and at what price everything is, the price

Dave

25:32

really drives everything. A great investment is a company that you buy, that grows in price from where you bought it over a long period of time. And as that value grows, the price, in theory should in tandem, work with that and grow from there. And that's how we, you know, have great investments. And that's how you can do well in the stock market. But understanding the mechanics of the different models and the valuations and everything, it all comes back to understanding the business and understanding where you think the company is going to go.

And there's lots of ways to do that. But it all comes down to reading, and listening and thinking, everybody out there that's listening to us, they're smart people. And these are all things that you can do. And for those of you that are newer to the show, and are listening to some of this and may think to yourselves, there is no way, there is a way it can be done, I am living proof of it, you know, I'm 55. Now, I didn't start doing this until later in life, you know, old dogs can learn new tricks, apparently. And so this is all stuff that you can do. It's just a matter of being systematic about it, having an understanding of what it is you're trying to do.

And then just trying to be methodical about it. I know you guys love my phrase, water dripping on a stone eventually makes an impression, but it does. And the more that you do this, the easier it becomes Warren Buffett likes to talk about how he doesn't do air quotes, do DCS, he doesn't mean his head, he's got a computer. And he can do these in his head. And I can't do them in my head. But I can tell you after doing hundreds and 1000s of these, after a while, you can start to see before you even hit the enter button on your Excel spreadsheet, you kind of know where it's going to turn out. Because you start to get a sense for what the numbers are telling you and the story that they're telling you, you'll start to pick up on those things. And the other thing that's great about this, there's two other things I guess I want to throw out there. Number one, when Andrew was talking about the price, the 286 versus the 280 versus a 315.

Try not to get bogged down in the minutiae of figuring out the exact number and only buying if it's the exact number Buffett monies per Bry Peter Lynch, you know, add name into infinity, all talk about having a range, and having an idea of around as a price. If you buy Microsoft at 282 versus 286.

Over the next 1520 years, it's not going to make a difference if you buy it at 330 versus 250. Yeah, that could impact it. But I think don't get bogged down in the minutia. So that's number one, please don't get bogged down in the minutia, like I got to find a perfect price, it doesn't exist, try to find a relative or range of prices, you know that you're comfortable investing in the company. Number two is you can do this, there's absolutely no reason why you can't do this. If you spend some time looking at the models, looking at numbers, reading about the companies, there are 1000 great resources out there. Ours is a great resource investing for beginners.com search bar, I've talked about this for many months.

And I'll continue to pound on that table. There's lots of great resources there that Andrew and I spent a lot of time working on to create to help you guys learn all this information. We have the little package evaluation that can help you learn all this stuff. Professor De Modren has a free website, that you can go and look at more mountains of data that you can possibly want. I know because I try.

And there's lots of great resources on there. And I'm gonna be honest with you, when I first started listening to him, six years ago, I had no idea what he was talking about. I didn't, but because I kept at it, and kept doing it, it eventually started to you know, get into this thick skull and I started to get some of what he's saying. And even now, I will go back and rewatch his videos to give me a better sense of what it is.

And I pick something new up that I may have forgotten or slipped or whatever. And you know, he's been teaching valuation for 30 plus 40 years. He's a smart cookie. And he's a very, very, very good teacher. And like I said, the videos are free on YouTube. You can go to his website and get them that way as well. So there's lots of great resources out there to help you do this. And if this is something that's important to you, it's important to learn this stuff. And it's not talked about a lot because a lot of people you know, poopoo it, but it is it is important and the best investors out there.

That's the way they do it. So that's good enough for Warren Buffett's good enough for me. So with that, I will go ahead and wrap up our conversation for today. I want to thank everybody for sending us those great questions. We really enjoyed answering those. They're great, keep them coming. And again, if you are looking to learn more about all the things that we talked about, and if you're overwhelmed, please go to investing for beginners.com type in P E ratio, type in relative valuation type in DCF models, or just type in income statement. And you can learn all about those things.

As you listen to the show, and it'll help you get better one step at a time every day. If you grind 1% better every day, you're gonna be shocked how much better you're gonna get. So, without any further ado, I'll go ahead and sign us off you guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week. We'll talk to y'all next week.